<table>
<thead>
<tr>
<th>Deregulatory Review of Private Pensions</th>
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Executive summary

Introduction

1. Since coming to power, the Government has committed to delivering greater security in retirement. The first priority was tackling the crisis of pensioner poverty. We have also taken steps to ensure confidence and security for members of occupational pension schemes, including establishing the Pension Protection Fund and the Pensions Regulator.

2. In addition, we have sought to tackle the long term issues faced by the pensions system due to an ageing society. In the White Paper Security in Retirement: towards a new pensions system, the Government outlined an integrated package of reforms to address the long-term challenges faced by the pensions system.

3. The Government is also committed to encouraging good private pensions, and ensuring that employers have confidence in the regulatory environment. These schemes could be defined benefit (DB), defined contribution (DC), whether occupational or personal, or hybrid schemes – the vital point is that they provide members with an adequate retirement income.

4. We commissioned a deregulatory review to look at how the private pensions regulatory framework can be made simpler and less burdensome, thereby encouraging employers to continue to provide good pensions.

5. The Government thinks it should be possible for employees and employers to decide jointly how to share the risks. However, the issues relating to risk sharing are complex and could have far reaching consequences for schemes and their members. This consultation looks at a range of ways in which risks could be shared in pension schemes and considers the issues associated with different approaches.

The decline in defined benefit provision

6. In the UK, pension provision in the private sector has historically been dominated by DB provision, with nearly 8 million people contributing to DB pensions at their peak in the late 1960s. However since the 1970s, there has been a trend of private sector employers closing DB schemes and switching to DC schemes.

7. There are several reasons for this trend. Traditionally most DB pension schemes in this country have been heavily invested in equities and the performance of the scheme has therefore been dependent on the performance of financial markets. This reliance on the performance of the market left DB schemes ill-prepared for the financial market downturn from 2000 to 2003. Increases in life-expectancy, the decrease in inflation during the 1980s and 1990s, increased member

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protection and changes in accounting standards all had an impact on the cost of DB provision.

8. Between 1979 and 2006 the number of active members of DB schemes fell from just under 6 million to 3.4 million. The closure of private sector DB schemes has been accompanied by increased participation in DC schemes from the late 1990s onwards. Only 1 per cent of private sector employees contributed to workplace personal pensions in 1997, but by 2007 this had risen to over 13 per cent.

**An overview of risk in pension provision**

9. A pension pays income at some future date. Before this income is paid, unknown future events can affect its value. This means that uncertainty is inherent in a pension. The main risks involved in providing pensions are investment risk and longevity risk, though there are also a number of others, including inflation risk and default risk.

10. A main difference between DB and DC schemes is how these risks are distributed. A DB scheme places the majority of the risk on the employer, whilst a DC scheme places the majority of the risk on the scheme member.

11. The decline in DB provision can usefully be seen as the result of some of the inherent risks to the sponsoring employer being realised. On the basis that these risks remain to some extent, it is useful to examine how the risks associated with pension provision could be more effectively distributed.

**International experience**

12. A number of other countries have adopted risk sharing approaches to occupational pension provision. It is useful to consider the different measures adopted in order to understand better the impact that such practices might have in the UK, but cultural differences mean that it is hard to reach definitive conclusions on the basis of experiences in other countries.

13. Like the UK, the Netherlands had a tradition of final salary DB schemes, but has seen an almost wholesale shift to conditional indexation schemes in the last decade, with a small minority of schemes run on a collective DC basis.

14. There are also risk sharing arrangements in place in Denmark, Switzerland, Ireland and the USA.

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2. Primarily those of increasing life expectancy and those related to investment.

3. Dutch conditional indexation schemes are run on an average salary basis, with indexation awarded each year depending upon the financial health of the scheme.

4. These are run similarly to conditional indexation schemes, but contributions are fixed, meaning that neither nominal nor indexation benefits are guaranteed.
Risk Sharing Consultation

Risk sharing within the current legislative framework

15. Whilst many employers have chosen to move to a pure DC model, other employers wish to continue to provide a DB scheme but are considering ways to make it more affordable and/or share risks differently. These employers may see advantages in providing a DB scheme as a part of the remuneration package for recruitment and retention purposes or because they take a paternalistic view towards pension provision.

16. Two main strategies have been adopted by employers, set out in the next two paragraphs.

Focus on managing cost

17. Employers can reduce the cost of their DB provision in a variety of ways. These typically lead to a reduction in members’ benefits and often mean that the employer retains all the risks associated with DB provision. Employers might for example:

- reduce the accrual rate for each year of future service; or
- provide benefits on a career average basis rather than final salary basis.

Sharing risk

18. Employers have also considered how they can continue to provide a DB scheme by sharing the risks involved with their employees – and there are a number of options available:

- increasing the scheme’s normal pension age for future accruals in line with life expectancy, mitigating the risk of having to pay the pension for longer;
- provision of hybrid schemes, where some benefits accrue on a DB basis whilst others accrue on a DC basis; or
- introduction of cash balance schemes, in which an individual’s fund grows by a set amount each year, meaning that scheme members do not bear all the risk of being within a pure DC arrangement but also do not reap the benefits high investment returns.

Alternative approaches to risk sharing

Conditional indexation approaches

19. Risk sharing could be introduced into DB schemes by allowing employers to operate conditional indexation. Conditional indexation schemes could be implemented in a number of different ways and this consultation sets out two possible approaches. Either would require significant changes to both primary and secondary legislation.
20. The first approach would allow conditional indexation to be applied to career average schemes. The key elements of this approach are:

- benefits would be calculated on an average salary basis;
- revaluation of salaries and indexation of pensions in payment would depend upon the financial health of the scheme;
- normal pension age within the scheme would be variable (within certain parameters) to take account of changes in life expectancy;
- when such a scheme has recovered after a period of underfunding, the reinstatement of revaluation and indexation rights would take priority.

21. The second approach would allow all DB schemes, including final salary schemes, to introduce conditional indexation arrangements, in a similar way to that set out above. It does not include any provisions for changes to normal pension age.

22. The key issues associated with both conditional indexation approaches are:

- moral hazard in relation to employer behaviour;
- administrative costs;
- complexity for members in understanding their entitlements;
- fairness of outcomes for members; and
- whether there is sufficient demand for these schemes from scheme sponsors.

Collective defined contribution approaches

23. The key elements of this approach are:

- it gives the employer complete certainty over costs, as the contribution rate is fixed;
- based on this contribution, benefits are calculated as in a DB scheme;
- if the scheme is underfunded, revaluation and indexation can be withheld;
- furthermore, if funding levels drop too low to allow payment of basic benefits, the scheme can either increase normal pension age or reduce basic benefits; and
- risks are shared between scheme members – unlike in pure DC arrangements, there are no individual accounts.

24. The key issues associated with this approach are:

- whether there is sufficient demand for these schemes from scheme sponsors;
- communications with members due to a more complex benefit structure; and
- lack of fit with the current regulatory framework.

Consultation Arrangements

25. Chapter 8 provides full details on the arrangements around this consultation. If you would like to respond to some or all of the consultation questions, please
reply by letter or email. The deadline for responses is 28 August 2008. Please send your responses to:

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Chapter 1: Introduction

1.1 Since coming to power, the Government has committed to delivering greater security in retirement. The first priority was tackling the crisis of pensioner poverty. There remains more to do, but we have made important progress. Thanks to measures like Pension Credit, Winter Fuel Payments, free TV Licences and above-inflation increases in the basic State Pension, by 2005/06 pensioners were less likely to be poor than the population as a whole.

1.2 We have also taken steps to ensure confidence and security for members of occupational pension schemes. In the Pensions Act 2004, the Government established the Pension Protection Fund (PPF) to protect people when the sponsoring employer of their defined benefit (DB) occupational pension scheme experiences an insolvency event. To ensure that there is a strong and clear protection regime for people with occupational pensions we set up a more powerful Pensions Regulator.

1.3 We also set up the Financial Assistance Scheme (FAS) to help those people who lost their pension before the PPF existed. In December 2007 we announced a new FAS package to deliver 90 per cent assistance to members of eligible schemes. We are going beyond our commitment to match the extra funding generated by the Young review of scheme assets, and, with a cost of £935 million in Net Present Value terms, we will deliver the protection people deserve.

1.4 Reducing pensioner poverty and setting up a protection regime for private sector DB schemes tackled the most pressing threats to income security in later life. Nevertheless, like other countries worldwide, we also have to address the challenges presented by an ageing society. While current pensioners are relatively well off, the evidence suggests that the outlook for tomorrow’s pensioners is less certain.

1.5 Today there are four people of working age to every one pensioner but by 2050 that ratio will have reduced to three to one. In the absence of State Pension reform it would have halved to two to one. At the same time, levels of retirement saving are in decline. Only around 14 per cent of 20 to 24 year olds are saving for a pension, compared with about half those aged over 35; and less than half of low earners (£5,000 to £25,000) are saving towards a pension, compared to over 55 per cent of all individuals in employment.

1.6 In the White Paper Security in Retirement: towards a new pensions system, the Government outlined an integrated package of reforms to address the long-

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5 Net Present Value is used to compare costs that occur in different time periods. It is a separate concept to inflation and is based on the principle of ‘time preference’, i.e. that people prefer to receive goods and services now rather than later.

6 Family Resources Survey 2005/06.

term challenges faced by the pensions system. Our pension reforms are designed to put in place a pension system which is sustainable, equitable and stable for future generations and encourages people to take personal responsibility for saving.

1.7 The first part of this reform package was implemented in the Pensions Act 2007. It ensures that there is a simpler, more generous and widely available State Pension. The current Pensions Bill builds on these changes through a set of reforms, primarily to the private pension system, that will enable and encourage more people to build up a private pension income to supplement the income received from the State.

1.8 The Bill will simplify pensions and enable individuals to take responsibility for saving for their own retirement. All eligible workers will be automatically enrolled into a qualifying workplace pension – helping to overcome barriers to saving such as inertia. Individuals will have the right to opt out. This will result in between six and nine million people saving more in workplace pensions, transforming the savings culture in the UK.

1.9 The Government is also committed to encouraging good private pensions, and ensuring that employers have confidence in the regulatory environment. These schemes could be DB, defined contribution (DC), whether occupational or personal, or hybrid schemes – the vital point is that they provide members with an adequate retirement income.

1.10 We commissioned a deregulatory review to look at how the private pensions regulatory framework can be made simpler and less burdensome, thereby encouraging employers to continue to provide good pensions. The current Pensions Bill includes measures arising from the deregulatory review of pensions. We are taking forward measures aimed at encouraging the continuation of good quality pension provision including a reduction in the cap on the mandatory level of revaluation of deferred pensions from 5 per cent to 2.5 per cent for future accruals.

1.11 Chris Lewin and Ed Sweeney, who carried out the independent deregulatory review, identified that there could be advantages for employers and employees in sharing the risk in DB schemes more evenly, and built much of their report to the Government around it.

1.12 The Government agrees with the reviewers and thinks it should be possible for employees and employers to jointly decide how to share the risks. However, the issues relating to risk sharing are complex and could have far reaching consequences for schemes and their members. The implications need to be worked through in detail to ensure that there is no significant detrimental impact on any party. This consultation looks at a range of ways in which risks could be shared in pension schemes and considers the advantages and disadvantages associated with different approaches.

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1.13 The objectives of the consultation are to explore ways in which we can encourage and support good pension provision and to gather evidence and opinions on risk sharing in occupational pensions. The five tests of pensions reform – to support personal responsibility and deliver fairness, simplicity, affordability and sustainability will serve as the guiding principles for this consultation. The overall aim of the deregulatory review has been to simplify the rules and structure for private provision and this consultation seeks to support this aim. We would also need to ensure that risk sharing is applied fairly to all members of pension schemes – whether they are active, deferred or pensioner members.

Consultation Question

1. Given that we have protected scheme members and are bringing in measures to combat undersaving, should we undertake a far-reaching deregulation of the way risks are shared in pension schemes?
Chapter 2: The decline in defined benefit provision

2.1 In the UK, pension provision in the private sector has historically been dominated by defined benefit (DB) provision, with nearly 8 million people contributing to DB pensions at their peak in the late 1960s.

2.2 However since the 1970s, there has been a trend of private sector employers closing DB schemes and switching to defined contribution (DC) schemes. This trend, which has not been mirrored in the public sector, accelerated in the early years of the current decade.

Box 2.1: Closing DB schemes

When an employer chooses to close a DB scheme, three main options are available:

**Closure to new members** – the most common measure. The scheme remains open to new accruals by existing members, but no new members are allowed to join.

**Closure to new members and new accruals** – the scheme allows neither new members nor new accruals from existing members. The rights of existing members are met by the scheme once the members reach pension age unless those rights have been transferred to another scheme.

**Winding up** – the scheme is fully closed, and the assets are used to secure members’ benefits.

2.3 The change from DB to DC provision has generally been accompanied by a reduction in contributions, particularly those made by employers.

The causes of the DB-DC shift

2.4 Traditionally most DB pension schemes in this country have been heavily invested in equities and the performance of the scheme has therefore been dependent on the performance of financial markets. During the period 1974 to 2000, the UK experienced very favourable financial market performance. During this period the average annual inflation adjusted return on UK equities was 13 per cent (long-term historic average return was 5.5 per cent)\(^9\). This created unrealistic expectations of returns from financial markets and meant that pension providers underestimated the true costs of DB provision, and delayed adjustments to pension scheme benefits.

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2.5 This reliance on the performance of the market left DB schemes ill-prepared for the financial market downturn from 2000 to 2003. The global financial market slowdown after the turn of the century had a strong and negative impact on investment returns from equities. Given that schemes were heavily invested in equities this had a major impact on the cost of DB provision and the closure of these schemes.

2.6 There are several other factors which have contributed to the increase in the cost of DB provision, most of which occurred before the turn of the century. Some of the key factors are:

- **Increases in life-expectancy**
  There have been significantly greater improvements in life expectancy than expected when DB schemes were first created. In 1950, a man aged 65 could expect on average to live to the age of 77. Today a man aged 65 can expect to live to 84\(^{10}\). For many years increases in life expectancy were not taken into account. This produced an unexpected and unfunded increase in schemes’ liabilities when new life expectancy assumptions were finally reflected in their calculations. Chapter 3 provides a detailed discussion on the risks of life expectancy in pension provision.

- **Decrease in inflation during 1980s-1990s**
  During the 1980s when inflation was high, some members’ benefits eroded very quickly because the scheme did not provide any revaluation or indexation. When compulsory indexation for preserved pensions and pensions in payment was introduced in the mid-1980s and late-1990s respectively it was limited by a 5 per cent cap. This cap serves as a risk sharing mechanism. When inflation is above the cap, the cost of provision in real terms is lower for the employer. For example, if inflation rises from 6 per cent to 10 per cent the cost of providing a pension falls in real terms due to the cap. However, when inflation falls below the cap, as it did in the late 1990s, the cost of inflation is entirely borne by the employer.

- **Increased member protection**
  Changes to pensions legislation, such as rules on scheme funding, debt on the employer and general rules on the administration of schemes, have helped to improve members’ benefits and protection.

- **Changes in accounting standards**
  In the UK, changes in accounting standards, in particular the shift from SSAP 24 to FRS 17 and IAS 19\(^{11}\), have changed the way pension scheme assets and liabilities are reported. These changes have increased the transparency of pension funding costs in company accounts and may have created a perception among some employers that the actual cost of funding pension

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\(^{11}\) FRS 17 and IAS 19 are accounting standards which set out the accounting requirements for retirement benefits. They replaced SSAP 24 ‘Accounting for pensions costs’, and has led to changes in the way scheme assets, liabilities and deficits are valued and reported in companies’ financial accounts.
risk sharing consultation - 16 -
schemes has increased. The changes brought the pension scheme deficit and the associated volatility onto the company balance sheet, raising the profile of the cost of the pension scheme.

2.7 It is important to note that most of these factors, which are related to the risks inherently associated with DB provision, are uncertain and largely beyond the control of employers. Chapter 3 provides a more detailed overview of these risks.

Future influences on employer behaviour

2.8 It is uncertain what could influence employer behaviour in the future but factors that have been raised as potential influences on decisions relating to pensions schemes are:

- **Accounting Standards:**
  The change from SSAP 24 to FRS 17 and IAS 19 may yet have wider implications on employers’ corporate activities; employers may choose to close their DB schemes to avoid these.

- **Continuing increase in life expectancy:**
  If life expectancy continues to grow faster than expected it will continue to raise the costs of DB provision for employers\(^\text{12}\).

- **Introduction of automatic enrolment of members into pension schemes**
  The introduction of auto-enrolment is likely to lead to higher participation in occupational pension schemes, increasing costs to employers. However, DB schemes already have high participation rates and benefits are likely to exceed the minimum required under the new employer duty\(^\text{13}\). Therefore the cost increase for most DB schemes is likely to be small. Employers have a range of options for coping with increased costs, including absorbing them through overheads and prices.

Recent trends in private sector pension provision

2.9 There has been a long-term trend away from DB provision since the beginning of the 1980s. The number of active members in private sector DB schemes (open and closed) fell from just fewer than 6 million in 1979 to 5.2 million in 1995, 4.6 million in 2000, and to 3.4 million in 2006.

2.10 As a result of DB scheme closures, we have also seen a decline in the number of active members who are in private sector DB schemes that are still open to new members and new accruals. The number of active members in open

\(^{12}\) The latest projections from National Statistics' Pension Trends suggest that a man aged 65 in 2050 can expect to live to the age of 87. For comparison, a man aged 65 today can expect to live to the age of 84.

\(^{13}\) Provisions in the Pensions Bill 2007 will place a responsibility on employers to automatically enrol jobholders into qualifying workplace pension arrangements.
private sector DB schemes has more than halved from just over 4 million in 2000, to around 2 million in 2004. This rapid decline shows how important the impact of the financial market downturn in the early years of this century was.

2.11 There has also been an increase in the number of DB scheme closures after the turn of the century, especially in the period between 2001 and 2003.

Figure 2.1: Number of DB schemes closures

![Bar chart showing the number of DB schemes closures from 1998 to 2006.]

Source: The Purple Book 2007, The Pensions Regulator and the Pension Protection Fund

2.12 The closure of private sector DB schemes has been accompanied by increased participation in DC schemes from the late 1990s onwards; these include both occupational DC schemes and workplace personal pensions. The growth in the latter has been particularly dramatic - Figure 2.2 shows that only 1 per cent of private sector employees contributed to workplace personal pensions in 1997, but by 2007 this had risen to over 13 per cent.
2.13 The shift from DB to DC provision has led to a focus on the question of which form of provision is better. It is important to note that in economic terms, one is not better than the other – each has different advantages and disadvantages; and each distributes risk in a different way. A fuller discussion of the issues around risks in DB and DC schemes can be found in Chapter 3.

2.14 The debate about DB and DC schemes in the UK has sometimes focused on the lower contribution rate associated with DC provision. Lower contribution rates are not an inherent feature of DC schemes, but a reflection of the fact that the cost of providing DB schemes has increased beyond employers’ expectations and some reduction in contributions is therefore not surprising. DC schemes do not require the employer to fund a benefit in the way that DB schemes do. After contributions have been made to a DC scheme, there is no further call on the employer for funds.

2.15 What is important in the comparison of DB and DC schemes is the pension outcome. Higher contributions in a DB plan do not mean that outcomes will automatically be higher than in a DC plan for a variety of reasons.

2.16 The generosity of DB and DC schemes cannot be compared simply by looking at contributions. DB pension outcomes are not affected by increased contributions, for example where they are used for deficit reduction or other exceptional changes. At any point in time DB contribution rates may be artificially inflated by deficit reduction contributions which are simply making up for low investment returns or part contribution holidays. On the other hand, DC members would be expected to benefit from comparable periods of investment out-performance, while DB members would not.
2.17 There are also several other factors which make it difficult to judge the generosity of DB and DC schemes solely on contribution rates:

- the age profiles of members will be different - DB members tend to be older and more costly; and
- DB schemes are usually contracted out while DC schemes are increasingly contracted in.

Consultation Question

2. Are you aware of any additional evidence of the impact on pension outcomes of lower contributions into DC schemes when all these complicating factors are taken into account?
Chapter 3: An overview of risk in pension provision

3.1 A pension pays income at some future date. Before this income is paid, unknown future events can affect its value. This means that uncertainty is inherent in a pension. Indeed, compensating employees through pensions exposes both employers and employees to risks that are additional to the risks they would face if employees were compensated purely in the form of wages.

Risks in the provision of pensions

3.2 There are two main risks involved in any system of pension provision which need to be borne by the parties involved (the member, sponsor, state and financial institutions):

- **Investment risk**
  Funded pension accrual exposes employers and employees to investment risk: the risk that a scheme or an individual’s assets will be adversely affected by fluctuations in the market value of the assets in which the pension fund is invested. At times there may be a high return on investments, but at other times a low return can lead to underfunding or an inadequate level of retirement income. Interest rates affect the value of liabilities and cash flow. There is a direct effect from the interest income on scheme assets and an indirect effect through potential additional employer contributions to reduce deficits.

