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Risk sharing – ‘a temporary setback’ (or Sir Humphrey lives on)

Executive summary

This article considers the recent DWP assessment of risk sharing, specifically CDC schemes, and:

- outlines the nature and advantages of CDC
- discusses the cost implications
- questions the obsession with avoiding risk at the cost of obtaining returns (in society and implicit within the DWP’s thinking)
- concludes with a rallying cry for the industry (including the PMI) to keep the issue on the agenda by focusing on society’s principles

On 17 December 2009 the Department for Work and Pensions (DWP) published its assessment of whether and how Collective Defined Contribution (CDC) schemes might operate in the UK. It finished with the Department’s conclusion “Government should take no further action on CDC schemes”.

This followed an earlier review which rejected Conditional Indexation (risk sharing on a ‘defined benefit’ [DB] model) and suggested CDC schemes (risk sharing on a ‘money purchase’ model) should be explored further.

Observers will feel discouraged by the process. It is hard not to draw parallels with the machinations of Sir Humphrey and his Yes Minister! associates, in particular the gradual attrition from consecutive reviews and the suggestions there is no demand for the product and that it is too complicated. As the fictional TV civil servant also pointed out, such processes often conclude with an acknowledgement that while something should have been done it is now too late.

So what’s it all about?



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John Branford

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Nigel Aston defines what corporate wrap will look like and what it intends to do



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Steve Hood looks at longevity and considers what we have learnt in 2009 and ponders what 2010 may bring



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CDC

The main features of CDC are as follows:

- a fixed employer contribution, like ‘raw’ defined contribution (DC) schemes
- an underlying target benefit
- a level playing field for inflation-driven increases to core benefits for active, deferred and pensioner members granted by the trustees
- direct payment of pension (although some variants include annuitisation, which introduces unnecessary complications)
- scope to change benefits (down and up)

I just want to make absolutely sure you're not asking me to make a courageous decision (Minister Jim Hacker)

The advantages of CDC

The natural approach of the DWP appears to have been to avoid risk (of almost any kind) and so focus on the negatives. Sadly nothing in life is without risk but that does not mean we do not do it. Anything worth achieving must inevitably involve some risk.

So a more positive approach is to look at the advantages and to consider the conditions under which CDC might exist.

Like DC, employer's costs are fixed under CDC. That means simple accounting with no employer debts. This does not preclude additional contributions of the sponsor's choosing.

From the member's perspective the expectation would be of a more predictable benefit (than DC) through smoothing. Avoiding annuitisation means the current inequalities arising from fluctuations in markets and annuity prices would be substantially reduced resulting in greater fairness for members.

Crucially substantial cost savings can be expected. The cost of providing a given level of benefit should be lower (or alternatively the benefit provided for a given amount of money should be higher) than under the DC alternative. This is because the ‘collective’ approach reduces costs and allows risk pooling enabling a more active and return-seeking investment strategy than can be achieved by the majority of individuals. These benefits are maximised if we can resist the temptation of introducing false ‘guarantees’ through annuitisation and the costs associated with this e.g. insurance companies expenses, contingency and profit margins and the cost of servicing their capital requirements – which are set to rise under new EU solvency requirements.

Suppose everyone went around saving money irresponsibly all over the place? (Sir Humphrey)

Costs

The potential savings (or improvements in benefits) really are significant. Modelling carried out by a leading pension

consultancy (which assumes that annuities are not purchased – in our view clearly the most efficient approach) suggest a CDC scheme might provide, on average £140 of pension for each £100 of pension that would be purchased with the same contributions to a DC scheme. Furthermore this level is achieved with greater certainty.

The DWP asked the Government Actuary's Department (GAD) to model CDC relative to DC. Unsurprisingly it recognised there is more predictability over the level of benefit from CDC. Their modelling confirmed the above figures suggesting a median average CDC benefit at retirement some 39% higher than the corresponding DC figure.

So that's a no-brainer isn't it?