- **Longevity risk**
  This is the risk that either an individual or a cohort of people will live longer than expected. In a defined contribution (DC) scheme this risk is partially realised when an individual buys an annuity. If life-expectancy for that individual’s cohort has increased, the individual may find that the pot they have accumulated does not translate to the level of income in retirement that they had anticipated. In a defined benefit (DB) scheme the scheme may underestimate members’ life expectancy, and be obliged to pay a pension for longer than anticipated, leading to an unexpected (and most likely unfunded) increase in liabilities.

3.3 It is useful to follow the Pensions Commission's example\(^\text{14}\) and break longevity risk down into three separate components:

- **Specific longevity risk, post-retirement**
  The fact that an individual at the point of retirement does not know how long they will live.

• **Average cohort longevity risk, post-retirement**
  The question of how long a given age cohort of pensioners will live, on average, given uncertainty today over future life expectancy.

• **Long-term average longevity risk, pre-retirement**
  The issue of uncertainty as to what will be the life expectancy at, for example, age 65, of someone who is half that age today.

3.4 In addition to these two main risks, there are a number of other risks which need to be considered:

• **Inflation risk**
  For both individuals and employers, the real value of the pension received and the real cost of providing it need to be considered. Revaluation of nominal benefits and indexation of pensions in payment are therefore key parts of scheme design and protects pension benefits from being vulnerable to fluctuations in value as inflation varies. In the UK, there is a cap on mandatory indexation and revaluation in DB schemes so in most schemes there is a limit on this protection. The existence of the cap means that the inflationary risk is shared between the sponsor and employee. In DC schemes, there is no such requirement, and the individual is free to choose between nominal and inflation-linked contract in the private annuity market.

• **Discontinuity/default risk**
  This is the risk that accrual or payment of the pension is interrupted. In the case of DB schemes, this is typically because the sponsor defaults on the scheme’s debt or becomes insolvent. In such cases there are real risks to the members’ pensions, though in practice the existence of the Pension Protection Fund mitigates much of this risk. Discontinuity risk exists in DC schemes through the possibility of business continuity of the fund manager in the accumulation phase and of the annuity provider in the decumulation phase. This risk is mitigated by the existence of the Financial Services Compensation Scheme.

• **Regulatory risk**
  It is well documented that successive governments have tightened the regulatory regimes governing occupational and personal pensions. While the thrust of much of this regulation has been to provide more security for members, there has been an associated increase in costs. Given the complex nature of pensions and the associated informational barriers, a degree of regulation is unavoidable and so the risk of increased cost of provision always exists.

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15 Salary and tenure risks are the risks to an individual’s pension income of uncertainty in future wage levels and uncertainty over job tenure respectively. They have been omitted from this discussion since they are less important risks in the context of risk sharing between the sponsor and the member. In particular, they are highly individual-specific risks which suggest little scope for risk sharing.
The distribution of risks

3.5 All pension schemes carry these risks in some form. A main difference between DB and DC schemes is in how these risks are distributed. This section focuses on the distribution of risks under the traditional final salary DB schemes (still the most common type of DB scheme) and pure DC schemes, as well as a brief discussion of who might be best placed to bear the risk. All references to DB schemes in this section refer specifically to final salary DB schemes.

3.6 It is useful to perform this comparison since final salary DB and pure DC schemes are at opposite ends of the spectrum in terms of the distribution of risk. The table below summarises who bears the different risks under final salary and pure DC schemes.

Table 3.1: Distribution of risks under final salary DB and pure DC schemes

<table>
<thead>
<tr>
<th>Risk</th>
<th>Final Salary DB</th>
<th>Pure DC</th>
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<tbody>
<tr>
<td>Risk borne by:</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Primary risks</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment risk</td>
<td>Sponsor</td>
<td>Member (pre-retirement)/Annuity provider (post-retirement)</td>
</tr>
<tr>
<td>Longevity risk</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Specific, post-retirement</td>
<td>Sponsor or Annuity provider</td>
<td>Annuity provider</td>
</tr>
<tr>
<td>Average cohort, post-retirement</td>
<td>Sponsor or Annuity provider</td>
<td>Annuity provider</td>
</tr>
<tr>
<td>Long-term average, pre-retirement</td>
<td>Sponsor</td>
<td>Member</td>
</tr>
<tr>
<td><strong>Secondary risks</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inflation risk</td>
<td>Sponsor (below cap)/member (above cap)</td>
<td>Member (non-indexed)/Annuity provider (indexed)</td>
</tr>
<tr>
<td>Default risk†</td>
<td>Member/the Pension Protection Fund</td>
<td>Member/Financial Services Compensation Scheme</td>
</tr>
<tr>
<td>Regulatory risk</td>
<td>Sponsor, possibly member</td>
<td>Member</td>
</tr>
</tbody>
</table>

* Depending on the type of annuity purchased.
† The risk of default in DB scheme arises from the possible of bankruptcy of the employer. In DC schemes the risk arises due to the possible bankruptcy of the fund manager or annuity provider.

3.7 In traditional DB schemes, all investment risk is borne by the scheme sponsor because of the nature of the pension benefits. Once the final salary is known, the sponsor is obliged to meet that commitment regardless of what happens to the scheme’s assets. Conversely, in a pure DC scheme, all the investment risk in the accumulation phase falls on the member. After retirement,
investment risk in a DC scheme is borne by the annuity provider, who guarantees a stream of income.

3.8 Employers may be better placed to bear investment risk up to a point because they can pool the risk across all members. For example, if investment returns are worse than expected, it may still be possible to pay the pensions of retirees in full, though liabilities for active and deferred members may be underfunded for a period.

3.9 Individuals cannot pool this risk—meaning that the impact of poor investment returns fall entirely on them. This is exactly what happens in a DC scheme. When the risk falls on an individual, their ability to bear that risk is likely to be related to their wealth, income and level of financial understanding. In the long run and over large fluctuations neither sponsors nor employees will be well placed to bear investment risk, which instead is best allocated to financial institutions.

3.10 The distribution of longevity risk is best dealt with by considering the three constituent elements of this risk described above. Specific longevity risk, post-retirement is never borne directly by an individual in either DB or DC schemes (except in the decision over whether to take a lump sum). In a DB scheme, which undertakes to provide a specified stream of income on retirement, the sponsor will either transfer the risk to an annuity provider, or carry this risk itself by maintaining responsibility to fund any unexpected improvements in an individual’s longevity. In a DC scheme, this type of longevity risk is transferred to the annuity provider.

3.11 Average cohort longevity risk, post-retirement is also generally absorbed by sponsors (DB) or annuity providers (DB/DC), along the lines described above. As before, individuals never directly bear this risk in either type of scheme, but in a DC scheme they may bear it indirectly through changes in annuity prices which reflect changes in mortality projections.

3.12 A given individual cannot know with certainty how much longer they will live, and were individuals to bear these risks directly, there is a danger that they might run out of money. It has been a fundamental tenet of UK pensions policy for these forms of longevity risk to lie with the sponsor or annuity provider. Annuity providers will typically charge a premium for taking on this risk, and are well equipped to do so. For the sponsor, the choice is between accepting this risk and paying a premium to transfer the risk to an annuity provider. The optimal response is likely to vary according to the characteristics and circumstances of the employer.

3.13 Long-term average longevity risk, pre-retirement in DB schemes is borne by the sponsor if the scheme’s retirement age stays unchanged far into the future. A flexible retirement age would allow some of this risk to be transferred to the individual. In DC schemes individuals bear this risk in full through changes in annuity rates. If their life-expectancy at retirement is longer than expected, individuals will need to choose between delaying retirement and accepting a lower annual income. Individuals are better placed to bear this form of longevity risk, compared to the two forms, because it occurs before retirement and they have time to adjust their saving and working preferences to accommodate long-
term increases in life expectancy. Given the individual’s ability to adjust to this risk, it would seem unnecessarily costly for the sponsor to bear it all – some form of risk sharing might therefore be desirable.

3.14 **Inflation risk** in a DB scheme is currently distributed between sponsors and individuals as a result of the system of caps that are applied both to deferred pensions and pensions in payment. In a low inflation environment, the entire nominal cost of inflation protection falls on the sponsor; however, when inflation rises above the cap, members begin to share the risk. Sponsors may have some ability to bear this risk as their trading cash flow will also tend to be linked to the price level.

3.15 In DC schemes, when the time comes to annuitise the fund, the member can assume as much or as little of the inflation risk as is desired, by purchasing flat-rate annuities or annuities which provide some degree of protection against inflation. The final choice will reflect the individual’s circumstances and preferences for bearing this risk. There is evidence that people typically purchase flat-rate annuities because they provide a higher starting income\(^\text{16}\). However, it is not clear whether this is due to a misunderstanding of inflation risk or a rational response to the individual’s circumstances.

3.16 **Discontinuity/default risk** is generally a greater threat for DB scheme members. There is a risk of default caused by insolvency of the scheme sponsor. In general terms, this risk falls on the individual, but the presence of the Pension Protection Fund means that a large part of the risk is transferred to that fund. A fund such as the PPF is better suited to bear this risk than individual members who cannot purchase such insurance.

3.17 In theory DC pension scheme members may also see their pensions affected by employer default, but this is unlikely to be significant given that both domestic and EU legislation limit investment in the sponsor’s stock. However, DC schemes may still be exposed to discontinuity risk in the accumulation phase through default of the fund manager, and in the decumulation phase, through default of the annuity provider. In practice such problems seldom arise, but the risk of them doing so falls on the member or in the case of pensions provided by Financial Services Authority regulated firms, the Financial Services Compensation Scheme.

3.18 The ability of the individual to bear this risk would then be related to their financial circumstances. Wealthier individuals with other assets will be better able to cope than those lacking alternative assets. The timing of any potential default is also a factor. Whilst an individual may find it possible to make alternative pension arrangements following default during the accumulation phase, default during the decumulation phase is likely to pose more of a problem.

3.19 Finally, **regulatory risk** can apply to both types of scheme. The impact of legislation introduced by successive governments has mainly affected DB schemes, as detailed elsewhere in this document. The impact of these

\(^{16}\) According to a report by the ABI, 87 per cent of all new contracts bought flat-rate annuities in 2006. Source: *Pension annuities: Pension annuities and the open market option* (ABI 2008).
regulations has generally been to improve member protection but sometimes at
the cost of making DB provision more expensive for sponsors. Because of the
nature of the benefits provided by DC schemes, they are generally not subject to
the same degree of regulation.

3.20 The question of who is best placed to bear these risks is not clear cut, but
there is no reason to think that any one party should bear unequal amounts of
these risks.

What does the distribution of risks mean for pension outcomes?

3.21 This chapter has focussed on the theoretical risks inherent in any form of
pension provision, and how they are distributed between the extremes of final
salary DB and pure DC provision. This final section considers the pension
outcomes that arise from these schemes, which in turn shows what the
distribution of risks means for these pension outcomes in practice.

3.22 The modelling results presented below focus on individual outcomes in DB
and DC plans. The results highlight what the distribution of investment risk –
perhaps the most important risk discussed here – means for these pension
outcomes in practice.

3.23 Figure 3.1 shows the results of modelling pension outcomes on retirement in
final salary DB and pure DC schemes. The model incorporates stochastic
modelling of asset returns which allows a range of outcomes in DC schemes to
be considered by introducing volatility in investment returns. The chart is
generated by considering a large number of different scenarios of investment
conditions over the next 35 years. For each scenario the pension that would be
paid at retirement from DC has been calculated. These outcomes are then
expressed in relation to 2007/08 earnings by correcting for wage inflation over the
period and ranked according to the ‘real’ size of pension that would result.

3.24 The members and plans are assumed to have the following characteristics:

- members have a starting salary of £30,000 on joining the scheme, which rises
  over time, and spend 30 years contributing to the scheme;

- the asset allocation in the DB plan is typical of most DB schemes in the UK,
  being a mix of equities and bonds. The DC plan assumes almost total
  investment in equities through most of the accumulation phase with a gradual
  switch into bonds in the 5 years prior to retirement;

- running costs for a DC scheme are assumed to be 0.5% pa; and

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17 A tool for determining probability distributions of potential outcomes by allowing for random variation
of one or more inputs over time.
• contribution rates in both plans are equal and at the level of average DB contribution rates in the UK.

**Figure 3.1: Pension outcomes on retirement in final salary DB and DC plans, 2007/08 earnings terms**

![Chart showing pension outcomes for DB and DC plans](chart.png)

Source: DWP modelling

3.25 The results show the potential range of dispersion in DC outcomes compared with the fixed DB outcomes. In practice DB outcomes will also vary with differences in salary growth, which is not illustrated here, but the range of outcomes is likely to be narrower than for a DC scheme. Investment returns are assumed to have no impact on the individual's DB outcome since the pension is a promise and the sponsor bears all of this risk.

3.26 The dispersion in the DC outcomes reflects potential variations in investment returns. The best outcomes as well as the mean and median outcomes in the DC plan are better than in the final salary DB plan, but DC schemes may also produce worse outcomes. This reflects the fact that DC plans allow the individual to benefit fully from high investment returns while exposing them to equivalent risk on the downside.

**Consultation Questions**

3. Is our characterisation of the allocation of risks in DB and DC schemes correct?
4. Which parties are best placed to bear each risk?
Chapter 4: Risk Sharing: International Comparisons

4.1 Several countries have risk sharing arrangements within their pension systems. The details of the most prominent examples are set out below to highlight the advantages and disadvantages of these approaches in different countries. Caution should be exercised in taking on policies from other countries as those policies have been designed in response to local working cultures, values and industrial relations, and will not necessarily be appropriate here.

4.2 For example, a country’s industrial relations system has a big impact on pension provision. In Europe, two very different models of capitalism dominate: the “Anglo-Saxon” model and “German” model. The Anglo-Saxon model tends to rely on market mechanisms and provides additional market elements where these are missing. This leads to pensions being used as a recruitment and retention tool, and helps companies to compete for workers in a free market. The German model, on the other hand, relies on non-market coordination such as collective wage bargaining and co-determination, and helps workers to have a say in company decision-making. Pensions in this model are often subject to collective bargaining, resulting in industry-wide pension schemes.

Netherlands

4.3 Though a German model country, the Netherlands has a tradition of final salary defined benefit (DB) pension provision like the UK. Until six years ago, this accounted for approximately 80 per cent of pension scheme membership in the Netherlands. However, during the first half of this decade the position began to change\(^{18}\), giving rise to two forms of risk sharing: conditional indexation career average schemes and collective defined contribution (collective DC) schemes. By 2006 such schemes accounted for 76 per cent of the Dutch total\(^{19}\). Given that these changes have only taken place recently it is too early to provide an accurate assessment of their impact.

4.4 In the Netherlands most industries have collective wage bargaining and significant employee representation on both pension scheme and company boards. This can affect scheme members’ approach to their pensions. They may feel that they don’t need to understand the complexities of how their pension works because they are confident their views are well represented.

4.5 This industrial relations system has produced industry-wide pension schemes. This makes it difficult for one employer in a sector to change their pension

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\(^{18}\) Largely in response to the decline in world financial markets in the early 2000s and subsequent more stringent requirements for schemes to hold solvency buffers.

\(^{19}\) De Nederlandsche Bank; Pension monitor [http://www.statistics.dnb.nl/](http://www.statistics.dnb.nl/).
provision unilaterally and might explain the high proportion of Dutch employees in either DB or collective DC schemes. It also means that employers do not use pensions as a recruitment and retention tool as has traditionally been the case in the UK.

**Conditional indexation average salary schemes**

4.6 In these schemes pension rights, which accrue on a DB basis, are based on the member’s salary in each year rather than their final salary, whilst the provision of indexed benefits is conditional on the financial health of the scheme.

4.7 Dutch schemes are required to fund to a level of 130 per cent of nominal liabilities\(^{20}\). If funding falls below this level the scheme is required to submit a recovery plan to the Dutch regulator. There are three main recovery measures available to a scheme:

- increasing contributions;
- withholding indexation; and, as a last resort
- making changes to accrued rights.

4.8 Pension funds are required to be transparent. They must explain to their members how they target indexation, what level of indexation they are aiming to achieve (price or earnings-linked) and how they expect to achieve it (for example by targeting additional contributions or earning high investment returns).

4.9 If annual indexation is withheld, the scheme is required to ‘make good’ (see paragraph 4.13) this lost indexation before the employer is allowed to reduce contribution levels.

**Advantages**

4.10 Under such arrangements risk is transferred from the employer to pension scheme members:

- The risk that assets do not perform is partially transferred as indexation does not need to be paid.
- The risk associated with rapid increases in pay towards the end of a working life is addressed by using career average accruals.

4.11 Conditional indexation schemes require a considerably lower funding level than those where indexation is mandatory – guaranteeing indexation is expensive, especially if one assumes, in the Dutch context, that the regulator’s requirement for a buffer would be retained.

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\(^{20}\) The term ‘nominal liabilities’ covers those pension benefits to which each scheme member has become entitled. In this case, it includes rights earned in previous years (including indexation previously awarded) and rights accrued in the current year, but not indexation for the current year or future years.
Disadvantages

4.12 Unlike members of traditional DB schemes, members of conditional indexation schemes cannot be certain about the value of their benefits. They cannot predict if indexation will be paid, and their accrued rights can be altered by the scheme. Such schemes add extra complexity for scheme members, and are difficult for most people to understand.

4.13 When indexation is withheld and then ‘made good’, risk can be unevenly distributed amongst scheme members. If indexation is withheld then only those with pensions in payment will see a direct effect on their income, whilst those still accruing rights may find the situation has recovered by the time they draw a pension. Furthermore, when indexation is ‘made good’, those drawing their pension are not paid back the money that they would have received the previous year. This can raise issues of fairness as pensioners may not be the best placed to bear this risk (see further discussion in Chapter 6).

4.14 Despite the requirement for schemes to be transparent about how they are targeting indexation, in at least one case scheme members have suggested that the employer is not providing sufficient contributions to achieve this.

Collective defined contribution schemes

4.15 In the Netherlands, collective DC schemes work in a similar way to the conditional indexation schemes outlined above, with expected benefit levels still calculated according to average salaries.

4.16 The key difference is that such schemes set a fixed employer contribution, meaning that nominal benefits are not guaranteed in the same way as under a conditional indexation scheme. The conditional indexation element and cuts to accrued benefits bring no direct financial benefit to the sponsor who always pays a fixed contribution. On this basis, these schemes are classed as DC rather than DB. The introduction of this type of scheme is a recent development and it therefore remains to be seen whether an employer would, in practice, bail out a collective DC scheme if it was significantly underfunded.

Advantages

4.17 The main advantage for the employer is that these schemes completely remove pension risk from the balance sheet and provides the employer with certainty on the cost of the pension scheme.

4.18 At the same time, expected outcomes are similar to those in conditional indexation schemes (assuming similar contribution rates) because the underlying

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21 However, it is worth noting that the employer often pays a risk premium when setting up such a scheme to improve its financial position.
benefits are the same. This means that such schemes are widely regarded as more desirable for scheme members than those operated on a pure DC basis.

4.19 These schemes enable the pooling of investment risk between scheme members, reducing the risk that particular cohorts are adversely affected by market downturns. Ultimately, the investment risk falls on the members and in significant downturns, members could see a reduction in the basic benefits as well as indexation and revaluation.

4.20 When setting up a collective DC scheme the collective bargaining process has often led to the employer paying a risk premium. This improves the financial health of the scheme before the employer passes the risk to the scheme members. Naturally this protects the scheme members, but that is at a cost to the employer, so it can also be viewed as a disadvantage to the employer.

Disadvantages

4.21 The downside for the scheme member is that these schemes remove certainty about the level of benefits that will be received.

4.22 The cost to the employer is still likely to be considerable. High employer contributions are required to target a level of benefits similar to a comparable conditional indexation scheme and conversion to such an arrangement often requires the employer to pay a sizeable risk premium.

Denmark

4.23 Denmark is also a “German” model country. The World Bank describes the Danish system as ‘risk sharing in [the] life-cycle’\(^\text{22}\) where the risks of longevity and costs are shared. Most workers are covered by collective DC schemes\(^\text{23}\). Benefits are calculated on the basis of a variable interest rate and annuity conversion rates that are set on joining the scheme. Contribution rates are fixed, agreed as part of the industry-wide bargaining agreements that are the normal basis for collective DC schemes. They are usually 8-20 per cent of wages and employers usually meet about 60 per cent of that contribution.

4.24 Risk is shared in a number of ways. Annual increases are only allocated when there are sufficient returns on investment. When there is underfunding, the minimum interest rate can be lowered for new entrants and employee contribution rates can be increased. The longevity risk can be shared among scheme members. In some schemes the value of the benefit depends on the average life expectancy of scheme participants.


\(^{23}\) Though the term ‘collective DC’ is used for these schemes and those in the Netherlands, they are designed to function in different ways, as set out in the text.
4.25 The risk of longevity to the pension fund can be off-set by the risk to the individual of dying before retirement. Schemes can use the ‘solidarity principle’, when a member dies before reaching retirement age that person’s contributions are put back into the fund to support the retirement of other members. Depending on scheme rules, provision can also be made for survivors.

Switzerland

4.26 Occupational pension schemes have been mandatory in Switzerland, a “German” model country, since 1985 for anyone earning a qualifying level of salary (currently around £10,000). The contribution rate depends on the age of the scheme member, increasing from 7 per cent for 25 to 34 year-olds to 18 per cent for those between 55 and pension age. Employers must pay at least half of these contributions. The pension schemes are funded, and the law provides for the accumulated fund to increase by a minimum amount, which was 2.75 per cent from January 1, 2008.

4.27 If the scheme becomes underfunded, recovery measures approved by the supervising authority must be put in place. The expected benefit can be adjusted according to the strength of the pension fund. Once the benefit is due, it can be reduced if there is a risk of bankruptcy. Other measures to combat under funding include withholding early retirement.

U.S.A. – Cash balance schemes

4.28 As a liberal market economy, the USA has an industrial relations system more similar to that of the UK than previous examples. The American Cash Balance scheme combines the features of DB and DC. A large number of DB schemes converted to cash balance over the period 1995-99.

4.29 Each participant has a notional account that is credited with a dollar amount. In most cases all contributions to the account are paid by the employer. The employer contributions are equal to a percentage of each year’s earnings and a rate of return on that contribution. The employer manages and invests the funds in aggregate. At retirement, the worker can take the money in his account as a lump sum or buy an annuity. This leads to risk sharing as the employer takes on pre-retirement investment risk while the member takes on the post-retirement longevity risk and interest rate risk.

4.30 There are certain advantages to this approach. The employer enjoys flexibility, and his contributions to the scheme in any given year may be more or less than the sum of the additions to all participants’ accounts. The employer determines how the assets from the scheme will be invested and assumes all risks. Workers benefit from the portability of the pension. They also find the benefits easier to understand, and female workers may do better with Cash Balance than DB as they tend to have slightly shorter job tenure.

4.31 However, the status of Cash Balance schemes in the USA has been questioned after a US court’s ruling that at least one Cash Balance scheme is
age discriminatory. When an employer moves from DB to Cash Balance, younger workers tend to benefit, while older workers are more likely to experience a loss. Indeed, regardless of age, workers who are moved from a final salary scheme to a typical Cash Balance scheme generally experience reductions from expected benefits. Some employees can lose out in the conversion process as they will not accrue additional benefits until pay and interest credits under the new scheme bring their cash account balance up to the value already earned under the old scheme.

Ireland

4.32 Ireland, another liberal market economy, encourages occupational and private pension schemes through favourable tax treatment and regulation to safeguard entitlements. The Irish Government wants to ensure that as many people as possible have supplementary pension cover in order to ensure that they can maintain their pre-retirement standard of living.

4.33 Pension schemes can be of any type (DB, hybrid or DC). They must be established as trusts and are by law distinct from life insurance undertakings and regulated separately.

4.34 Benefits must be paid as annuities though a small part (up to one and a half times final annual salary) can be paid as lump-sums.

4.35 There are no mandatory indexation requirements for pensions in payment, but deferred benefits must be indexed to the consumer price index (CPI) with a cap of 4 per cent per annum.

4.36 Most DB and hybrid schemes in Ireland are contributory, but while employee contributions are a fixed percentage of salary, employer contributions vary depending on the funding level.

4.37 In case of underfunding, it is normally only the scheme sponsor that makes additional contributions.

Consultation Question

5. Are you aware of any further international examples, or details of the experiences outlined above, which would be relevant to the debate on risk sharing in this country?
Chapter 5: Risk sharing within the current regulatory framework

5.1 Whilst many employers have chosen to move to a pure defined contribution (DC) model, as set out in Chapter 2, other employers wish to continue to provide a defined benefit (DB) scheme but are considering ways of making it more affordable and/or share risks differently. These employers may see advantages in providing a DB scheme as a part of the remuneration package for recruitment and retention purposes or because they take a paternalistic view towards pension provision.

5.2 Some employers have been exploring ways to manage the cost without significantly changing the balance of risk within their scheme. For example, they might reduce the accrual rate for each year of service or provide benefits on a career average rather than final salary basis.

5.3 Other employers have explored risk sharing options. These have included raising the normal pension age of the scheme and various forms of hybrid and cash balance schemes.

5.4 This chapter will consider these options and include specific examples of schemes which have made these changes. It is worth bearing in mind that these are not isolated examples. Evidence from the Occupational Pension Schemes Survey suggests that a significant number of employees covered by DB provision belong to schemes where such changes have been made.
5.5 When asked whether they expect to make changes to their scheme in the next five years, many employers with open DB schemes say they will do nothing. Around 20 per cent of employers said that they would retain their DB scheme but reduce costs or risks. Only around 15 per cent said that they would switch to DC for new members\(^{25}\).

**Managing cost**

5.6 As set out above, some employers do wish to continue to provide defined benefits but have changed their schemes to make them more affordable. These changes do not affect accrued rights and have sometimes been applied only to future joiners.

5.7 Employers can reduce the cost of their DB provision in a variety of ways. One-off rule changes along these lines typically lead to a reduction in members’ benefits and often mean that the employer retains all the risks associated with DB provision. Employers might for example:

- Reduce the accrual rate for each year of future service; or
- Provide benefits on a career average basis rather than final salary basis.

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\(^{24}\) Many schemes made changes to lump sum payments in 2006 as they were affected by ‘A-Day’.

\(^{25}\) NAPF Survey 2007.
Box 5.1: Cost sharing: the Railways Pension scheme

One option for employers looking to manage the cost of their DB schemes is to introduce cost-sharing arrangements, such as those operating in the Railways Pension scheme. This scheme takes advantage of the flexibility available within the current DB legislation to share costs.

The Railways Pension scheme shares costs between the employer and active scheme members according to a pre-determined 60:40 ratio. This has the logical consequence of sharing risks between the employer and active scheme members. In its first report, the Railway Pensions Commission noted\textsuperscript{26} that this arrangement has protected the benefit structure of the scheme at times when other schemes have come under increased pressure.

5.8 Increases in normal pension age can be used as a cost cutting measure, but can also be seen as a way of sharing the risk of increasing longevity and will therefore be discussed under the heading of Sharing Risk.

Reduced accrual rates

5.9 A conceptually simple way to reduce the costs associated with DB provision is to reduce the accrual rates for future service. Such cuts have often been combined with the other changes explained below. As shown in Figure 5.1, this has not been one of the most common changes to DB schemes in the past few years. This might be due to practical obstacles such as member acceptance of the changes. However, there have been a number of high-profile examples in recent years of schemes taking advantage of this approach.

Box 5.2: Examples of reduced accrual rates

\textit{Marks and Spencer}

Marks and Spencer moved to a defined contribution scheme for new employees from April 2002. Their DB scheme has been kept open for existing members. From 1 October 2007, members had to choose from one of three options for future accruals: to maintain the 1/45th accrual rate but to limit increases in pensionable pay to the rate of inflation (capped at 5 per cent); to maintain the 1/45th accrual rate but begin paying member contributions starting at 2 per cent of salary in the first year gradually rising to 7 per cent; or to reduce the future accrual rate to 1/60th but continue paying no contributions and keep all salary increases as pensionable.

\textit{Church of England}

From 1 January 2008, the Church of England scheme has reduced accruals from 1/37ths to 1/40ths for future service and reduced the LPI cap from 5 per cent to 3.5 per cent.

\textsuperscript{26} Drake, J. Davies, B. and Thompson, P. 2007, \textit{The Railway Pensions Commission First Report}
**British Airways**

British Airways introduced a DC scheme for new employees in 2003. The DB scheme is open for existing staff but, from 2007, the normal pension age was increased to 65, accrual rates were reduced from 1/56th or 1/52nd to 1/60th and employees were offered the option of a higher contribution rate in exchange for a lower normal pension age and / or improved accrual rates. Future pensionable pay increases were capped in line with retail price index (excluding promotions).

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**Career average schemes**

5.10 Career average schemes are DB schemes where benefits accrue based on the member’s salary in each year rather than on final salary. A career average scheme may yield a lower income at retirement than a final salary scheme, especially for members who reach their earnings peak shortly before normal pension age. However, it may also provide some comfort that the employer will continue to provide some guaranteed benefits and for some employees, for example those on flat salaries or those who are phasing their withdrawal from the labour market, it may be a positive change.

5.11 For employers, providing a career average scheme is likely to achieve a reduction in the overall cost (provided that they do not increase accrual rates), but they will still generally be subject to the same legislative framework as final salary schemes. They will also continue to bear the major risks associated with pension provision. Employers reduce their exposure to salary risk as accruals are based on earnings in each year.

5.12 Figure 5.2 shows the results of modelling the impact of moving from a final salary DB scheme to a career average scheme. For comparative purposes, accrual rates are the same in both schemes, as are the length of time the individual spends in the scheme and the individual’s starting salary. The only difference between the two scenarios is the salary used in the benefit formula – final salary in one and career average in the other. In practice employers sometimes choose to increase accrual rates when moving to a career average scheme.
Figure 5.2: Annual pension outcomes on retirement for an individual in a career average scheme compared to a final salary scheme, £ per annum 2007/08 earnings terms

Source: DWP modelling

5.13 The chart indicates that the pension resulting from a career average scheme is likely to be lower than that from a final salary scheme, reflecting the underlying assumption that earnings typically increase in real terms over a working life.

5.14 However, the chart clearly shows that across the entire distribution of pension outcomes, the pension resulting from a career average scheme is lower than that from a final salary scheme and some of this is attributable to scheme design.

5.15 Around six per cent of active members of DB schemes are in career average schemes. Companies with career average schemes include: the BBC; the Co-operative Group; DSG International; Mothercare; Nationwide; and Unilever.

5.16 There are also examples of tiered career average schemes where employees can choose to contribute different percentages of salary with different accrual rates. The Automobile Association (the AA), for example, allows five different employee contribution rates (accrual rates in brackets): 1.5 per cent (1 per cent); 3 per cent (1.25 per cent); 4.5 per cent (1.43 per cent); 6 per cent (1.67 per cent); and 7.5 per cent (1.82 per cent) in the career average section of its pension scheme. In addition, benefits once earned may be subject to revaluation over the period to retirement on a discretionary basis.

27 Occupational Pension Schemes Survey 2006
Box 5.3: Examples of career average schemes

**Co-operative Group**
In April 2006, the Co-operative Group moved to a career average scheme for existing and new members. In return for a 6 per cent employee contribution, members of the new pension scheme receive 1/60th of pensionable earnings for each year of service. Each year’s salary is revalued in line with inflation, capped at 5 per cent. Pension rights accrued before the date of change continue to be based on final pensionable salary at retirement, or leaving service if earlier.

**Railway pensions commission**
In 2008, the Railway Pensions Commission proposed that the scheme moves to a career average scheme with 1/50th accruals in order to reduce costs. The proposed scheme also includes increases in normal pension age.

Sharing risk

5.17 Employers have also considered how they can continue to provide a DB scheme by sharing the risks involved with their employees – and there are a number of options available. Changing normal pension age, hybrid schemes and cash balance schemes are discussed in this section.

**Changing normal pension age**

5.18 As set out in Chapters 2 and 3 it is generally recognised that life expectancy is increasing and is likely to continue to do so, though the rate at which it will increase is uncertain. Most occupational pension schemes were established when life expectancy was considerably shorter and normal pension age under these schemes was set accordingly.

5.19 Increasing longevity means pensions are often in payment for longer than expected, increasing the scheme’s liabilities and consequently the cost to the employer. Some employers are looking for ways to share the risk of increasing longevity with members by increasing normal pension age²⁸.

**Issues facing schemes considering changing normal pension age**

5.20 Section 67 of the Pensions Act 1995 (section 67) was introduced following the Pensions Law Review Committee recommendation that scheme members should be protected against adverse amendment of scheme rules affecting their rights in relation to accrued service.

5.21 It does this by making potentially voidable any modification of an occupational pension scheme which would or might adversely affect a member’s accrued rights (subsisting rights). It does not restrict changes to rights that accrue in the

²⁸ Normal pension age is the age at which benefits can be taken from a DB scheme without actuarial reduction, and is usually set out in the rules of the scheme.
future. This limits the employer’s ability to share longevity risks in the short to medium term.

5.22 Schemes can make detrimental amendments if the value of the subsisting rights before and after the change is actuarially equivalent, or if the member consents to the change. A change to normal pension age could be detrimental because it would alter the extent of the entitlement making benefits less generous.

The Government’s position

5.23 In the Government response to the Deregulatory Reviewers’ report (22 October 2007) the Government set out its position on "risk sharing" in relation to improving longevity. The reviewers had commented that there were concerns that section 67 would prevent schemes from sharing the risk of improving longevity.

5.24 Many in the pensions industry are concerned that section 67 is open to misinterpretation and that a contingent promise could be construed to result in an accrued benefit even in circumstances where the contingency has not occurred. In this event, some fear, a court could hold section 67 to require a benefit to be paid, or paid at a higher level, than had been intended by those who established the scheme.

5.25 This concern has been raised in the context of normal pension age where schemes are considering fixing normal pension age by reference to a longevity index. However, Section 67 only acts to limit the detrimental application of modification powers, so provided the contingencies are written into the scheme rules in such a way that no further exercise of a modification power is necessary, the subsisting rights provisions in section 67 should not apply.

5.26 The Government and the Pensions Regulator agree with the reviewers that section 67 should not prevent schemes from drafting rules in such a way that benefits in respect of future service are linked to clearly defined contingencies. However, the Government is mindful that it is ultimately for the courts to determine how statute applies in particular circumstances. Any employer or scheme considering amending existing scheme rules or setting up a new scheme should consider taking their own legal advice so that the particular circumstances in their case can be fully taken into account.

5.27 The Government response to the Deregulatory Reviewers’ report agreed that it is too early to assess the impact of section 67 and to obtain information about any possible unintended effects, and accepted the reviewers’ recommendation that DWP should keep section 67 under consideration.
Box 5.4: Examples of changes to normal pension age

**BAE**

The BAE Systems DB Scheme is open to new entrants and the members bear the risk of unexpected future increases in longevity for newly accrued rights by reducing the pension payable at retirement in proportion to the impact of any improvements in life expectancy beyond those allowed for in the relevant mortality tables used by the scheme at the time of the risk sharing introduction.

**The Railway Pensions Commission**

As set out in the previous box, one of the proposals of the Railway pensions commission is to adjust the accrued pension at the normal pension age of the scheme in line with changes in the mortality basis.

**Hybrid schemes**

5.28 The term ‘hybrid scheme’ covers a range of possibilities, including schemes incorporating both DB and DC elements. These will be the focus of this section. They provide a clear approach to risk sharing, with one section where the employee takes all the risk and one where the employer takes all the risk.

5.29 The most common types currently employed are:

- **Combination hybrid 1**: a two part scheme where employees are offered DB benefits with a less generous accrual rate than generally seen in pure DB schemes (e.g.: 1/100th) alongside a DC element into which the employer contributes a percentage of salary per annum.
- **Combination hybrid 2**: a two part scheme defined by salary, with DB benefits based on earnings up to a certain level and DC above it.
- **Nursery hybrid**: benefits based on age where active members up to a certain age are offered DC benefits and begin to accrue DB benefits above that age.
- **Sequential hybrid**: benefits based on service where active members accrue DC benefits for a certain number of years of service and DB benefits thereafter.

5.30 For employers the risks reduced will depend on the specific hybrid model employed, although whatever hybrid model is used it is likely that there will be a reduction in investment and longevity risks compared to a standard DB scheme. It is also likely that administration will be more complex. The DB element of the scheme will continue to be subject to the full regulatory framework which applies to DB schemes.

5.31 Employees will be exposed to some additional risks but will be sharing them rather than taking them all on as they would in a pure DC scheme. Although a hybrid scheme will be more complex for the member than a pure DB or a pure DC scheme, these schemes do provide a very clear sharing of risk, as the
member takes all the risk in one section of the scheme and the employer shoulders all the risk in the other section.

5.32 The Pensions Regulator’s scheme returns suggest that less than 3 per cent of occupational pension schemes are hybrid schemes. Figures from other sources tend vary from around 4 per cent to 10 per cent.

5.33 One potential downside to hybrid schemes, and as such a reason why there has not been greater take-up, is the administrative complexity of running separate schemes or sections of schemes (one DB and one DC).

5.34 A possible solution to this problem is for the employer to run a DB scheme whilst at the same time making contributions to a Group Personal Pension, leaving the task of running the DC element of the arrangement to an external provider.

Box 5.5: Hybrid scheme examples

**Unilever** adopt a combination hybrid model. Employees pay 5 per cent of a band of pensionable pay (currently between £4,675 and £39,150 reviewed each 1 April) and receive career average on this band of pensionable pay. Unilever contributes 12.5 per cent of pensionable pay above the upper band limit into a DC scheme. Alternatively, members can choose to take some or all of the 12.5 per cent as salary.

**BAE** also adopt a combination hybrid model. The scheme includes a final salary DB element worth 1 per cent of salary for each year of service and a 2 per cent employer contribution to a DC scheme. Employees contribute 4 per cent.

Box 5.6: Combination hybrid schemes and pension reforms

It is worth considering that the pensions landscape will change following the introduction of automatic enrolment and a minimum employer contribution from 2012.

The key element of this reform is that it will place a duty on employers to automatically enrol their employees into a pension scheme of sufficient quality, and pay a minimum contribution. Schemes such as the combination hybrids described above require the employer to make two sets of contributions – one set on a DC basis, and the other set on a DB basis.

To fulfil the employer duty, either:

1. the employer must auto-enrol employees into a hybrid scheme which meets the quality requirements for hybrid schemes; or,
2. where the employer runs separate schemes, the employee must be auto-enrolled into one of them, which must meet the qualifying requirements for that scheme type.
In the latter case, if the employer chose to discharge their duty through the DC element, this would allow flexibility to use a DC occupational scheme, a Group Personal Pension or the personal accounts scheme. Of these, the Group Personal Pension or personal accounts scheme possibilities would have the benefit of reducing the administrative complexity for the employer (when compared with the administrative burden of running a traditional DC occupational scheme), potentially removing the main objection to hybrid schemes as set out in paragraph 5.33.

Cash balance schemes

5.35 Cash balance schemes are structured along DC lines with accumulation and decumulation phases. Unlike a DC scheme, these schemes incorporate some form of sponsor guarantee and the size of a member’s pot is therefore not exclusively reliant on contributions and investment returns. This leads to risk sharing as the employer takes on pre-retirement investment risk while the member takes on the longevity risk and interest rate risk at retirement.

5.36 In cash balance schemes, each member has an individual account which is credited with contributions each year and grows by a fixed percentage. At retirement, the member’s accumulated individual account will be available in the same way as under a pure DC scheme.

5.37 Employees take on post-retirement longevity risk in cash balance schemes as annuity rates available at the point of retirement will dictate the level of income they can get for their money. Some employees might favour this type of scheme over a DB scheme as they can see their account “growing”. On the other hand, investment returns will be smoothed due to the sponsor guarantee and members may not understand why they do not reap the full benefits in periods of high investment returns.

5.38 Under DWP legislation, cash balance schemes fall outside the definition of money purchase schemes, and are treated as defined benefit schemes due to the guarantee provided by the employer\(^\text{29}\). This means that they are subject to mandatory revaluation of deferred benefits, scheme funding regulation and the Pension Protection Levy. It also means that those members are required to buy annuities which contain statutory pension increases. This is likely to be one of the barriers for employers considering adopting these schemes and might be a reason why they are rare.

5.39 There have been suggestions that issues of age discrimination might arise for cash balance schemes. Issues have arisen in the United States but it has normally been found that the schemes are not discriminatory or discrimination can be justified. The reasons for possible age discrimination are:

- that the cost of funding the pension earned for a younger employee is less than for an older employee earning the same salary; and

\(^{29}\) This classification also arises from Article 15(2) of the IORP Directive 2003/41/EC.
that a younger member with the same accrual period will get greater benefit from the interest applied up to retirement age than a comparable older member who has less time, and therefore less interest applied, to retirement age, on the same accumulated “pot”.

5.40 Depending on the detail behind the design of such schemes, it is probable that these practices would fall within the existing exemptions to the Employment Equality (Age) Regulations 2006.

Box 5.7: Examples of cash balance schemes

**House of Fraser** picks up the balance of the cost of providing the appropriate retirement balances for members dependent on the tier they have chosen to contribute to. Each tier promises a cash balance of the relevant salary (either 10 per cent, 20 per cent or 25 per cent). Members pay 3.5 per cent for membership of the 10 per cent tier; 7 per cent for the 20 per cent tier and 6 per cent for the 25 per cent tier. Members’ pots are increased by RPI each year up to a maximum of 5%.

Employees who joined **Barclays** before 1997 accrue rights in a 1/60th final salary scheme. The company switched to pure DC in 1997, with a 5 per cent employer contribution and up to a further 6 per cent of matching contributions. As part of a regular review, the lower than expected take up of the matching contributions could have lead to lower pensions than expected.

In 2003 the DC scheme was converted to a cash balance scheme. In return for a 3 per cent mandatory employee contribution, Barclays promises a cash sum of 20 per cent of salary per month payable at normal pension age. This amount is also revalued annually at RPI (capped at 5 per cent), plus a discretionary investment uplift of up to 2 per cent per annum. In addition, Barclays also matches employee contributions up to a further 3 per cent of salary into a DC account.

**Building up from DC**

5.41 We would also be interested in exploring what, if anything, defined contribution schemes are doing to share the risk more evenly between the member and the employer.

**Consultation questions:**

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?

7. Would this greater flexibility encourage employers who are considering a move out of DB provision to continue to bear some risk rather moving fully to DC?
8. Would employers currently offering DC consider a move to a risk sharing arrangement?