I'm discussing our position, the facts are neither here nor there (Sir Humphrey)

Our risk adverse society

In a nutshell, we have reached the absurd position where any risk to any individual seems to weigh more heavily than potential gains for society. You can see this almost everywhere; a recent example being the closure of schools in the snow denying education for all in case a few teachers injured themselves. The word ‘opportunity’ seems to be disappearing from the English language and the consequences are frightening.

Given Government is not profit making, what incentive is there for it to countenance risk? Perhaps society needs to take a step back and consider the role of Government – is it to manage risk or opportunity?

The concept of ‘risk sharing’ has no hope unless society accepts that responsibility for risk must itself be shared between Government, employers and its citizens.

The GAD report quite rightly points out that in spite of the enormous positives of CDC there are some risks attached - but there are risks attached to all pension arrangements. In other words, there can be no guarantees – not even for the public sector.

The DWP accepts that even when imposing the toughest membership conditions the median outcome will be better under CDC than DC. But the ultimate objection which seems uppermost with the DWP is there are scenarios in which some CDC members could be worse off than under DC (because others are better off!).

It is worth remembering that, in any circumstance where a CDC scheme ceases, one option would be to wind it up, effectively reverting to a conventional DC scheme (a form of benefit provision which we understand to still be acceptable to the Government) at which point the advantages of the CDC are lost i.e. risk is crystallised at the expense of opportunity.

What seems to be overlooked is that in the circumstances where CDC fails, the failure of DC is likely to be even greater.

The (Foreign Office) aren't there to do things. They're there to explain why things can't be done (Sir Humphrey)

The DWP has learnt from the Foreign Office. Their objections reflect the following:

- the modelling, which raises the possibility of adverse outcomes for some members in extreme conditions (see above) – but all private sector pension arrangements are exposed to these risks! Perhaps it is time public sector pensions were more exposed to these risks too
- the possibility that CDC schemes are not consistent with European law (a soft target – remember the Great British Banger?). Senior pensions lawyers disagree. But if there is an issue, why not seek to change the legislation for the greater good?
- the lack of demand; this conclusion deriving from what the DWP acknowledges was ‘small-scale qualitative research’ with employers. Again this seems unreasonable given most employers have not heard of CDC and relied in their responses (which illustrate a misunderstanding of the subject) on the DWP’s own briefing.

Not a single one of these emerges as a serious objection to an employer who wants to set up a CDC scheme for the benefit of its workforce so allowing the prospect of a better standard of living in retirement. The DWP’s conclusions reflect a truly woeful attitude towards risk at the expense of opportunity and choice.

And we are unquestionably faced with an emergency. Conventional DB schemes are closing at a frightening rate – demonstrating that they are not risk free. They are being replaced by DC schemes which put all the risk on members with no prospects for smoothing of outcomes in what have been fast changing markets. The need for something between the two

extremes has never been greater. With 2012 fast approaching and the attendant fear of levelling downwards coupled with the spectre of spending cuts it is a worrying time for prospective pensioners.

The pensions industry (and the PMI membership is an important and influential part of this) now needs to step forward and promote understanding and demonstrate the demand for risk sharing.

Change has to come from the top and the politicians need to hear the message loud and clear. Society needs ‘risk sharing’ not just for pensions, but across all aspects of our lives.

Conclusion

We find the DWP’s response hard to understand and dispiriting in the extreme, but perhaps its not really surprising. After all, the DWP is an adviser and the role of the adviser is to explain risk. It is their principals that take the risk.

What is needed, therefore, is for society to re-examine the role of its principals i.e. that of Government, employers and its citizens.

To leave on a positive note and one inspired by Sir Humphrey we offer the following exchange from our hero:

Sir Desmond: Surely a decision’s a decision

Sir Humphrey: Only if it’s the decision you want. If not it’s just a temporary setback.

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HamishWilson is a specialist actuarial and pension consultancy providing fresh perspectives for sponsors and trustees on all aspects of pensions, from strategic issues to day-to-day care and problem solving.