9. Do employers consider the existing risk sharing options (for example cash balance schemes, career average) when looking at alterations to DB pension arrangements?

10. Have you considered any options other than those outlined in this chapter?

11. Have the existing options proved inadequate and if so how?

12. What could be done to regulation, legislation to make the risk sharing alternatives discussed in this chapter easier to achieve?

13. What could be done in information or guidance to make the risk sharing alternatives discussed in this chapter easier to achieve?

14. Is the DB legislative framework disproportionate for cash balance schemes? Should the legislative framework be changed to allow schemes more freedom to apply revaluation and to increase annuity options available to members?

15. Are you aware of any issues related to age discrimination in cash balance schemes in the UK today? Is this an issue which is stopping employers from setting up cash balance schemes?
Chapter 6: Conditional indexation schemes

Introduction

6.1 Risk sharing could be introduced into defined benefit (DB) schemes by allowing employers to operate conditional indexation. The most developed approaches to creating new risk sharing schemes are the Association of Consulting Actuaries’ (ACA) proposals for conditionally indexed career average schemes. Chris Lewin (one of the two independent authors of the Deregulatory Review of Private Pensions) has suggested an approach to conditional indexation in all DB schemes.

Conditional indexation – career average schemes

Outline

6.2 The ACA has suggested that the Government should enable a new type of pension scheme to be set up that would enable employers to manage their pension contributions over the long term, whilst also offering scheme members more certainty about their benefits than in a defined contribution scheme. They suggest that these schemes could be used by medium to large employers prepared to share investment and longevity risks with members. Conditionally indexed schemes also offer the prospect of higher investment returns over the long term due to fewer constraints on investment strategy.

6.3 The compulsory elements of such a scheme would be that the benefits are based on earnings in each year rather than on the final salary (career average schemes). As part of the benefit design, the scheme would specify a target rate of revaluation of accrued benefits with the same target to be used for increases to pensions in payment each year. Any revaluation or increase granted in a particular year would become a defined benefit but there would be no guarantee of future revaluations or increases.

6.4 These schemes would be subject to the scheme funding requirements set out in Part 3 of the Pensions Act 2004 and the Scheme Funding Regulations 2005. Trustees would therefore be required to adopt prudent assumptions in actuarial valuations of their scheme. In particular, it would be a requirement to include within the technical provisions a prudent allowance for future revaluation and

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pension increases on accrued benefits in line with the stated target. Furthermore, the employer contribution rate for future service benefits would include a full allowance for future revaluation and pension increases using the same prudent assumptions as in the technical provisions for the accrued benefits. Surpluses arising at valuations could not be used to reduce employer future service contributions. Therefore, over the long term, the expectation would be that the scheme would remain in surplus.

6.5 The conditional elements of these schemes would come into force if the scheme became underfunded. If the most recent actuarial valuation were to show that the scheme was fully funded, the benefits would be increased in line with the schemes’ target index. If an actuarial valuation revealed a funding deficit, the next year’s indexation and revaluation benefits would be withheld if the employer chose not to meet the deficit by making additional contributions.

6.6 For years when the revaluation and pension increases were not paid, the resultant savings would reduce the funding deficit. After recovering the deficit, the scheme would be required to use any surpluses to reinstate any revaluation and indexation which had been withheld. A scheme would also be required to carry out annual valuations until all revaluations and pension increases had been reinstated.

6.7 The employer would have the right to increase normal pension age (NPA) in respect of the past service benefits accrued from the point the new scheme was established. This would apply only to active and deferred members who are more than 10 years short of NPA and would be subject to actuarial evidence of increased life expectancy and prescribed safeguards.

6.8 On the winding up of a conditionally indexed scheme, the employer debt would be based on the accrued defined benefits excluding future revaluation and pension increases. The expectation would be that, because of the use of prudent funding assumptions and no return of surplus to reduce employer contributions, the fund would be sufficient to secure future revaluation and pension increases for some years. A refund to the employer would be possible only if increases for all future years had been secured.

6.9 The ACA proposes that compensation available from the Pension Protection Fund would be 100% of the accrued defined benefits without a cap excluding future revaluation and pension increases. The Pension Protection Levy would be based on these benefits and would be separate from the levy charged by the Pension Protection Fund for defined benefit schemes.

6.10 The scheme would be required to fully disclose the risks being shared between the employer and members of the scheme and conditionally indexed schemes would not be contracted out of the State Second Pension.

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31 There is a cap on the amount of PPF compensation an individual can receive. It is currently £27,770 per year.
Objectives and rationale

6.11 The main objective of this approach would be to encourage continuing good workplace pension provision, particularly among employers who can no longer afford to keep their final salary schemes open. It would allow employers to reduce their exposure to the risks associated with DB schemes. This would allow costs to be controlled despite financial market downturns or increases in longevity.

6.12 The ACA suggest that this sort of scheme would enable risk sharing between the employer and all members of the pensions scheme – active, deferred and retired members – in a fair and equitable way. This could enable employers to continue to offer good pension provision with some reduction in cost and risk compared to continuing traditional final salary provision.

6.13 Under this approach investment risk would be shared between the sponsor and member through conditional indexation. Post-retirement longevity risks would be shared between the sponsor and member to the extent that if the scheme became underfunded due to increased liabilities, indexation could be removed until the funding position improved. The average pre-retirement longevity risk would be borne by the member as the scheme would have the ability to increase normal pension age.

6.14 Inflation risk would be shared between the sponsor and member due to the conditional indexation element of this approach. Default risk would continue to fall on the member or guarantee fund while regulatory risk would stay largely with the sponsor (with the possibility of the member being affected).

Table 6.1: Risk allocation in conditionally indexed career average schemes

<table>
<thead>
<tr>
<th>Risk borne by:</th>
<th>Secondary risks</th>
<th>Primary risks</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Inflation risk</td>
<td>Investment risk</td>
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<tr>
<td></td>
<td>Default risk</td>
<td>Longevity risk</td>
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<td></td>
<td>Regulatory risk</td>
<td>Specific, post-retirement</td>
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<td></td>
<td></td>
<td>Average cohort, post-retirement</td>
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<td></td>
<td></td>
<td>Long-term average, pre-retirement</td>
</tr>
<tr>
<td></td>
<td>Member</td>
<td>Sponsor and member</td>
</tr>
<tr>
<td></td>
<td>Member/Guarantee fund</td>
<td>Sponsor and member</td>
</tr>
<tr>
<td></td>
<td>Sponsor, possibly member</td>
<td>Sponsor and member</td>
</tr>
</tbody>
</table>
Risks

6.15 There are some risks associated with this approach which may undermine its objectives. We would welcome views on these risks and how likely they are to materialise.

Moral hazard

6.16 One of the risks is that employers might have an incentive to resist agreeing to appropriately strong scheme funding targets in order to increase the likelihood that they might be able to withhold indexation and revaluation and thus reduce overall funding costs. Considering how significant such a risk might be, we have looked at two ways in which it might be possible to “create” a deficit:

- pay insufficient contributions into the scheme; and
- use overly prudent assumptions to inflate the liabilities, and thus appearing to have a deficit.

6.17 On the first point, the scheme funding regulations should be sufficient to avoid this risk materialising. The trustees of a defined benefit scheme are required to obtain actuarial valuations of the scheme at least every three years, and if a valuation reveals a funding shortfall they are required to put in place a recovery plan for eliminating the deficit. They must also send a copy of any recovery plan to the Regulator, who has significant powers to intervene in cases of concern. These include, for example, the power to direct the actuarial assumptions to be used in a valuation, or to impose a schedule of contributions.

6.18 It might also be possible to “create” a deficit by using more prudent assumptions in the actuarial valuation. This would lead to higher liabilities and therefore a lower funding level. If this led to the scheme going into deficit, the employer could cut indexation which in turn would lead to a reduction in liabilities. Due to the reduction in liabilities, the scheme would be likely to find themselves better funded at the next valuation and might have to reinstate indexation. Therefore, if they wanted to continue to be in deficit they would have to use ever more prudent assumptions.

6.19 However, even if it were possible for the employer to “create” a deficit, it is not clear whether there would be an incentive for them to do so.

6.20 As schemes are required to target revaluation and increases to pensions in payment in their funding strategy but are able to wind up the scheme without being liable for any liabilities arising due to future indexation, there might be an incentive for employers to wind-up the scheme and walk away with a surplus. In order to reduce this risk, a condition could be set out which would not allow the return of surplus to the employer unless the scheme is funded to a level which would enable all targeted benefits, including revaluation and indexation, to be
paid. Whilst such a condition would reduce this risk, employers would still be able to wind up the scheme at a relatively low cost.

6.21 The trust-based nature of DB schemes would also make it difficult for employers independently to follow these strategies. The trustees of the scheme and the employer are required to agree to the assumptions used in the valuation and as it would not be in the best interest of members to have overly prudent assumptions, trustees would be unlikely to agree to such assumptions.

Administrative costs

6.22 There is a possibility that this approach could lead to increased administrative costs. It is, for example, proposed that schemes must carry out an annual valuation until they have reinstated all revaluation and increases in pensions in payment. Due to the complexity of the scheme, discussed in more detail below, there might also be a need to increase the requirements on employers to communicate to their members. This might lead to an increase in the administrative costs for employers choosing to set up such schemes.

Complexity for members

6.23 Conditionally indexed schemes are by virtue of their design more complex than pure DB schemes and it is likely that members would find them more difficult to understand. Trustees would, of course, continue to protect members’ interest, but there is a risk that people would find the benefits more difficult to understand and therefore choose not to participate in the scheme.

6.24 Complex schemes might work well in a country like the Netherlands where pension decisions are made through the collective bargaining process and members trust the system to provide them with a fair outcome. In this country, on the other hand, there might be more scepticism.

6.25 As these schemes would be more complex than a pure DB scheme, it would be essential to communicate the nature of the benefits to the members. Schemes would need to set out clearly which benefits are guaranteed and which are conditional. The conditions would also need to be communicated.

Fairness

6.26 As set out above, one of the objectives of this approach is to share risk in a fair and equitable way between active, deferred and pensioner members. This would be achieved by applying any reductions of revaluation of salaries and indexation of pensions in payment equally to all members of the scheme.

6.27 One could envisage a situation where certain cohorts would be worse affected by a cut in benefits than others. For example, individuals who are close to retirement during a period of reduced revaluation would lose out on these rights and would retire with a lower than expected pension. They might also continue to
receive lower indexation in retirement. The ACA has suggested that pensioner members would have their lost revaluations reinstated when the employer recovered their deficit. These members would therefore experience a delay in their income but would not permanently lose out on revaluation.

**Demand**

6.28 These schemes would be quite different from any pension scheme design seen in the UK to date so it is difficult to estimate the demand for these schemes. We have little evidence on whether employers who would otherwise have switched to defined contribution (DC) would be interested in opening such a scheme or whether it would appeal more to employers who would otherwise have kept their DB schemes open.

6.29 These schemes would remain DB schemes and would still be subject to all the relevant regulation and accounting standards. Despite the benefits that conditional indexation offers employers, it is unclear whether it would provide sufficient incentive for employers to set up a new scheme.

**Policy and legal implications**

6.30 Implementing this approach would require significant changes to both primary and secondary legislation. If it were to be decided that such changes were desirable in principle, it would be important to ensure that they did not affect pension schemes that wish to continue operating as they do at present, that the proposals were workable and that there were no unintended consequences.

6.31 Detailed consideration of a number of the policy and legal implications of is included in Annex A.

**Impact assessment**

6.32 See Annex B
Conditional indexation for all defined benefit schemes

Outline

6.33 Legislation would enable conditional indexation of pensions in payment to apply to any DB scheme, including a final salary scheme, where the scheme rules specifically permit this. Such a scheme would cover only the future service of active members after the change and would have no impact on existing deferred members or pensioners. It could either be an entirely new scheme or a new section of an existing scheme.\[32\]

6.34 The normal contributions payable each year for active members would be calculated, using prudent assumptions, on the basis that the pension accruing in that year would be fully indexed at Limited Price Indexation (LPI, up to 2.5 per cent per annum) after it comes into payment.

6.35 The trustees would be obliged to fully index pensions in payment, provided that the scheme’s funding level remains sufficient to support this for all existing and future pensioners. If, however, the funding level fell below this, full indexation would have to be suspended (though partial indexation would continue if affordable and increases already granted to existing pensioners would not be affected). The suspension could be lifted, however, if the employer voluntarily agreed to make additional payments.

6.36 As soon as the trustees believe that there is a significant risk that active members and deferred pensioners will not qualify for full indexation after their pensions commence in future, the trustees must warn them and keep them informed thereafter.

6.37 Full future indexation would be resumed after a period of suspension if the financial position of the scheme permits. As a second step, any loss of indexation during the period of suspension would have to be restored once the finances of the scheme allowed for it. No surplus could be distributed to the employer unless full indexation had been resumed and any loss of indexation during a period of suspension had been made good.

6.38 If the funding of the scheme fell below the level required to support the guaranteed benefits, excluding future indexation after retirement, the employer would be required to restore that funding level by making extra payments over a suitable period.

6.39 The Pensions Regulator would supervise such schemes to ensure that the detailed provisions share the risks fairly in accordance with the above principles.

\[32\] In the latter case, the finances of the new section would have to be kept separate from the finances of the old section.
Objectives and rationale

6.40 As with the previous approach, the main objective would be to support good workplace pension provision, particularly among employers who can no longer afford to continue providing DB schemes on the same terms as when the scheme opened. It would allow employers to reduce their exposure to the risks associated with pure DB schemes.

6.41 This type of scheme would not provide immediate savings to employers, as they would still be providing the same benefits, but it would allow them to manage risks and control costs in the future.

6.42 The approach is likely to lead to lower pension incomes than in a final salary scheme but it would provide more certainty for members than in a DC scheme.

6.43 Under this approach investment risk would be shared between the sponsor and pensioner members (but not active or deferred members) through conditional indexation. Post-retirement longevity risks would be shared between the sponsor and pensioner members to the extent that if the scheme became underfunded due to increased liabilities (arising from increased longevity), indexation could be removed until the funding position improved. The average pre-retirement longevity risk would be borne by either the member or the sponsor depending on the decision of the latter to raise normal pension age.

6.44 Inflation risk would be shared between the sponsor and pensioner members due to the conditional indexation element of this approach. Default risk would continue to fall on the member or guarantee fund while regulatory risk would stay largely with the sponsor (with the possibility of the member being affected).

Table 6.2: Risk allocation in conditionally indexed final salary schemes

<table>
<thead>
<tr>
<th></th>
<th>Risk borne by:</th>
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<tbody>
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<td><strong>Primary risks</strong></td>
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<td>Investment risk</td>
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<td>Longevity risk:</td>
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<tr>
<td>Specific, post-retirement</td>
<td>Sponsor and pensioner members</td>
</tr>
<tr>
<td>Average cohort, post-retirement</td>
<td>Sponsor and pensioner members</td>
</tr>
<tr>
<td>Long-term average, pre-retirement</td>
<td>Sponsor</td>
</tr>
<tr>
<td><strong>Secondary risks</strong></td>
<td></td>
</tr>
<tr>
<td>Inflation risk</td>
<td>Sponsor/annuity provider and pensioner members</td>
</tr>
<tr>
<td>Default risk</td>
<td>Member/Guarantee fund</td>
</tr>
<tr>
<td>Regulatory risk</td>
<td>Sponsor, possibly member</td>
</tr>
</tbody>
</table>
Risks

6.45 The risks related to this approach are similar to those discussed in the previous section. We would welcome views on these risks and how likely they are to materialise.

6.46 The issue of fairness applies differently to this approach. As these schemes would only use indexation as a risk sharing tool, rather than indexation and revaluation, the conditional nature of the scheme would only apply to pensions in payment. This means that pensioners would be the only members to feel the impact of a reduction in indexation. This approach might also mean that the schemes might have to reduce indexation more heavily, since the impact would not be spread across the membership. This effect would become less marked the more mature the scheme became.

6.47 The same moral hazard issues apply due to the conditional nature of the scheme. The risk of employer intentionally underfunding the scheme to avoid paying indexation is considered small under these proposals as well. The primary moral hazard issue is around the employer debt at wind-up, as set out in the previous section. Similar issues would need to be addressed for this approach.

6.48 There is a possibility that this approach could lead to increased administrative costs. It might be necessary to have more stringent requirements for actuarial valuations to ensure that conditional indexation is applied in an appropriate manner. Due to the complexity of the scheme there might also be a need to increase the requirements on employers to communicate to their members. This could lead to an increase in the administrative cost for employers choosing to set up such schemes.

6.49 As set out in the previous section, conditionally indexed schemes are by virtue of their design more complex than pure DB schemes and it is likely that members would find them more difficult to understand. Trustees would, of course, continue to protect members’ interest, but there is a risk that people find the benefits more difficult to understand and therefore choose not to participate in the scheme. It would be essential to communicate the nature of the benefits to the members and schemes would need to set out clearly which benefits are guaranteed and which are conditional.

6.50 These schemes would be quite different from any pension scheme design seen in the UK to date so it is difficult to estimate the demand for these schemes. As the proposals do not give rise to any immediate savings for the employer, and might give rise to some set-up costs for the new or converted scheme, it is unclear whether there would be an incentive for employers with defined benefit schemes to set up such schemes.

Policy and legal implications

6.51 Implementing this approach would require significant changes to both primary and secondary legislation. If it were to be decided that such changes were
desirable in principle, it would be important to ensure that they did not affect pension schemes that wish to continue operating as they do at present, that the proposals were workable and that there were no unintended consequences.

6.52 Detailed consideration of a number of the policy and legal implications is included in Annex A.

**Impact assessment**

6.53 See Annex B.

**Consultation Questions**

16. Would the introduction of conditional indexation schemes add significantly to the risk sharing already available to DB schemes?
17. Is sharing investment risk with pension scheme members through indexation and revaluation provisions a suitable response to the costs and risks facing DB scheme sponsors? Is it acceptable that this risk should be transferred to retirees?
18. Are there other approaches to conditional indexation which you consider to be better?
19. To what extent would DB scheme sponsors adopt this option as a middle ground for continuing to provide some sort of DB provision? If so, in what circumstances? If not, what might be adopted instead?
20. To what extent would DC scheme sponsors be expected to adopt a conditional indexation option to protect their employees from the risks inherent in DC provision?
21. Are the risks of implementing conditional indexation identified in this chapter appropriate? If not, which other risks do you think apply? How likely is it that these risks would materialise?
22. If risk sharing is adopted, what sort of protection for members is appropriate?
23. Does the fact that the risk sharing available to sponsors depends on the rate of inflation reduce the potential value of conditional indexation to them?
Chapter 7: Collective defined contribution schemes

Introduction

7.1 As set out in Chapter 4 collective defined contribution schemes (DC) have been set up in the Netherlands in the past few years. Some proposals developed by Hewitt Associates are discussed below.

7.2 The key difference between these schemes and conditional indexation schemes is that the risks would be shared between the members, rather than between the members and the employer. Employers would have complete certainty over their contributions. These schemes would therefore be purely DC to the employer but offer some of the benefits of defined benefit (DB) to the employee.

Outline

7.3 In a collective DC scheme, the employer pays fixed contributions into the scheme. These contributions are calculated as a percentage of pensionable pay and are paid into a collective fund instead of individual savings accounts.

7.4 Based on the amount of money available from the employer contribution, a targeted rate of pension is calculated. This rate is calculated each year as a percentage of pensionable pay on a career average basis. The collective DC scheme will also target a rate of revaluation which will apply in each year until retirement and to pensions in payment. These benefits look similar to defined benefits, but they are conditional on the funding position of the scheme and are not guaranteed. If the scheme were underfunded, revaluation and indexation would be reduced in the first instance, but benefit levels could also be reduced if the scheme remained underfunded.

7.5 The design of the scheme, with pooled investments and conditional benefits, means that the risks are shared between members. A fall in investment returns causing the scheme to be underfunded, for example, would lead to a reduction in future revaluation and indexation. In case of a significant fall in investment returns, the basic benefits could also be reduced. The impact of the fall in investment returns is spread across all the members, but is designed to impact those approaching retirement less heavily than in a traditional individual DC scheme.

7.6 These collective DC schemes would be occupational schemes where investment decisions were taken collectively by the scheme trustees.
7.7 It has been proposed that the following principles might provide a framework for the regulation of such schemes:

- Prudence in the financial assumptions used to value liabilities, consistent with the risks/rewards of the chosen investment strategy;
- Efficiency in risk-allocation processes, investment management and the administration of benefits and contributions;
- Fair treatment in benefit design covering age, sex, access and early leavers;
- Flexibility to combine collective targeted DB design with individual savings account design;
- Accountability with clear allocation of powers over benefits and contributions appropriate for the chosen risk sharing formulae;
- Governance covering the separation of pension assets from the sponsor, trusteeship and appropriate regulatory oversight;
- Transparency of benefit design and how risks are shared; and
- Disclosure to members of benefits and how different risks will impact them.

Objectives and rationale

7.8 The primary objective of this approach would be to enable employers to provide a pension which gives them the same certainty of cost as a pure DC scheme but which also provides more predictability for members. The shift from DB to DC schemes, as described in Chapter 2, shows that employers are looking for greater certainty of the cost of their pension scheme when considering future provision.

7.9 This approach enables risk to be shared between all the members of the scheme by pooling the investments in one fund. This allows investment returns to be smoothed, avoiding significant negative impacts on those retiring in a downturn.

7.10 In individual DC schemes, members tend to invest in lifestyled funds, where investments are gradually moved into safer assets closer to retirement. Because investments in a collective DC scheme are pooled, scheme can instead invest in more risky assets throughout the life-cycle and seek out the rewards that can be gained from these assets.

7.11 In order to gain further efficiencies from economies of scale in administration and investment management for example, these schemes would need to be large. It has been suggested that these schemes would only really appeal to large employers or industry-wide schemes.
7.12 In a collective DC scheme, investment risk would be pooled across all members via conditional indexation and the possibility of cuts to benefits. Post-retirement longevity risks would be shared between the sponsor (or annuity provider if the sponsor purchases annuities for its members) and member to the extent that if the scheme becomes underfunded due to increased liabilities, indexation would be removed (and benefits be cut) until the funding position improved. The long-term average pre-retirement longevity risk could be borne by either the member or the sponsor depending on the decision of the latter to raise normal pension age.

7.13 Inflation risk would be shared between the sponsor and pensioner members due to the conditional indexation element of the proposal. Default risk would continue to fall on the member or guarantee fund while regulatory risk would stay largely with the sponsor (with the possibility of the member being affected).

Table 7.1: Risk allocation in collective DC schemes

<table>
<thead>
<tr>
<th>Risk borne by:</th>
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</thead>
<tbody>
<tr>
<td><strong>Primary risks</strong></td>
</tr>
<tr>
<td>Investment risk</td>
</tr>
<tr>
<td>Longevity risk:</td>
</tr>
<tr>
<td>Specific, post-retirement</td>
</tr>
<tr>
<td>Average cohort, post-retirement</td>
</tr>
<tr>
<td>Long-term average, pre-retirement</td>
</tr>
<tr>
<td><strong>Secondary risks</strong></td>
</tr>
<tr>
<td>Inflation risk</td>
</tr>
<tr>
<td>Default risk</td>
</tr>
<tr>
<td>Regulatory risk</td>
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</tbody>
</table>

**Risks**

7.14 **Demand**

These schemes would be quite different from any pension scheme design seen in the UK to date so it is difficult to estimate the demand for them. The schemes would need to be large in order to generate efficiencies and therefore industry-wide schemes would seem attractive. Historically there have been few industry-wide schemes in the UK, and the schemes might not fit easily with the UK industrial relations system. It has been suggested that large employers with a closed DB scheme may choose to open a collective DC scheme to move away from two-tier pension provision.
7.15 **Communications with members**
These schemes are different from those operating in the UK today and would be more complicated to understand than a pure DB or a pure DC scheme. Trustees would, of course, continue to protect members’ interest, but there is a risk that people find the benefits more difficult to understand and therefore choose not to participate in the scheme. It would be essential to communicate the nature of the benefits to the members and schemes.

7.16 **Fit with the current regulatory framework**
Introducing these schemes would require a new definition of “collective money purchase schemes” to sit alongside the existing definition of “money purchase scheme”. This would involve a significant amount of policy and legislative work.

### Policy and legal implications

7.17 Under this approach employer contributions would be calculated as a percentage of pensionable pay, at a fixed rate. This looks like a DC arrangement. However, the proposal also suggests that the pension earned in each year is calculated as a percentage of pensionable pay, on a career average basis and revaluation paid both up to retirement and in retirement.

7.18 Section 181 of the Pensions Act 1993, gives the following definition of money purchase benefits:

“money purchase benefits”, in relation to a member of a personal or occupational pension scheme or the widow, widower or surviving civil partner of a member of such a scheme, means benefits the rate or amount of which is calculated by reference to a payment or payments made by the member or by any other person in respect of the member and which are not average salary benefits.

7.19 Since the approach envisages calculating the benefits with reference to the members’ salaries in each year, such a scheme would not be ‘money purchase’ under the current legislation and, if introduced without any changes to the legislation, it would therefore be subject to the same regulations as any other average salary scheme (for example scheme funding and the Pension Protection Fund).

7.20 In order to be able to introduce these schemes as defined contribution schemes in this country, a new definition of “collective money purchase scheme” in legislation to sit alongside existing definition of “money purchase scheme” would be required.

7.21 In defining a collective defined contribution scheme we would need to consider legal precedents and obligations under European Law. The Court of Appeal’s judgment in the AON trustees v KPMG case[^33^], held the scheme to be a DB scheme.

[^33^]: Aon Trust Corporation Ltd v KPMG (a firm) and others [2005] EWCA Civ 1004
scheme because it used actuarial factors to calculate benefits. This appears very similar to the way in which a collective DC scheme would calculate benefits.

7.22 In order to be consistent with the UK’s obligations under the European Occupational Pensions (IORP) Directive it would need to be very clear that these schemes were not offering any promise or guaranteed level of benefits. If some level of benefits were promised and employer contributions were fixed, the scheme could become underfunded if actuarial assumptions about investment growth, longevity or future active membership levels proved to be wrong. The scheme would then be required to make up deficiencies in funding to provide for accrued benefits.

7.23 The key factor in making this scheme viable is that no promises are made as to levels of benefit accrued, or to the level of pension payable on retirement. The level of benefit would be determined at the point of conversion to an annuity on retirement.

7.24 In collective DC schemes in the Netherlands such guarantees have been removed, often in return for a “risk premium” paid by the employer. This has tended to put the schemes in a very strong funding position. The “risk premium” effectively acts as a buffer to help the scheme absorb any unforeseen falls in investment returns or increases in longevity.

7.25 If a collective DC scheme were to provide its own annuities based on the size of the member’s ‘pot’ at retirement, it would be subject to the regulatory own funds requirements (Article 17 of the IORP Directive, implemented in the UK by the Occupational Pension Schemes (Regulatory Own Funds) Regulations 2005 (SI 2005/3380)). It would therefore be required to hold additional assets above the scheme’s technical provisions in order to absorb any unforeseen expenses.

Impact assessment

7.26 See Annex B.

Consultation Questions

24. Would the introduction of collective DC schemes add significantly to the risk sharing already available to DB schemes?
25. Is sharing investment risk between pension scheme members through indexation and revaluation provisions a suitable response to the costs and risks facing DB scheme sponsors?
26. To what extent would DB scheme sponsors adopt this option as a middle ground for continuing to provide some sort of DB provision? If so, in what circumstances? If not, what might be adopted instead?
27. To what extent would DC scheme sponsors be expected to adopt a collective DC option to protect their employees from the risks inherent in DC provision?
28. Do you think members would accept this way of sharing risk?
29. Are the principles for the regulation of collective DC schemes appropriate? If not, which other principles would be appropriate? Would these schemes be able to operate under these principles?

30. Is the attraction of collective DC great enough to justify the creation of new regulatory regime for them? Are the other ways in which they would be permitted?

31. What else could be done to increase the certainty or predictability for members in DC schemes?
Chapter 8 – Consultation Arrangements

8.1 This consultation looks at a range of ways in which risks could be shared in pension schemes and considers the advantages and disadvantages associated with different approaches.

8.2 The objectives of the consultation are to explore ways in which we can encourage and support good quality pension provision and to gather evidence and opinions on risk sharing in occupational pensions.

8.3 The consultation period begins on 5 June 2008 and runs until 28 August 2008.

8.4 The Government would welcome your responses to any aspect of the consultation document, but in particular the following questions:

<table>
<thead>
<tr>
<th>Chapter 1: Introduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Given that we have protected scheme members and are bringing in measures to combat undersaving, should we undertake a far-reaching deregulation of the way risks are shared in pension schemes?</td>
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</table>

<table>
<thead>
<tr>
<th>Chapter 2: The decline in defined benefit provision</th>
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<tbody>
<tr>
<td>2. Are you aware of any additional evidence of the actual impact of lower contributions into DC schemes when all these complicating factors are taken into account?</td>
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</table>

<table>
<thead>
<tr>
<th>Chapter 3: An overview of risk in pension provision</th>
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<tbody>
<tr>
<td>3. Is our characterisation of the allocation of risks in DB and DC schemes correct?</td>
</tr>
<tr>
<td>4. Which parties are best placed to bear each risk?</td>
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</tbody>
</table>

<table>
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<tr>
<th>Chapter 4: Risk Sharing: International Comparisons</th>
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</thead>
<tbody>
<tr>
<td>5. Are you aware of any further international examples, or details of the experiences outlined above, which would be relevant to the debate on risk sharing in this country?</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter 5: Risk sharing within the current regulatory framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>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?</td>
</tr>
</tbody>
</table>
| 7. Would this greater flexibility encourage employers who are
considering a move out of DB provision to continue to bear some risk rather moving fully to DC?
8. Would employers currently offering DC consider a move to a risk sharing arrangement?
9. Do employers consider the existing risk sharing options (for example cash balance schemes, career average) when looking at alterations to DB pension arrangements?
10. Have you considered any options other than those outlined in this chapter?
11. Have the existing options proved inadequate and if so how?
12. What could be done to regulation, legislation to make the risk sharing alternatives discussed in this chapter easier to achieve?
13. What could be done in information or guidance to make the risk sharing alternatives discussed in this chapter easier to achieve?
14. Is the DB legislative framework disproportionate for cash balance schemes? Should the legislative framework be changed to allow schemes more freedom to apply revaluation and to increase annuity options available to members?
15. Are you aware of any issues related to age discrimination in cash balance schemes in the UK today? Is this an issue which is stopping employers from setting up cash balance schemes?

Chapter 6: Conditional indexation schemes

16. Would the introduction of conditional indexation schemes add significantly to the risk sharing already available to DB schemes?
17. Is sharing investment risk with pension scheme members through indexation and revaluation provisions a suitable response to the costs and risks facing DB scheme sponsors? Is it acceptable that this risk should be transferred to retirees?
18. Are there other approaches to conditional indexation which you consider to be better?
19. To what extent would DB scheme sponsors adopt this option as a middle ground for continuing to provide some sort of DB provision? If so, in what circumstances? If not, what might be adopted instead?
20. To what extent would DC scheme sponsors be expected to adopt a conditional indexation option to protect their employees from the risks inherent in DC provision?
21. Are the risks of implementing conditional indexation identified in this chapter appropriate? If not, which other risks do you think apply? How likely is it that these risks would materialise?
22. If risk sharing is adopted, what sort of protection for members is appropriate?
23. Does the fact that the risk sharing available to sponsors depends on the rate of inflation reduce the potential value of conditional indexation to them?

Chapter 7: Collective defined contribution schemes
24. Would the introduction of collective DC schemes add significantly to the risk sharing already available to DB schemes?
25. Is sharing investment risk between pension scheme members through indexation and revaluation provisions a suitable response to the costs and risks facing DB scheme sponsors?
26. To what extent would DB scheme sponsors adopt this option as a middle ground for continuing to provide some sort of DB provision? If so, in what circumstances? If not, what might be adopted instead?
27. To what extent would DC scheme sponsors be expected to adopt a collective DC option to protect their employees from the risks inherent in DC provision?
28. Do you think members would accept this way of sharing risk?
29. Are the principles for the regulation of collective DC schemes appropriate? If not, which other principles would be appropriate? Would these schemes be able to operate under these principles?
30. Is the attraction of collective DC great enough to justify the creation of new regulatory regime for them? Are the other ways in which they would be permitted?
31. What else could be done to increase the certainty or predictability for members in DC schemes?

How to respond

8.5 If you would like to respond to some or all of the above questions, please reply by letter or email.

8.6 The deadline for responses is 28 August 2008. Please send your responses to:

Mary Ball
Deregulatory Review, Department for Work and Pensions
3rd Floor, The Adelphi
1 – 11 John Adam Street
London, WC2N 6HT

Email: adelphi.deregulatoryreview@dwp.gsi.gov.uk
Phone: 020 7712 2756

8.7 It would be very helpful when responding to indicate whether you are responding as an individual or representing the views of an organisation. If responding on behalf of a larger organisation please make it clear whom the organisation represents and, where applicable, how the views of members were assembled.
Queries about the content of this document

8.8 Any queries about the subject matter of this consultation should be made to:

Mary Ball
Deregulatory Review, Department for Work and Pensions
3rd Floor, The Adelphi, 1 – 11 John Adam Street
London, WC2N 6HT

Email: adelphi.deregulatoryreview@dwp.gsi.gov.uk
Phone: 020 7712 2756

Alternative ways of being involved in the consultation

8.9 We want to ensure that we get views from as broad a range of people as possible about this issue. As well as written responses to the questions we ask in this document, and any other points you would like to make, we will arrange discussion sessions and workshops for people to tell us what they think.

8.10 Details of the consultation events we have planned, and copies of the consultation documents, can also be found in the consultations section of our website http://www.dwp.gov.uk/consultations/2008/

8.11 We have sent this consultation document to a large number of people and organisations who have already been involved in this work or who have expressed an interest. Please do share this document with, or tell us about, anyone you think will want to be involved in this consultation.

Freedom of Information

8.12 The information you send us may need to be passed to colleagues within the Department for Work & Pensions and published in a summary of responses received, and referred to in the published consultation report.

8.13 All information contained in your response, including personal information, may be subject to publication or disclosure if requested under the Freedom of Information Act 2000. By providing personal information for the purpose of the public consultation exercise, it is understood that you consent to its disclosure and publication. If this is not the case, you should limit any personal information which is provided, or remove it completely. If you want the information in your response to the consultation to be kept confidential, you should explain why as part of your response, although we cannot guarantee to do this. We cannot guarantee confidentiality of electronic responses even if your IT system claims it automatically.

8.14 If you want to find out more about the general principles of Freedom of Information and how it is applied within DWP, please contact:
8.15 Please note that Charles and his team are unable to answer any questions you may have about the consultation exercise itself. Questions about the consultation should be made to the contact in paragraph 8.4.


The Consultation Criteria

8.17 The consultation is being conducted in line with the Code of Practice on Consultation. The six consultation criteria are as follows, and the full version can be accessed at the Cabinet Office website:

- consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy;
- be clear about who may be affected, what questions are being asked, and the timescale for responses;
- ensure that your consultation is clear, concise and widely accessible;
- give feedback regarding the responses received and how the consultation process influenced the policy;
- monitor your department’s effectiveness at consultation, including through the use of a designated Consultation Co-ordinator; and
- ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

Feedback

8.18 A summary of responses will be published following the consultation. The Government will aim to publish this summary within three months of the consultation closing. The summary of responses will be available on the Department’s website: http://www.dwp.gov.uk/consultations/2008/.

8.19 We value your feedback on how well we consult. If you have any comments on the process of this consultation (as opposed to the issues raised) please contact our Consultation Coordinator:

Name: Roger Pugh
List of organisations included in consultation exercise

Actuarial Profession
Age Concern (England)
Association of British Insurers
Association of Consulting Actuaries
Association of Corporate Trustees
Association of Pension Lawyers
BAE Systems
Barclays
BBC
British Airways
British Chambers of Commerce
Carers UK
Church of England
Clarks
Confederation of British Industry
Department for Social Development in Northern Ireland
DSG International
Engineering Employers’ Federation
Equal Opportunities Commission
Equality and Human Rights Commission
Federation of Small Businesses
Financial Services Authority
Help the Aged
Hewitt Bacon and Woodrow
HM Revenue and Customs
HM Treasury
House of Fraser
Hundred Group
Institute of Chartered Accountants
Investment Managers Association
Marks and Spencer
Mothercare
National Association of Pension Funds
Nationwide
Occupational Pensioners’ Alliance
Pensions Management Institute
Pensions Policy Institute
Pension Protection Fund
SAUL Trustee Company
Society of Pension Consultants
Tesco
The Automobile Association
The Co-operative Group
The Pensions Advisory Service
The Pensions Regulator
The Railways Pension scheme
TUC
Unilever
Unite
Which
Annex A: Policy and Legal Considerations

Conditional Indexation – Career Average Schemes

Definition of a conditional indexation scheme

A.1  Section 51 of the Pensions Act 1995 requires that occupational pension schemes, which are not money purchase schemes, must provide certain increases to pensions in payment. The proposed conditional indexation schemes would not be required to provide these increases.

A.2  Conditional indexation schemes would involve an entitlement to a payment which depends on the existence of specified pre-conditions. The scheme would have to pay indexation and revaluation, subject to a cap, unless the scheme becomes underfunded.

A.3  In the pensions context, two examples of conditional entitlement to a particular benefit are authorised payments from scheme funds to sponsoring employers and authorised payments (at favourable tax rates) to members of schemes (see Part 4 of the Finance Act 2004). The principles used in these circumstances could provide a guide to designing the legislative framework for this type of scheme.

A.4  The basic principle is that where legislation grants a conditional entitlement it must clearly specify:

- the general rule (i.e. the legislative requirements which will apply in the absence of particular facts); and
- the conditions which must be met in order to disapply the general rule.

A.5  This approach would allow schemes to continue to operate as they do today, if they wish, but would also provide the flexibility within the regulatory framework to enable employers to operate conditionally indexed schemes.

A.6  In the case of conditionally indexed career average schemes the general rule would remain as now – that schemes are required to pay indexation on pensions in payment, subject to a cap of 2.5 per cent (section 51 of the 1995 Act).

A.7  There would then be a number of conditions that would need to be met in order to disapply this general rule. The conditions might be:
- The scheme must be underfunded

Section 51 would continue to apply the normal requirements for indexation, unless the scheme assets fell below a particular level (specified in secondary legislation). Where the scheme assets fall below the specified level and the scheme actuary (or other prescribed person) issues a certificate confirming this, the scheme would not be required to index benefits for that year.

- The scheme must be a career average scheme

The Association of Consulting Actuaries (ACA) has suggested that this type of scheme should be a career average scheme as this would enable conditional indexation and revaluation to apply fairly across the membership. One of the conditions for disapplying the general rule would therefore be that the scheme must be a career average scheme.

- The scheme must apply the same rules to all members of the scheme – whether active, deferred or pensioner.

DWP legislation does not require career average schemes to revalue salaries, provided that active and deferred members are treated equally, so there is nothing at present in legislation to stop career average schemes applying revaluation in way envisaged by the ACA. However, in order for these schemes to operate as intended, we would need to ensure that schemes operating conditional indexation applied it equally to all members – whether active, deferred or pensioner.

- The scheme must make this decision subject to actuarial advice

It might be necessary to set out a condition which provides some rules on the way the decision would be made.

Preservation

A.8 Section 72 of the Pension Schemes Act 1993 requires that there should be no discrimination between deferred benefits and benefits payable to those who remain in pensionable service until normal pension age.

A.9 This approach does not appear to discriminate, as any restriction on the revaluation of salaries would apply equally to deferred and non-deferred benefits and would therefore be in line with the legislation on preservation.

Adjustment of normal retirement age and age discrimination

A.10 A discussion of changes to normal pension age was included in Chapter 5. In addition, the ACA has proposed that flexibility in normal pension age should only apply to those members more than 10 years from retirement. This raises
questions about the UK’s obligations under European Union age discrimination legislation.

A.11 There would seem to be grounds for younger workers to argue that the ACA proposal would indirectly discriminate against them on the basis of their age. In the case of an increase in normal pension age, younger workers might argue that they are discriminated against when compared to workers within 10 years of retirement who were allowed to retain their original normal pension age.

A.12 Given the assumption that this approach would provide for the ability to alter normal pension age, younger workers could have further grounds for complaint when compared with their colleagues within the ten year window. The rights of the younger workers would lose value if normal pension age increased, whilst those of their older colleagues would not be affected.

A.13 The Employment Equality (Age) Regulations 2006 implement the age strand of the European Equal Treatment Directive (Directive 2000/78 EC) which prohibits age discrimination in the workplace. However, it also gives Member States some discretion to permit different treatment on age grounds within the context of national law when ‘objectively and reasonably justified by a legitimate aim’ and more specifically to fix ages for entitlement to retirement benefits including the fixing of different ages for employees or groups or categories of employees.

A.14 Recognising that many age-related rules and practices are fundamental to the operation of pension schemes, the Age Regulations currently exempt many age-related rules, practices or decisions as listed in Schedule 2.

A.15 The ACA proposal would necessitate amendments to Schedule 2 to include extra exemptions to allow employers and trustees to exercise the proposed power to increase the normal pension age as of right and to operate an exemption for persons within ten years of retirement.

A.16 Before agreeing to amend Schedule 2 the Government would have to be satisfied that the proposed exemptions did not constitute discrimination prohibited by Directive 2000/78/EC.

A.17 The Government would need to consider in detail whether such an exemption could be justified. In particular, we would welcome your views (and any evidence in relation to the position experienced by pension schemes) on the use of the following points to support this justification:

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34 Directive 2000/78/EC, Article 6(1) and (2)
35 Where a particular age-related rule is not covered by a specific exemption in the Age Regulations it may still be lawful. Whether or not it can be so considered is a matter for an employer, and/or pension scheme trustees and administrators, in the light of their specific circumstances.
36 Though without this exemption schemes could still take steps to objectively justify such a practice on a scheme-by-scheme basis.
Schemes need to be allowed to raise normal pension age as of right as a result of:

- increased pressure on funding due to increased life expectancy and other factors; leading to
- increased likelihood of scheme closure, which would not be in the interests of scheme members.

Those within ten years of normal pension age should be excluded from this because:

- employers need certainty about the age employees will reach normal pension age; and
- those within ten years of retirement need more certainty than their younger colleagues about when they will be able to afford to retire\(^{37}\).

### Scheme funding

A.18 As set out in the discussion on moral hazard, appropriate scheme funding legislation would be essential to the correct functioning of these schemes.

A.19 The ACA has suggested that the current scheme funding regime should apply to conditional indexation schemes and that the rules for cutting revaluation or increases to pensions in payment should be set out in scheme rules. The statement of funding principles would be used to ensure that schemes were functioning as proposed.

A.20 Trustees would be required to target future revaluation and increases, and would be required, as they are currently, to use prudent assumptions in actuarial valuations of their scheme. The term ‘targeting’ might be difficult to define in legislation. However, it may be that ‘targeting’ is a misnomer. Essentially, the scheme would need to set out, in scheme rules (as today), what level of revaluation and increases it was aiming to provide, and fund for these benefits in the same way as it funds for the nominal benefits. If the scheme, due to unexpected increases in cost, runs into a deficit over the valuation period, the conditional indexation and revaluation would allow the employer to reduce these benefits.

A.21 The ACA has suggested that recovery plans and annual valuations would be used as a tool to ensure that employers were not intentionally continuing to underfund the schemes. Recovery plans would need to accommodate withholding of future LPI and revaluation. This could be achieved through secondary legislation. The requirement for annual valuations rather than triennial where revaluation and LPI have not been provided in full would also require a change to secondary legislation.

\(^{37}\) In particular, we would welcome views on why the break should be placed at 10 years rather than another arbitrary point.
Winding up, employer debt and surplus

A.22 This approach suggests that the debt on the employer should only include indexation and revaluation liabilities accrued to the date of wind-up but that any possible future indexation or revaluation would be excluded. This would be different from the scheme funding regime where the employer would, under normal circumstances, be required to fund for future revaluation and increases in pensions in payment.

A.23 Conditionally indexed schemes would be required to pay full indexation and revaluation as long as the scheme is fully funded. If a scheme were to be fully funded when it entered wind-up, it could therefore be argued that it follows that the full obligations (including revaluation and indexation) should be included in the buy-out calculation. The case for full indexation may be less clear where the scheme is underfunded, but if employers could cease to participate in the scheme and the buy-out value could be calculated without including any rights for revaluation and indexation this would pose something of a moral hazard.

A.24 As set out in the section on moral hazard above, it is unlikely that the employer would have an incentive to underfund the scheme on an ongoing basis, but if they were to decide that they no longer wanted to keep the scheme, they might find it relatively easy to wind it up and walk away with a surplus.

A.25 In order to reduce such incentives, a condition could be set out which would not allow the return of surplus to the employer unless the scheme was funded to a level which would enable all accrued and future benefits, including revaluation and indexation, to be paid. This would need to be certified by the actuary and could be achieved through changes in secondary legislation. Changes to surplus regulations would then feed through to employer debt.

A.26 If conditional indexation schemes were to be introduced, the Government would need to consider the impact of any changes to wind-up and employer debt legislation on multi-employer schemes. This might be best achieved by requiring that all multi-employer schemes which choose to apply conditionally indexation are segregated schemes.

The Pension Protection Fund

A.27 The Pension Protection Fund (PPF) pays compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover PPF levels of compensation.

A.28 PPF protection is provided through compensation based on scheme rules. Compensation is paid at two levels:
- 100 per cent level of compensation for people who have reached the scheme’s pension age and for those under the scheme’s pension age who are either in receipt of survivors’ benefit or already in receipt of pension on the grounds of ill-health; and
- 90 per cent level of compensation for people below that age, subject to an overall compensation cap and subject to a review of the scheme’s rules.

A.29 Compensation is funded by assets inherited from schemes for which the PPF assumes responsibility supplemented by investment income and the annual Pension Protection Levy raised from eligible schemes.

A.30 Conditional indexation schemes would not have the same certainty about future benefits to be paid to members and it would therefore be more difficult to define the level of compensation and the Pension Protection Levy in respect of such schemes.

A.31 The ACA has for instance suggested that the PPF should not be required to provide compensation for future revaluation or indexation, but compensation would be provided for 100 per cent of the benefits with no cap though it is not clear what the justification for this change to PPF compensation is.

A.32 A key principle is that PPF compensation should not exceed scheme benefits and the 90 per cent level of compensation and the application of a cap of £27,770 per year are important features of the compensation regime designed to ensure that trustees, high earners, and others in positions of influence in a company or pension scheme have a clear incentive to ensure the proper management and funding of the scheme. These incentives would be seriously diminished if no one would lose out should a scheme be inadequately funded.

**Transfer values**

A.33 The ACA has proposed that transfer values should reflect revaluation and indexation already accrued but not future conditional indexation and revaluation. Instead, the accrued defined benefits would be valued on a discount rate reflecting the yield on UK Government bonds. The methodology for valuing pension rights applies not just to the calculation of transfer values but also in other areas including pension sharing on divorce. Whilst this section of the consultation document focuses on transfer values, a full evaluation of the proposals as they applied to pension sharing would also be needed before any legislation was introduced.

A.34 The impact of using a gilt discount rate and not including indexation and revaluation in calculating cash equivalent transfer values could be significant. This illustrative example compares the cash equivalent transfer value of a deferred benefit, with a retirement age of 65 and a 50 per cent spouse’s pension, using two approaches:
i. statutory 2.5 per cent revaluation before and statutory 2.5 per cent LPI indexation after retirement, using an equity-oriented discount rate before retirement; and
ii. no revaluation before and no indexation after retirement, using a gilt discount rate (assumed to be 1 per cent a year less than the equity-oriented discount rate).

A.35 The transfer value from approach i at age 65 might be around 30 per cent more than the value under approach ii. For younger deferred members, the difference would be greater, so that for an individual aged 35 the value of approach ii would only be around 50 per cent of that of approach i.

A.36 There are likely to be issues of fairness around this approach to calculating transfer values. An argument could be made that members wanting to transfer were treated unfairly by the proposal and this would need to be fully explored before the proposal could be put into legislation.

A.37 Another option might be to assimilate transfers from conditional indexation schemes within the existing rules on the calculation of transfer values. The calculation of a transfer value is intended to reflect the expected cost to the scheme of the member's benefits if the member had remained in the scheme rather than transferring. For conditional indexation schemes, consideration would need to be given to a number of issues:

- **Revaluation**
  Members who remain in the scheme may or may not have full revaluation during the period until normal pension age. For the calculation of transfer values the issue therefore is whether schemes should be required to revalue the transferring member's benefit to normal pension age when, for members remaining in the scheme, they may not do so.

- **Normal pension age**
  Under these proposals it would be possible for the scheme to change normal pension age, but for the purposes of calculating the transfer value it would make sense to use the normal pension age in place at the time the transfer value calculation is made.

- **Indexation**
  Under these proposals, pensions in payment may or may not be indexed in particular years. As with revaluation, the issue for the purposes of calculating the transfer value is whether schemes should be assumed to fully index pensions in payment, even though this might actually not be the case.

- **Underfunding**
  Schemes are currently allowed to cut back transfer values if they are underfunded. It would possibly be regarded as unfair if schemes were allowed to factor conditional revaluation and indexation into the calculation as well as allowing them to cut back that transfer value if the scheme was underfunded.
We would welcome views on how the calculation of transfer values from conditional indexation schemes could be assimilated into the existing rules.

A.38 In terms of legislation, section 97(1) of the Pension Schemes Act 1993 contains a very broad regulation making power to the effect that cash equivalents are to be calculated in the prescribed manner. Section 182(2) of that Act allows the regulation making powers in the Act to be used in relation to specified cases or classes of case. Conditional indexation schemes would probably be regarded as a class of case. It is probably the case that there are the necessary powers to make regulations either to give effect to the ACA’s proposal or to make modifications to the existing requirements, perhaps along the lines described above.

Disclosure

A.39 As set out above, due to the complexity of conditional indexation, good communication with members would be important. The Netherlands has rules about what needs to be communicated to members. For example, schemes have to explain at what funding level indexation rights are cut and in what way. Similar rules might need to be considered if conditional indexation was to be introduced in this country.

Contracting out

A.40 The ACA has proposed that these schemes should be contracted in to the State Second Pension (S2P), primarily for purposes of simplicity. Whilst this might be an appropriate way forward on these grounds, it also has an impact on employers’ costs and on members’ pay.

A.41 The contracted-out rebate recognises that schemes contracted out on a DB basis provide benefits in place of S2P. This is achieved through a reduction in the National Insurance contributions paid by both employers and members. Employers factor this rebate into the overall costs of the scheme and, if they moved from a contracted-out DB scheme to a conditionally indexed scheme, they would be expected to set the accrual rate of that scheme at a level which they considered affordable, having regard to the higher National Insurance contributions payable. For members, the loss of the rebate would mean higher National Insurance contributions, in return for which their S2P rights in retirement are of course increased. This means that they would experience a fall in their take-home pay unless they also get a corresponding reduction in their contributions to the scheme (other things being equal).

The employer duty in Pensions Bill 2008

A.42 The qualifying test, under the employer duty in the Pensions Bill 2008, for defined benefits schemes with members whose employment is contracted out of the State Second Pension Scheme is the existence of a contracting-out certificate. This is evidence that the scheme meets the Reference Scheme Test
which is a test of scheme quality for contracted-out schemes\textsuperscript{38}. The Test Scheme Standard establishes a similar test for schemes with members whose employment is not contracted-out. Both tests are based on the comparison of a scheme's pensions against those provided from a hypothetical test scheme or reference scheme.

A.43 If conditional indexation schemes were introduced, they may be able to qualify under the employer duty, provided their benefits were generous enough. Actuaries might need to make an assumption about how often the scheme is likely to reduce or stop paying indexation and revaluation in order to illustrate the level of benefits payable by the scheme. The interaction with the employer duty in the Pension Bill 2008 would need to be considered in more detail if these schemes were to be introduced.

**Compliance and monitoring**

A.44 It is likely that conditional indexation schemes could largely be incorporated within the current regulatory regime from a compliance and monitoring point of view. There are however some additional checks that would need to be carried out:

- That schemes which are underfunded reduce revaluation and increases in pensions in payment in the appropriate manner.
- Annual valuations would be required for schemes that are underfunded and have reduced the levels of revaluation and increases. This could mean increased activity for the Pensions Regulator and would need to be monitored on a regular basis.
- In order to insure against the moral hazard issues discussed above, the Regulator would need to check recovery plans and might be required to intervene in cases of concern.
- Additional communication to members might be required due to the complexity of the scheme and compliance with any new disclosure requirements would need to be checked.

**Conditional Indexation for all schemes**

**Conditional Indexation**

A.45 This approach is different from conditionally indexed career average schemes since they make conditional indexation available to all defined benefit schemes and use only the tool of indexation for risk sharing, rather than both indexation and revaluation. The approach to conditional indexation in the legislation could therefore look somewhat different.

\textsuperscript{38} DB contracted-out schemes are also required to comply with the legislation on indexation and revaluation.
A.46 The approach involves an entitlement to a payment which depends on the existence of specified pre-conditions. The scheme would have to pay indexation, subject to a cap, unless the scheme becomes underfunded. Again, legislation would need to specify:

- the general rule (i.e. the legislative requirements which will apply in the absence of particular facts); and
- the conditions which must be met in order to disapply the general rule.

A.47 In the case of conditional indexation the general rule would remain as now – that schemes are required to pay indexation on pensions in payment, subject to a cap of 2.5 per cent (sections 51 of the 1995 Act).

A.48 Section 51 would continue to apply the normal requirements for indexation, unless the scheme’s assets fell below a particular level (specified in secondary legislation). Where the scheme assets fell below the specified level and the scheme’s actuary (or other prescribed person) issued a certificate confirming this, the scheme would not be required to index benefits for that year. As there are a number of different methods of calculating the value of assets and the scheme’s technical provisions, secondary legislation would also have to specify methods of calculation which may be used.

Other policy considerations

A.49 As this approach is similar to that discussed in the previous section, many of the policy consideration are the same. The Government would need to consider the following issues in the same way as in the previous section:

- scheme funding;
- winding up, employer debt and surplus;
- transfers;
- PPF compensation; and
- disclosure.

A.50 Some of the issues discussed in the previous section are not relevant as they do not apply to these proposals, namely:

- adjustment of normal retirement age and age discrimination – it has not been proposed that these schemes should incorporate a mechanism to change normal retirement age; and
- contracting out.

Contracting Out

A.51 Under these proposals, new schemes could, if they wished, choose to contract out of S2P. This could have implications for the reference scheme test (RST), an overall scheme quality test which schemes must meet to contract out on a DB basis.
A.52 The RST is based on a comparison between the actual scheme benefits and those under the Reference Scheme as set out in legislation. The Reference Scheme provides, for example, for an 80ths accrual rate on average qualifying earnings in the last three tax years of scheme membership; a normal pension age of 65; and a 50 per cent survivors pension. DB contracted-out schemes are also required to comply with the legislation on indexation and revaluation.

A.53 Usually, the respective benefit structures are simply compared but, if necessary, an actuarial assessment is made, comparing the actuarial value of the scheme benefits with the actuarial value of the Reference Scheme benefits. This means that a scheme’s benefits do not need to be the same or better than the Reference Scheme in every respect. For example, a scheme could still pass the RST if it has a pension age higher than 65 provided that some of the other benefits are more generous than the Reference Scheme, for example a higher accrual rate.

A.54 However, the RST provides that discretionary benefits must be ignored in determining whether or not a scheme passes the RST. Conditional indexation would be viewed as a discretionary benefit and it is therefore unlikely that the scheme would be able to pass the RST as things stand.

A.55 If it is likely that new schemes, or new sections of schemes, would wish to contract out under these proposals, changes to the contracting-out legislation would need to be considered. It might be possible to permit conditional indexation to be taken into account for the RST, perhaps as part of an actuarial assessment. It would be important that rules were in place to ensure that it was likely that indexation would be awarded over the period covered by the actuarial assessment. If a scheme was unable to award indexation, the risk would fall on scheme members who would face a reduced scheme pension in retirement as well as reduced entitlement to S2P because of their contracted out status.
Annex B: Impact Assessment

Conditional indexation – career average schemes

B.1 This section provides an initial analysis of what the proposals for conditionally indexed career average schemes might mean for schemes and sponsors as well as for individual members. A full assessment of the impact of conditional indexation would require modelling of scheme funding outcomes that reflects potential future variations in relevant economic variables, and link those outcomes to individual pension accruals. DWP has not commissioned a model of this kind at this stage but the initial analysis set out in this section illustrates the potential impact of these proposals.

Scheme level analysis

B.2 We have used a stochastic model developed by PGGM\textsuperscript{39}, a Dutch pension fund, to look at how these proposals might impact on pension schemes and their members. Further details of the modelling can be found in Annex C.

B.3 The PGGM model is based on the characteristics of the PGGM pension fund and uses assumptions appropriate to the Dutch pensions and economic environment. It cannot be taken as being representative of UK schemes but does illustrate the likely scale of impacts of a switch from unconditional to conditional indexation in the context of one specific career average scheme.

B.4 In the base case of the model, we assume the scheme is initially fully funded, to meet both existing and expected future indexation costs. We then compare, over a 15 year period, the range of outcomes if the scheme provides unconditional indexation (subject to a cap of 2.5 per cent per annum) with outcomes under a conditional indexation arrangement. The conditional indexation rules used are set out in Annex C.

Table B.1: Average indexation quality delivered by the scheme (as a percentage of cumulative inflation over 15 year period)

<table>
<thead>
<tr>
<th></th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Without conditional indexation</td>
<td>82%</td>
</tr>
<tr>
<td>With conditional indexation</td>
<td>73%</td>
</tr>
</tbody>
</table>

Source: DWP modelling

B.5 The average indexation quality refers to the average proportion of cumulative indexation received over the 15 year time horizon of the model. Table B.1 shows that, with unconditional indexation subject to a cap, indexation would on average be 82 per cent of total price inflation. This is less than 100 per cent because the

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\textsuperscript{39} PGGM administers collective pension schemes for the healthcare and social work sector in the Netherlands.
existence of the cap means that less than full indexation is paid in years when inflation rises above the cap. So, for example, pension rights worth £100 in the base year would be worth £82 in real terms by the end of the period with unconditional indexation and £73 with conditional indexation.

B.6 The chart in Figure B.1 shows the projected distribution of outcomes for the scheme funding ratio. The funding ratio is calculated on a nominal basis, which means that it excludes the cost of future indexation. A funding ratio of around 150 means that the scheme is fully funded to the extent that it can pay total liabilities, including full indexation.

Figure B.1: Distribution of the funding ratio, unconditional indexation (left panel) and conditional indexation (right panel)

Source: DWP modelling

B.7 The distributional charts for the funding ratio show that the probability of worse scenarios of underfunding decreases somewhat in the case of conditional indexation compared to the case of unconditional indexation, although the impacts are not particularly marked. Although conditional indexation helps to maintain the funding position of the scheme, the range of potential adverse funding outcomes remains quite wide.

B.8 Figure B.2 shows the projected distribution of the real value of members’ pensions. The relative pension represents the value of the pension as a proportion of the pension that would be paid if benefits were fully linked to inflation (without any cap). Since even in the best economic scenarios the maximum pension received can never exceed 100 per cent of the targeted pension, the chart only shows the outcomes in the bottom half of the distribution. In effect the best 50 per cent of outcomes in the distribution collapse to a straight line at the 100 per cent relative pension outcome line.
B.9 The distributional charts for the relative pension outcome show that the entire distribution of outcomes shifts down under a conditionally indexed scheme compared with the unconditional scheme. Again, however, the distribution is not markedly different, indicating that conditional indexation in this case has a limited impact on the value of members’ pensions.

B.10 We have also tested the sensitivity of these results to altering some of the main assumptions. Annex C sets out more detail on the alternative scenarios and the modelling results.

**Pension outcomes for members**

B.11 The relative pension distribution charts in Figure B.2 above provide some idea of the effects of conditional indexation on the individual member’s pension outcome. However, it is instructive to also look at the impact in terms of monetary amounts.

B.12 The analysis focuses on comparing the pension outcomes on retirement from a conditionally indexed career average scheme with those from a career average scheme with unconditional indexation. For the purposes of this comparison the following assumptions have been made:

- Members have a starting salary of £30,000 on joining the scheme, which rises over time, and spend 30 years in the scheme;
- The asset allocation is 60 per cent equities, 40 per cent bonds; and
- Contribution rates are equal in both schemes and at the level of average DB contribution rates in the UK.

B.13 We have assumed that in one in five years indexation is removed\(^40\). Figure B.3 shows pension outcomes on retirement under both scenarios in 2007/08 earnings terms.

\(^{40}\) This is necessarily a simplistic assumption as actual levels of indexation would depend on scheme funding positions, the precise specification of conditional indexation rules, and the time period considered. Different assumptions would clearly change the ratio between the outcomes.
B.14 The chart shows that as expected, pension outcomes are lower across the distribution of outcomes under conditional indexation. Under conditional indexation pension incomes are estimated to be around 10% lower.

Qualitative assessment of financial impacts for sponsors

B.15 These proposals would involve setting up a brand new scheme. The initial setup costs will form a significant part of the costs to the sponsor in implementing this proposal over and above maintaining existing forms of provision. If these proposals were implemented they would be optional and the costs in this section would therefore only arise if the scheme sponsor chooses to take up the option.

B.16 There will also be the costs involved in running the scheme, but it is not clear that these would be any greater under these proposals than would be the case for an existing DB scheme. Examples of on-going costs will include:

- Cost of professional advice;
- Cost of compliance with regulations (which may also feed through to the cost of professional advice); and
- Administration costs – the costs of communicating to members information about their benefits, which may be higher under these proposals due to the complexity of the scheme, the requirement for annual valuations.

B.17 A potential saving to the sponsor arising from these proposals would be realised by moving from a final salary to a career average DB scheme. It has already been noted in Chapter 5 that moving from a final salary DB scheme to a career average scheme can reduce costs.

B.18 The issue of whether savings would also arise from conditional indexation is less clear cut. If the scheme were always sufficiently well-funded, indexation
would always be paid and there would be no savings. In the event of indexation being removed, the sponsor must make good the lost indexation when the scheme’s funding position improves sufficiently. As long as the lost indexation is fully compensated later on there would be no net saving to the sponsor – all that changes is the timing of the payment. The sponsor would only make a net saving in the long-run if the catch-up indexation did not compensate the full value of the lost indexation.

B.19 So the real benefit of this type of conditional indexation scheme to the sponsor would not be the ability to make savings, but the cashflow impact – the ability to shift expenditure from times of low scheme funding to times of higher scheme funding. Deferring the payment of indexation to times when the scheme’s funding position is better frees up money to improve the financial health of the scheme when it is needed most. This should make for a more sustainable pension arrangement.

Conditional Indexation for all schemes

Scheme level analysis

B.20 The proposals in this section are very similar to the proposals for conditional indexation career average schemes and the impacts are therefore similar. The scheme-level analysis in the previous section also provides some insight into the Lewin proposals. The reader is therefore referred to the relevant section of the previous section.

Pension outcomes for members

B.21 In order to consider the impact of these proposals on individual members’ pension outcomes, we have undertaken some modelling of outcomes under the current indexation regime and the proposed conditional variant. Since the Lewin proposal would apply to all existing DB schemes, it is best conceived of as applying to final salary schemes, since these form the majority of DB schemes in the UK.

B.22 The analysis therefore focuses on comparing the pension outcomes on retirement from a conditionally indexed final salary scheme with those from a final salary scheme with unconditional indexation. For the purposes of this comparison the following assumptions have been made:

- Members have a starting salary of £30,000 on joining the scheme, which rises over time, and spend 30 years in the scheme;
- The asset allocation is 60 per cent equities, 40 per cent bonds; and
- Contribution rates are at the level of average DB contribution rates in the UK.
B.23 We have assumed that indexation is removed one in every five years\textsuperscript{41}. The chart below shows pension outcomes 10 and 20 years after retirement (since the proposal affects pensioners only) under both scenarios in 2007/08 earnings terms.

**Figure B.4: Pension outcomes 10 and 20 years after retirement for a final salary scheme, under conditional and unconditional indexation, 2007/08 earnings terms**

![Chart showing pension outcomes](chart.png)

Source: DWP modelling

B.24 The chart shows that as expected, pension outcomes are lower under conditional indexation. Under conditional indexation pension incomes are estimated to be around five per cent lower 10 years after retirement and around 10 per cent lower 20 years after retirement.

**Qualitative assessment of financial impacts for sponsors**

B.25 This proposal would be the simplest and cheapest to implement from the viewpoint of the employer since it would not require the setting up of a new scheme (unless the employer chose to do so). Instead the desired effect could be achieved by opening a new section of an existing scheme. However, this would result in the cost of tracking a new set of pension accruals subject to a different indexation policy regime.

B.26 If these proposals were implemented they would be optional and the costs in this section would therefore only arise if the scheme sponsor chooses to take up the option.

B.27 Beyond that there would also be the usual costs involved in running the scheme; again it is not clear that these would be any greater under these

\textsuperscript{41} This is necessarily a simplistic assumption as actual levels of indexation would depend on scheme funding positions, the precise specification of conditional indexation rules, and the time period considered. Different assumptions would clearly change the ratio between the outcomes.
proposals than would be the case for an existing DB scheme. Examples of ongoing costs would include:

- Cost of professional advice;
- Cost of compliance with regulations (which may also feed through to the cost of professional advice);
- Administration costs – in particular the costs of communicating to members information about their benefits, which may be higher under these proposals due to the complexity of the scheme.

B.28 The conditional indexation feature is not devised to produce savings, rather to allow the deferment of indexation payments to a point where the scheme’s funding position is healthier. The sponsor would only realise savings if lost indexation is not fully re-paid. There is a greater chance of this happening under these proposals compared to the ACA variant purely because the former applies conditional indexation only to pensioners. Since, all else being equal, pensioner members will have a greater risk of dying sooner than active or deferred members, there is a greater chance that pensioners (especially older ones) might not live to see any lost indexation fully repaid. In such circumstances the sponsor would make a financial gain.

Collective defined contribution schemes

Pension outcomes for members

B.29 The analysis in this section focuses on the pension outcomes for members in collective DC schemes compared to individual DC schemes. For the purposes of comparison both arrangements are assumed to have the following features:

- Members have a starting salary of £30,000 on joining the scheme and spend 30 years in the scheme;
- The fund is invested in equities and property for most of the pre-retirement phase. Under individual DC a gradual switch into bonds is assumed in the 5 years prior to retirement. For collective DC the scheme is invested in equities and property throughout the accumulation phase;
- Members buy a level annuity at retirement with an external provider and leave the scheme.

B.30 Under the collective DC arrangement there is a target amount of pension each year. This target is calculated allowing for revaluations prior to retirement that are expected to broadly match rises in inflation. However, these revaluations are not guaranteed and provide the risk sharing mechanism for the collective DC scheme.

B.31 The implication of this is that active and deferred members bear all the risk of lost indexation, with pensioners not bearing any. However, this model has been
designed specifically to provide a meaningful comparison with individual DC; in practice the market might develop different risk sharing mechanisms for different situations which would be tailored for specific circumstances.

B.32 Figure B.5 shows the results of modelling that compares outcomes under individual DC and collective DC.

**Figure B.5: Distribution of pension outcomes on retirement in individual DC and collective DC schemes with equal expense levels, 2007/08 earnings terms**

![Distribution of pension outcomes](image)

Source: Hewitt Associates; assumes an expense level of 0.4 per cent per annum.

B.33 Figure B.5 compares the range of pension that might be paid under individual and collective DC for an individual retiring after 30 years in the scheme. The chart is generated by considering 5,000 different scenarios of investment conditions over the next 30 years. For each scenario the pension that would be paid at retirement from both collective and individual DC has been calculated. These outcomes are then corrected for wage inflation over the 30 year period and ranked according to the ‘real’ size of pension that would result.

B.34 The thick black line on the chart represents the median pension for individual and collective DC. This is the level of pension a member would have an equal chance of receiving more (or less) than. The bars illustrate the range of outcomes in 90 per cent of the scenarios tested. The chart illustrates that, for this model, collective DC has a higher median level of pension with a smaller range of possible outcomes. The higher median pension reflects the assumption that collective DC schemes would not switch into less risky investments as individuals approach pension age.

B.35 Pension outcomes under collective DC show less variability compared with outcomes under individual DC, reflecting the transfer of risk from members closer to retirement to younger members. This feature would diminish as the scheme matured.
B.36 A further benefit of the collective DC scheme is that, for the majority of members, it would be cheaper to run than individual DC. Individual savings accounts, individual investment decisions and switching would not be needed under collective DC.

B.37 Evidence suggests that, at the moment, individual DC schemes incur expenses that average out at around 0.7 per cent per annum for a typical medium-sized employer\(^{42}\). Some larger schemes will be less than this, but personal arrangements with active management and lifestyle options can be considerably more. Multi-employer collective DC schemes would benefit from economies of scale and collective bargaining power and should incur a lower level of expenses that are estimated to be around 0.2 per cent\(^{43}\). Figure B.6 illustrates the effect of allowing for this difference in expense levels by repeating the analysis of Figure B.5 above using different expense levels.

**Figure B.6: Distribution of pension outcomes on retirement in individual DC and collective DC schemes with different expense levels, 2007/08 earnings terms**

<table>
<thead>
<tr>
<th>£0</th>
<th>£5,000</th>
<th>£10,000</th>
<th>£15,000</th>
<th>£20,000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Collective DC</strong></td>
<td>5%-25%</td>
<td>25%-50%</td>
<td>50%-75%</td>
<td>75%-95%</td>
</tr>
<tr>
<td><strong>Individual DC</strong></td>
<td>5%-25%</td>
<td>25%-50%</td>
<td>50%-75%</td>
<td>75%-95%</td>
</tr>
</tbody>
</table>

Source: Hewitt Associates; assumes an expense level of 0.7% per annum in individual DC and 0.2% per annum in collective DC.

B.38 The chart shows that the impact of differing charge levels is significant. Now the difference in median pension outcomes under collective DC and individual DC is even higher and there is even less variability in comparison to the outcomes under individual DC.

B.39 The analysis demonstrates the three main advantages of a collective DC scheme over an individual DC scheme:

- collective DC schemes can hold assets with a greater risk-reward profile for longer without jeopardising individuals closer to retirement. This in turn generates a higher level of benefits;

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\(^{42}\) Source: Hewitt Associates

\(^{43}\) Source: Hewitt Associates
• risk sharing allows collective DC schemes to provide members close to retirement with more predictable benefits by transferring risk to younger members; and
• collective DC schemes will normally be cheaper to run than individual DC schemes, as individual savings accounts, individual investment decisions and switching would not be needed.

**Qualitative assessment of financial impacts for sponsors**

B.40 As with the conditional indexation proposals, the collective DC proposal would involve setting up a new scheme. Thus the sponsor would incur the initial set up costs associated with the new scheme. If these proposals were implemented they would be optional and the costs in this section would therefore only arise if the scheme sponsor chooses to take up the option.

B.41 The only on-going cost to the employer will be the fixed contribution rate. The employer would not incur the costs associated with running a DB scheme. The key attraction from an employer viewpoint is that collective DC retains the fixed costs and resulting certainty of traditional DC schemes.

B.42 Administration costs in the collective DC scheme would be borne by the individual member and not the sponsor. As discussed in paragraph B.36, administration costs should be lower in a collective DC scheme in comparison to an individual DC scheme.

B.43 The conditional indexation element and cuts to accrued benefits bring no financial benefit to the sponsor, who always pays the fixed contribution rate regardless of the scheme’s funding position. In this proposal, conditional indexation and the reduction of accrued benefits are used as tools to bring the scheme to a more sustainable funding level – at no point does the sponsor derive any financial benefit from cutting indexation or accrued benefits.
**Summary: Intervention & Options**

**Department /Agency:** Department for Work and Pensions  
**Title:** Impact Assessment of the Government consultation on risk sharing pension schemes

<table>
<thead>
<tr>
<th>Stage: Consultation</th>
<th>Version: Consultation Stage</th>
<th>Date: 5 June 2008</th>
</tr>
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</table>

**Related Publications:**

Available to view or download at: [http://www.dwp.gov.uk/pensionsreform](http://www.dwp.gov.uk/pensionsreform)

**Contact for enquiries:** Mary Ball  
**Telephone:** 020 7712 2756

**What is the problem under consideration? Why is government intervention necessary?**

Recent years have seen a decline in the provision of Defined Benefit pensions in the UK which is believed to have been accompanied by a fall in employer contributions. This decline has been driven by a number of factors which have increased the costs and risks faced by employers who run DB schemes. Whether and at what speed the decline of DB provision and its replacement with DC provision continue into the future are crucial for the counterfactual to potential policy options (i.e. what would happen if those options were not adopted).

This consultation explores whether there are sufficient flexibilities within the current regulatory framework, whether there are barriers which should be removed, or whether legislating to allow for new forms of risk sharing scheme is necessary or appropriate.

**What are the policy objectives and the intended effects?**

The policy objective is to encourage employers to continue to provide high quality pensions of a form that is appropriate to them. The two main forms of pension provision in the UK today, final salary Defined Benefit and pure Defined Contribution, allocate risks mainly to the employer and mainly to the individual member respectively. Risk sharing is possible under the current regulatory framework but has not been widely taken up. Providing employers with greater flexibility over the form of pension scheme they offer could encourage the continued provision of good occupational pensions in the UK.

The policy options considered would provide ways in which different types of pension schemes could be established, but this would be at the discretion of scheme sponsors. These options would not impose any mandatory costs on pension schemes or their sponsor employers.

**What policy options have been considered? Please justify any preferred option.**

- Making risk sharing easier within the current regulatory framework
- Introducing conditionally indexed career average scheme
- Introducing Collective Defined Contribution schemes
- Extending conditional indexation of benefits to existing UK DB schemes

There is no preferred approach – this document merely seeks to set out and analyse the proposals and solicit views on them.

**When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?** Following the consultation, the Government will consider the case for change and would, if necessary, bring forward proposals and any required legislation as soon as practicable.

**Ministerial Sign-off**

For consultation stage Impact Assessments:

*I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.*

Signed by the responsible Minister:

Mike O’Brien ................................................................. Date: 5 June 2008
## Summary: Analysis & Evidence

**Policy Option:** 1 New conditional indexation schemes  
**Description:** A new type of conditionally indexed career average salary pension scheme

### ANNUAL COSTS

- **One-off (Transition) Yrs**
- **£**

### Average Annual Cost (excluding one-off)
- **£**

**Total Cost (PV)**

**Other key non-monetised costs by ‘main affected groups’**
- Members receive less certainty about the level of benefits they receive.
- Members and sponsors will have a more complicated and less transparent scheme which may require additional regulation.

### ANNUAL BENEFITS

- **One-off Yrs**
- **£**

### Average Annual Benefit (excluding one-off)
- **£**

**Total Benefit (PV)**

**Other key non-monetised benefits by ‘main affected groups’**
- Employer risk - increased certainty because of more controllable pension scheme costs which could result in improved company viability.
- Scheme members - may increase likelihood of continuing high quality pension provision by the employer.

### Key Assumptions/Sensitivities/Risks
In the long run scheme funding levels would be set so as to provide a reasonable expectation that members can be fully compensated for any lost indexation.

<table>
<thead>
<tr>
<th>Price Base Year</th>
<th>Time Period Years</th>
<th>Net Benefit Range (NPV)</th>
<th>NET BENEFIT (NPV Best estimate)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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<td></td>
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</tbody>
</table>

- What is the geographic coverage of the policy/option? **Great Britain**
- On what date will the policy be implemented? **Unknown**
- Which organisation(s) will enforce the policy? **The Pensions Regulator**
- What is the total annual cost of enforcement for these organisations? **£ Unknown**
- Does enforcement comply with Hampton principles? **N/A**
- Will implementation go beyond minimum EU requirements? **N/A**
- What is the value of the proposed offsetting measure per year? **£ N/A**
- What is the value of changes in greenhouse gas emissions? **£ N/A**
- Will the proposal have a significant impact on competition? **No**

<table>
<thead>
<tr>
<th>Annual cost (£-£) per organisation (excluding one-off)</th>
<th>Micro</th>
<th></th>
<th>Small</th>
<th></th>
<th>Medium</th>
<th></th>
<th>Large</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Are any of these organisations exempt?</td>
<td>N/A</td>
<td></td>
<td>N/A</td>
<td></td>
<td>N/A</td>
<td></td>
<td>N/A</td>
<td></td>
</tr>
</tbody>
</table>

**Impact on Admin Burdens Baseline (2005 Prices)**

<table>
<thead>
<tr>
<th>Increase of</th>
<th>£ N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decrease of</td>
<td>£ N/A</td>
</tr>
<tr>
<td>Net Impact</td>
<td>£ N/A</td>
</tr>
</tbody>
</table>

**Key:** Annual costs and benefits: Constant Prices  
(Net) Present Value
## Summary: Analysis & Evidence

### Policy Option: 2 (Conditional indexation for existing DB schemes)

**Description:** Allow existing Defined Benefit schemes to apply conditional indexation to pensions in payment for future accruals only

<table>
<thead>
<tr>
<th><strong>ANNUAL COSTS</strong></th>
<th>Description and scale of key monetised costs by ‘main affected groups’</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>One-off (Transition) Yrs</strong></td>
<td>Compared to a counterfactual of continuing DB provision, conditional indexation (CI) would transfer cash flow risks to scheme members. This will have a net cost if members find it more costly to bear risks than scheme sponsors do. Over the long term CI does not reduce the expected value of member benefits. Compared to a counterfactual of moving to DC provision, the effects would be the opposite. The net impact would depend on the behaviour of scheme sponsors and the counterfactual considered. There could be some costs arising from setting up and administering new schemes, but these would only arise if the scheme sponsor chooses to take up the option. No additional costs would therefore be imposed by this option.</td>
</tr>
<tr>
<td><strong>Average Annual Cost (excluding one-off)</strong></td>
<td></td>
</tr>
<tr>
<td>£</td>
<td></td>
</tr>
</tbody>
</table>

**Costs:**

Other key non-monetised costs by ‘main affected groups’ Reduced certainty for scheme members over their benefit levels and additional scheme complexity. There is also an issue of equity since only pensioner members bear the costs of lost indexation.

### ANNUAL BENEFITS

**Description and scale of key monetised benefits by ‘main affected groups’**

The benefits to sponsors are the mirror image of the costs to scheme members outlined above.

| **One-off** | |
| **Average Annual Benefit (excluding one-off)** | |
| £ | |

**Benefits:**

Other key non-monetised benefits by ‘main affected groups’ Employer sponsoring schemes - increased certainty over pension scheme costs could result in improved company viability. Scheme members - may increase likelihood of continuing defined benefit pension provision by employer.

### Key Assumptions/Sensitivities/Risks

In the long run scheme funding levels would be set so as to provide a reasonable expectation that members can be fully compensated for any lost indexation.

<table>
<thead>
<tr>
<th><strong>Price Base Year</strong></th>
<th><strong>Time Period Years</strong></th>
<th><strong>Net Benefit Range (NPV)</strong></th>
<th><strong>NET BENEFIT (NPV Best estimate)</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>£</strong></td>
<td><strong>£</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- **What is the geographic coverage of the policy/option?** Great Britain
- **On what date will the policy be implemented?** Unknown
- **Which organisation(s) will enforce the policy?** The Pensions Regulator
- **What is the total annual cost of enforcement for these organisations?** £ Unknown
- **Does enforcement comply with Hampton principles?** N/A
- **Will implementation go beyond minimum EU requirements?** N/A
- **What is the value of the proposed offsetting measure per year?** £ N/A
- **What is the value of changes in greenhouse gas emissions?** £ N/A
- **Will the proposal have a significant impact on competition?** No
- **Annual cost (£-£) per organisation (excluding one-off)**
  - Micro
  - Small
  - Medium
  - Large
  - N/A

### Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

- **Increase of £ N/A**
- **Decrease of £ N/A**
- **Net Impact £ N/A**

**Key:**

Annual costs and benefits: Constant Prices (Net) Present Value
## Summary: Analysis & Evidence

**Policy Option:** Collective DC schemes

**Description:** Collective Defined Contribution pension scheme

### Costs

<table>
<thead>
<tr>
<th>ANNUAL COSTS</th>
<th>Description and scale of key monetised costs by ‘main affected groups’</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-off (Transition) yrs</td>
<td>Compared to a counterfactual of continuing DB provision, collective defined contribution (CDC) would transfer cash flow risks to scheme members. This will have a net cost if members find it more costly to bear risks than scheme sponsors do. Compared to a counterfactual of moving to DC provision, the effects would be the reverse. The net impact would depend on the behaviour of scheme sponsors and the counterfactual considered. There could be some costs arising from setting up and administering new schemes, but these would only arise if the scheme sponsor chooses to take up the option. No additional costs would therefore be imposed by this option.</td>
</tr>
<tr>
<td><strong>£</strong></td>
<td><strong>Total Cost (PV)</strong></td>
</tr>
</tbody>
</table>

**Other key non-monetised costs by ‘main affected groups’**

Members will still have some uncertainty over the eventual benefit they receive, although less so than in a normal defined contribution scheme. The scheme is not as simple for them to understand as a normal defined contribution pension where the individual has their own account.

### Benefits

<table>
<thead>
<tr>
<th>ANNUAL BENEFITS</th>
<th>Description and scale of key monetised benefits by ‘main affected groups’</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-off yrs</td>
<td>The benefits to sponsors are the mirror image of the costs to scheme members outlined above.</td>
</tr>
<tr>
<td><strong>£</strong></td>
<td><strong>Total Benefit (PV)</strong></td>
</tr>
</tbody>
</table>

**Other key non-monetised benefits by ‘main affected groups’**

Employer - greater certainty over pension scheme costs could result in improved company viability. Scheme members - pooling arrangement allows smoothing of investment risk; greater likelihood of continuing high quality pension provision by employer.

---

### Key Assumptions/Sensitivities/Risks

In the long run scheme funding levels would be set so as to provide a reasonable expectation that members can be fully compensated for any lost indexation.

<table>
<thead>
<tr>
<th>Price Base Year</th>
<th>Time Period (Years)</th>
<th>Net Benefit Range (NPV)</th>
<th>NET BENEFIT (NPV Best estimate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>What is the geographic coverage of the policy/option?</td>
<td>Great Britain</td>
<td></td>
<td></td>
</tr>
<tr>
<td>On what date will the policy be implemented?</td>
<td>Unknown</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Which organisation(s) will enforce the policy?</td>
<td>The Pensions Regulator</td>
<td></td>
<td></td>
</tr>
<tr>
<td>What is the total annual cost of enforcement for these organisations?</td>
<td>£ Unknown</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Does enforcement comply with Hampton principles?</td>
<td>N/A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Will implementation go beyond minimum EU requirements?</td>
<td>N/A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>What is the value of the proposed offsetting measure per year?</td>
<td>£ N/A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>What is the value of changes in greenhouse gas emissions?</td>
<td>£ N/A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Will the proposal have a significant impact on competition?</td>
<td>No</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Annual cost (£-£) per organisation (excluding one-off)</th>
<th>Micro</th>
<th>Small</th>
<th>Medium</th>
<th>Large</th>
</tr>
</thead>
<tbody>
<tr>
<td>Are any of these organisations exempt?</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Impact on Admin Burdens Baseline (2006 Prices)</th>
<th>(Increase - Decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase of £</td>
<td>Decrease of £</td>
</tr>
<tr>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>

**Key:** Annual costs and benefits: Constant Prices | (Net) Present Value
Annex C: Technical Annex

C.1 This section provides some more detail on the modelling used to provide illustrations of the impacts of the main risk sharing proposals set out in this document.

Modelling of the scheme level impacts of conditional indexation proposals

The model

C.2 Annex B set out the analysis of the scheme level impacts of the conditional indexation proposals. As stated in that section a full assessment of the impact of conditional indexation would require modelling of scheme funding outcomes that reflect potential future variations in relevant economic variables, and link those outcomes to individual pension accruals.

C.3 DWP does not have a model of this kind but we have utilised a model designed by PGGM, a Dutch pension fund, to provide an illustrative analysis of the scheme-level impacts of the conditional indexation proposals. The model is based on a career average scheme and allows the user to alter various parameters such as contribution rates, indexation levels, benefit levels and the asset mix in order to look at the effect on a range of simulated outputs at the scheme level. These include expected values and distributions of the funding ratio and relative pension levels. The model has a 15 year time horizon and uses stochastic simulations of the economic environment in generating results.

C.4 The scheme underlying the model is a career average scheme with the membership profile based on PGGM’s own scheme profile – an immature scheme, with only 12 per cent of its members being pensioners.

C.5 The characteristics of the scheme mean that it cannot be taken to be representative of a UK scheme. However we consider it useful in illustrating the likely scale of impacts of a switch from unconditional to conditional indexation in the context of one specific career average scheme.

Indexation policy in the model

C.6 Conditional indexation is applied in the model by specifying an indexation policy ladder. This sets out the rules in relation to the scheme’s funding level for paying indexation. The model allows for ladders to be designed as required. A typical ladder would look as in Figure C.1 below.
C.7 When the funding ratio falls below a specified lower threshold (LT), indexation is not payable at all. As the funding level increases from lower threshold the level of indexation increases linearly until it reaches 100 per cent at the upper funding threshold (UT). Above the upper funding threshold the normal position is to pay full indexation.

C.8 However, if indexation has not been paid in earlier years, then once funding has sufficiently recovered, additional indexation – known as ‘catch-up indexation’ may be payable. This could be payable immediately above the upper threshold (as shown by the first dotted red line) or it might require an even higher level of funding (as shown by the second dotted red line). The model allows the user to set the level of the thresholds, thus allowing different indexation policies to be tested.

C.9 The model has been calibrated to offer indexation linked to price inflation, with a cap of 2.5 per cent, the current situation that applies to UK Defined Benefit schemes.

C.10 The policy ladder used in the modelling in Annex B is described in Table C.1. A funding ratio of 150 represents the point at which the scheme is fully funded to the extent that it can pay total liabilities, including full indexation. Therefore the policy ladder described in the table below begins to cut indexation as soon as the scheme becomes underfunded.
Table C.1: Conditional indexation policy ladder used in the baseline conditional indexation scenario in Annex B

<table>
<thead>
<tr>
<th>Funding ratio</th>
<th>Indexation paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 125</td>
<td>None</td>
</tr>
<tr>
<td>Between 125 and 150</td>
<td>Increases linearly up to full indexation at a funding ratio of 150</td>
</tr>
<tr>
<td>Between 150 and 170</td>
<td>Full indexation</td>
</tr>
<tr>
<td>Above 170</td>
<td>Catch-up indexation</td>
</tr>
</tbody>
</table>

Sensitivity of the results to alternative assumptions

C.11 We have also tested the sensitivity of the results in Annex B by altering some of the main assumptions. Table C.2 below sets out more detail on the alternative scenarios.

Table C.2: Description of alternative scenarios used in sensitivity analysis

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Assets invested 100 per cent in equities</td>
</tr>
<tr>
<td>2</td>
<td>Assets invested 100 per cent in bonds</td>
</tr>
<tr>
<td>3</td>
<td>Weak indexation policy ladder – indexation not paid below a funding ratio of 95, full indexation paid at a funding ratio of 150</td>
</tr>
<tr>
<td>4</td>
<td>Strong indexation policy ladder – indexation not paid below a funding ratio of 155, full indexation paid at a funding ratio of 180</td>
</tr>
<tr>
<td>5</td>
<td>Variable contribution rate – 25 per cent if the funding ratio is less than 125, 20 per cent if the funding ratio lies between 125 and 150, and 15 per cent if the funding ratio is greater than 150</td>
</tr>
</tbody>
</table>

C.12 The comparator for these alternative scenarios is the baseline as outlined in Annex B. All model parameters were set to be the same as this baseline case with the exception of the parameters specified in Table C.2 above.

C.13 The results of the alternative scenarios are set out in Table C.3. The unconditionally indexed scheme has also been included for completeness. The relevant outputs are the indexation quality figure and the probability that the funding ratio falls below 100. The model automatically outputs this probability and it has been included here to show at a glance the sensitivity of funding levels to the scenarios described above.
### Table C.3: Results of the sensitivity analysis for the conditionally indexed scheme

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Indexation quality (%)</th>
<th>Probability that the funding ratio is less than 100 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unconditional indexation</td>
<td>82</td>
<td>4.1</td>
</tr>
<tr>
<td>Baseline conditional indexation</td>
<td>73</td>
<td>3.1</td>
</tr>
<tr>
<td>1</td>
<td>68</td>
<td>9.5</td>
</tr>
<tr>
<td>2</td>
<td>76</td>
<td>0.0</td>
</tr>
<tr>
<td>3</td>
<td>78</td>
<td>3.4</td>
</tr>
<tr>
<td>4</td>
<td>54</td>
<td>2.7</td>
</tr>
<tr>
<td>5</td>
<td>79</td>
<td>0.8</td>
</tr>
</tbody>
</table>

Source: DWP modelling

C.14 The results are sensitive to changing the asset mix. In general, 100 per cent equity investment results in a lower average indexation quality compared to the baseline, due to the additional volatility in funding levels caused by 100 per cent equity investment, as illustrated by the probabilities in the final column. On the upside there is potential for significant increases in the funding level, but the opposite applies on the downside when equity returns are poor. For the 100 per cent bond investment scenario the average indexation quality is higher even than the baseline, with much lower volatility in funding levels.

C.15 This does not imply that a pure bond investment strategy is a better one than 100 per cent equities or a mixture of bonds and equities. The 100 per cent bond scenario produces a much narrower distribution of funding outcomes than a strategy with some equity investment, implying that the possibility of high returns is traded off for less volatility. The key point to emerge from the alternative asset allocation scenarios is that the extra risk run by a more equity-dominated asset allocation does not always lead to the reward of a better indexation outcome.

C.16 The two alternative indexation policy scenarios show that a much stronger policy (cutting indexation at a higher funding ratio than the baseline – scenario 4) significantly reduces the value of conditional indexation paid without significantly reducing the probability of lower funding levels, making this policy unnecessarily painful for members. At the other extreme a weaker policy (cutting indexation at a much lower funding ratio than the baseline – scenario 3) has the expected impact of increasing the average indexation paid at the cost of an increase in the probability of a lower funding ratio.

C.17 Finally, the variable contribution policy delivers the best conditional indexation outcome and the lowest likelihood of a low funding ratio (bar the 100 per cent bonds scenario), at the cost of a higher average contribution rate (16.7 per cent) than in the baseline scenario (15.5 per cent). This is unsurprising as now there are two instruments to steer the funding level as opposed to just one.
Modelling of the impacts on members’ pension outcomes

C.18 In order to estimate the impact of the three main risk sharing proposals on individual pension outcomes, we have used illustrative modelling of the outcomes for hypothetical individuals.

C.19 The models from which these analyses have been produced allow for stochastic modelling of investment returns and the economic environment, which adds an extra dimension of realism to the results in comparison to deterministic modelling, which requires that the value of the relevant variables be specified.

C.20 Nonetheless the results of this modelling should only be seen as indicative of actual outcomes – different assumptions about scheme designs and individual characteristics would lead to different results.
## Annex D: Glossary

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrual rate</td>
<td>The rate at which rights build up for each year of pensionable service in a defined benefit scheme.</td>
</tr>
<tr>
<td>Active members</td>
<td>Active members are current employees who are contributing (or having contributions made on their behalf) to an organisation’s occupational pension scheme. The scheme may be open or closed.</td>
</tr>
<tr>
<td>Additional Pension (AP)</td>
<td>The earnings–related state pension paid in addition to the Basic State Pension. From 1978-2002 it accrued under the State Earnings Related Pension Scheme (SERPS) and from 2002 under the State Second Pension (S2P) scheme.</td>
</tr>
<tr>
<td>Annuity</td>
<td>Purchased with an individual pension fund, which has been built up in a defined contribution pension scheme, to provide a pension that is usually payable for life. A single-life annuity pays benefits to an individual. A joint-life/survivors annuity pays benefits to the spouse/dependent partner after death of the first. A level annuity pays constant payments whereas an index-linked annuity pays benefits relating to an index (for example the Retail Prices Index).</td>
</tr>
<tr>
<td>Automatic enrolment</td>
<td>A system whereby an individual is made a member of a pension scheme unless they actively opt out of the scheme.</td>
</tr>
<tr>
<td>Basic State Pension (BSP)</td>
<td>An amount of money payable to those who are entitled to it (who have reached State Pension age and claimed it) that is based on the amount of National Insurance contributions a person has paid, has been treated as having paid or has been credited with.</td>
</tr>
<tr>
<td>Bond</td>
<td>A debt investment in which the investor loans money to an entity (company or government) that borrows the funds for a defined period of time at a specified interest rate.</td>
</tr>
<tr>
<td>Cohort</td>
<td>A group of persons having a common statistical characteristic, esp. that of being born in the same year</td>
</tr>
<tr>
<td>Contracting out</td>
<td>The system by which individuals can choose to opt out of State Second Pension and use a proportion of their National Insurance Contribution to build up a funded pension. There are four types of schemes, into which an individual may contract out of. The rules and rebate levels are different for each. These are: contracted-out salary related scheme, contracted-out mixed benefit scheme, contracted-out money purchase scheme and approved personal pension.</td>
</tr>
<tr>
<td>Decumulation</td>
<td>The drawing down of pension assets to fund retirement. In the UK, it is permitted to access pension assets partially as a tax-free lump sum and partially as an income stream (i.e. annuity or income draw down).</td>
</tr>
<tr>
<td>Defined benefit (DB) pension scheme</td>
<td>A pension scheme where the pension is related to the members’ salary or some other value fixed in advance.</td>
</tr>
<tr>
<td>Defined contribution (DC) pension scheme</td>
<td>A scheme where the individual receives a pension based on the contributions made and the investment return that they have produced. They are sometimes referred to as money.</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
</tr>
<tr>
<td>------</td>
<td>------------</td>
</tr>
<tr>
<td>Discount Rate</td>
<td>An interest rate used to reduce an amount of money at a date in the future to an equivalent value at the present date.</td>
</tr>
<tr>
<td>Equity</td>
<td>Share or any other security representing an ownership interest.</td>
</tr>
<tr>
<td>Funded pension scheme</td>
<td>Pension schemes in which pension contributions are paid into a fund which is invested and pensions are paid out of this fund.</td>
</tr>
<tr>
<td>Guarantee Credit</td>
<td>A means-tested benefit which is part of Pension Credit and brings pensioners’ income up to a guaranteed minimum level. In 2007/08 the standard minimum guarantee for a single person is £119.05 a week. For a couple the level is £181.70 a week. The guaranteed minimum is higher for some groups, such as disabled people, carers and people with certain housing costs who qualify for additional amounts.</td>
</tr>
<tr>
<td>Guaranteed Minimum Pension (GMP)</td>
<td>The minimum pension that must be provided by a contracted-out salary-related scheme for pensions accrued between 1978 and 1997. The GMP is roughly equivalent to the foregone SERPS from contracting out.</td>
</tr>
<tr>
<td>Income related benefits</td>
<td>State benefits where the amount paid depends on the level of income and capital and other personal circumstances.</td>
</tr>
<tr>
<td>Independent Financial Adviser (IFA)</td>
<td>Someone who is authorised to provide advice and sell a wide range of financial products. They are distinguished from tied financial advisers, who can only give advice on investment products offered by a specific company.</td>
</tr>
<tr>
<td>Indexation</td>
<td>A system whereby pensions in payment and/or preserved benefits are automatically increased at regular intervals by reference to a specific index of prices or earnings.</td>
</tr>
<tr>
<td>Liabilities</td>
<td>Amounts which a pension scheme has an obligation to pay now or in the future.</td>
</tr>
<tr>
<td>Life expectancy</td>
<td>Life expectancy at a given age, x, is the average number of years that a male or female aged x will live thereafter, and is calculated using age- and gender-specific mortality rates at ages x, x+1, x+2, etc.</td>
</tr>
<tr>
<td>Longevity</td>
<td>Length of life.</td>
</tr>
<tr>
<td>Median</td>
<td>The median of a distribution divides it into two halves. Therefore half the group are above the median value and half below.</td>
</tr>
<tr>
<td>Moral hazard</td>
<td>The risk that the existence of a contract will cause behavioural changes in one or both parties to the contract, as where asset insurance causes less care to be taken over the safeguarding of the assets.</td>
</tr>
<tr>
<td>National Insurance (NI)</td>
<td>The national system of benefits paid in specific situations, such as retirement, based on compulsory or voluntary contributions. There are four main classes of contributions.</td>
</tr>
<tr>
<td>Nominal benefits</td>
<td>Without adjustment by indexation</td>
</tr>
<tr>
<td>Occupational pension.</td>
<td>A pension which is provided via the employer, but the pension scheme takes the form of a trust arrangement and is legally separate from the employer</td>
</tr>
<tr>
<td>Open Market Option (OMO)</td>
<td>The longstanding Government policy for money-purchase (defined contribution) pension arrangements that individuals...</td>
</tr>
<tr>
<td>Term</td>
<td>Description</td>
</tr>
<tr>
<td>----------------------------------</td>
<td>-----------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Risk Sharing Consultation</td>
<td>may shop around for an annuity rather than remaining with the provider with whom they made their pension saving, since incorporated into tax legislation (Section 165 of the Finance Act 2004).</td>
</tr>
<tr>
<td>Pension accrual</td>
<td>The build up of pension rights. In a Defined Benefit scheme this may be based on the number of years of contributions.</td>
</tr>
<tr>
<td>Pension Credit</td>
<td>The main income related benefit for pensioners, which combines the Guarantee Credit and the Savings Credit.</td>
</tr>
<tr>
<td>pension credit</td>
<td>The share of a pension arrangement awarded to a former spouse on divorce</td>
</tr>
<tr>
<td>Pension Protection Fund (PPF)</td>
<td>Established in April 2005 to pay compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover Pension Protection Fund levels of compensation.</td>
</tr>
<tr>
<td>The Pensions Commission</td>
<td>The Pensions Commission, chaired by Lord Adair Turner, was set up in 2002 to review the UK private pension system and long-term savings. The Pensions Commission has now concluded its review and been disbanded.</td>
</tr>
<tr>
<td>The Pensions Regulator (tPR)</td>
<td>The regulator of work-based pension schemes in the UK.</td>
</tr>
<tr>
<td>Persistency (in relation to saving)</td>
<td>Where someone continues to make contributions to a pension scheme over time.</td>
</tr>
<tr>
<td>Personal pension</td>
<td>A pension which is provided through a contract between an individual and the pension provider. The pension produced will be based on the level of contributions, investment growth and annuity rates. A personal pension can either be employer provided (a Group Personal Pension) or purchased individually.</td>
</tr>
<tr>
<td>Price-indexed</td>
<td>Increasing each year in line with inflation.</td>
</tr>
<tr>
<td>Protected rights</td>
<td>The element of the Defined Contribution pension arising from Contracted-out rebates.</td>
</tr>
<tr>
<td>Rate of return</td>
<td>The gain or loss of an investment over a specified period, expressed as a percentage increase over the initial investment cost. Gains on investments are considered to be any income received from the asset, plus realised capital gains.</td>
</tr>
<tr>
<td>Real terms</td>
<td>Figures have been adjusted to remove the effect of increases in prices over time (i.e. inflation), usually measured by the Retail Prices Index. Thus if something shown in real terms increases then it is rising faster than prices, whereas if it is constant, it rises at exactly the same pace as prices.</td>
</tr>
<tr>
<td>Reference Scheme Test (RST)</td>
<td>A test of overall pension scheme quality currently used for defined benefit schemes that are contracted-out of the State Second Pension. A scheme satisfies the test if the pensions provided to at least 90 per cent of the members are broadly equivalent to, or better than, the pension which would be provided under the Reference Scheme which: is payable from age 65; is paid for life; accrues for each year of pensionable service (40 years maximum) at the rate of one-eighthieth of average qualifying earnings in the last three years of service; is based on qualifying earnings defined as 90 per cent of earnings between the Lower Earnings Limit and the Upper</td>
</tr>
<tr>
<td><strong>Risk Sharing Consultation</strong></td>
<td><strong>Earnings Limit</strong>; and provides a 50 per cent survivor benefit for a spouse or civil partner.</td>
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</tr>
<tr>
<td><strong>Retail Prices Index (RPI)</strong></td>
<td>This is an average measure of the change in the prices of goods and services bought for consumption by the vast majority of households in the UK.</td>
</tr>
<tr>
<td><strong>Savings Credit</strong></td>
<td>Part of the Pension Credit. It is a means-tested benefit for people aged 65 or over, which accrues at the rate of 60p for each £ of income above a threshold (currently set at £87.30 for a single person and £139.60 for a couple) up to a maximum amount (£19.05 for a single person, £25.26 for a couple).</td>
</tr>
<tr>
<td><strong>Stakeholder pension</strong></td>
<td>A personal pension product which complies with regulations which limit charges and allow individuals flexibility about contributions.</td>
</tr>
<tr>
<td><strong>Stakeholder charge cap</strong></td>
<td>A 1.5 per cent annual management charge (AMC) for cap the first ten years of the policy, and thereafter a 1 per cent AMC.</td>
</tr>
<tr>
<td><strong>Standard minimum guarantee</strong></td>
<td>The minimum level of income guaranteed to pensioners through the Guarantee Credit element of Pension Credit. (The guaranteed level for some groups of pensioners, such as severely disabled people, carers and people with certain housing costs who qualify for additional amounts, is higher than the standard minimum guarantee.)</td>
</tr>
<tr>
<td><strong>State Earnings Related Pension Scheme (SERPS)</strong></td>
<td>The forerunner of the State Second Pension, which provides an earnings-related National Insurance pension based on contributions.</td>
</tr>
<tr>
<td><strong>State Pension age (SPA)</strong></td>
<td>The minimum age at which a person can claim their State Pension. It is currently 65 for men and 60 for women born before 6 April 1950. For women born on or after 6 April 1950 and before 6 April 1959 State Pension age will gradually increase to 65 between 2010 and 2020. The State Pension age will further increase for both men and women from 65 to 68, between 2024 and 2026. This further increase will affect anyone born on or after 6 April 1959.</td>
</tr>
<tr>
<td><strong>State Second Pension (S2P)</strong></td>
<td>The earnings-related National Insurance pension paid in addition to basic State Pension – gives a more generous pension than would have been provided by SERPS for: low and moderate earners; carers who are looking after young children or a disabled person; and long-term disabled people. The 2007 Pensions Act introduced a simpler S2P from 2012. This Pensions Bill proposes to wrap up the complex accrual structures of GRAD, SERPS and pre-2012 S2P into a consolidated cash amount for persons retiring from 2020.</td>
</tr>
<tr>
<td><strong>Stochastic</strong></td>
<td>A tool for determining probability distributions of potential outcomes by allowing for random variation of one or more inputs over time.</td>
</tr>
<tr>
<td><strong>Tax credits</strong></td>
<td>There are two main types of tax credit. Working Tax Credit is an income related credit for working adults and Child Tax Credit is an income-related credit payable to families with responsibility for children, whether they are in or out of work.</td>
</tr>
<tr>
<td><strong>Tax-free lump sum</strong></td>
<td>Twenty-five per cent of pension saving may be taken as a tax-free lump sum. This 25 per cent may include protected rights but not the Guaranteed Minimum Pension.</td>
</tr>
<tr>
<td><strong>Tax relief</strong></td>
<td>Individuals making contributions to tax approved pension...</td>
</tr>
</tbody>
</table>
schemes receive tax relief at their marginal tax rate (e.g. a standard rate taxpayer will receive tax relief at 22 per cent). Individuals contributing to stakeholder pensions receive tax relief at a minimal rate of 22 per cent. Individuals with very low or no tax liabilities can also receive “tax relief” at 22 per cent on contributions of up to £2,808 per year. Employers' contributions are made from gross profits and thus are both tax and National Insurance privileged.

<table>
<thead>
<tr>
<th><strong>Risk Sharing Consultation</strong></th>
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<tbody>
<tr>
<td><strong>Trivial commutation</strong></td>
<td>If an individual’s total pension accumulation is less than 1 per cent of the lifetime limit on tax relievable pension saving (£15,000 on 2006/07) then individuals are not required to annuitise their fund and can instead take it as a taxable lump sum.</td>
</tr>
<tr>
<td><strong>Trust</strong></td>
<td>A legal concept whereby property is held by one or more persons (the trustees) for the benefit of others (the beneficiaries) for the purposes specified by the trust instrument. The trustees may also be beneficiaries.</td>
</tr>
<tr>
<td><strong>Unfunded pension scheme</strong></td>
<td>Pension schemes that are not backed by a pension fund. Instead, current contributions are used to pay current pensions along with other funds provided by the employer.</td>
</tr>
<tr>
<td><strong>Workplace personal pension arrangements</strong></td>
<td>A workplace personal pension arrangement refers to any personal pension, or collection of personal pensions, to which the employer makes a contribution. This includes group personal pensions and group stakeholder pensions. The contractual agreement in such arrangements lies between the provider and the individual. The employer is not part of the contractual agreement but often facilitates such arrangements for their workers (for example by giving workers access to the scheme, making payroll deductions, etc.).</td>
</tr>
</tbody>
</table>