Deregulation and Risk-sharing

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The Deregulatory Review

Recommendations (seeking consensus) included:

- Do not permit worsening of pre-2007 accruals
- Surplus: allow refunds once scheme funding target met and remove requirement for refunds to be in members' interests. Permit advance agreement in principle but subject to trustees' final agreement
- Section 75 debt: make more sponsor-friendly, by allowing period of grace and making group reconstructions easier
- Reduce burden on trustees by making TKU a group requirement and allowing reclaims of legal costs

Deregulatory Review

- Recommendations (continued)…
  - Introduce limited over-riding legislation
  - Go for principles-based regulation based on outcomes only, with helpful non-binding guidance.
  - No rewrite for existing compliant schemes
  - Use plain English and avoid cross-referencing
  - Use sunset clauses where possible
  - Start with disclosure and establish rolling programme
  - Tackle trivial commutation
  - Risk-sharing: clarify and facilitate

Risk-sharing: overall aims

- Risk-sharing will provide a middle course on risk between DB and DC
- Risk-sharing should require as little new regulation as possible
- Sponsors need reassurance that they will not have to bear employees’ risks after all

Risk-sharing currently allowed

- DB + DC
- DB with automatic adjustments
- DB for minimum benefits + augmentation
- Cash balance

DB + DC

- Very straightforward
- Sponsor bears 100% of risk on DB part
- Employees bear 100% of risk on DC part
- Sponsor has option to top-up DC part at retirement

DB with automatic adjustments

- Longevity adjustments, e.g. NPA increased by specified index or in line with State pension age
- Investment performance adjustments, e.g.

Real return p.a.	*Reduction in pension*
3%	Nil
2.5%	0.2% per yr of membership
2%	0.4% " " " "
1.5%	0.6% " " " "
1%	0.8% " " " "

- E.g. return 2% after 20yrs…8% reduction
- Should there be upward adjustments, too?
- Effect of section 67

DB for minimum benefits + augmentation

- Base normal contributions on higher benefits than those specified
- E.g. specify NRA 70 but hope for 65
- Or specify 80ths but hope for 60ths
- Effect of section 67
- Employees bear 100% of top-slice of risk
- Cost escalation for sponsors less likely

Cash balance

- Employee is guaranteed a fund at retirement, based on salary
- Employee bears 100% of conversion risk at retirement, i.e. the longevity risk up to and beyond retirement plus the investment risk at retirement
- Sponsor bears 100% of the salary and investment risks pre-retirement

Risk-sharing – our conclusions

- Existing law permits many risk-sharing designs
- Would help if Govt confirmed section 67
- The LPI requirement stops “targeted” pension increases
- PPF compensation and levy should take more account of risk levels
- A separate regulatory regime is unnecessary
- Risks should be disclosed in <u>all</u> schemes
- Risk-sharing could help sponsors

How could risk-sharing help sponsors?

- Expected cost cheaper than DC per £1 of pension
  - No-one gets too much
  - Investment can be pooled and widely diversified throughout life in some designs
- Less risk of disgruntled employees seeking top-up at retirement than in DC
- Less risk of cost escalation than traditional DB
- Can sometimes be “bolted on” to closed DB

Topping-up DC schemes

- Big risks for employees in DC schemes
- Sponsor can top up at retirement but may not then be willing or able
- We recommend allowing pre-funding of discretionary top-ups without going into the DB regime
- Tax relief should be allowed for pre-funding
- Would help to prevent the worst outcomes

Post-retirement increases

- Remove mandatory LPI requirement in DB schemes?
- Against removal
  - Too soon
  - Pensioners need LPI
  - Would increase burden on State
  - Sponsors would just remove it to save cost

Post-retirement increases (continued)

- For removal
  - Other designs have been freed up
  - Not required for DC
  - Some pensioners prefer higher spending power initially
  - Removal would permit more risk-sharing

- We did not agree

Risk-sharing – a personal view

- It should be possible to fund for post-retirement pension increases without guaranteeing them in advance – the trustees would award them by augmentation if finances permitted
- The best type of risk-sharing for the members is a design in which they are guaranteed a minimum level of benefits

Conclusion

If our recommendations are implemented:

- Employees would win where risk-sharing is introduced in preference to DC or where sponsors pre-fund top-ups to DC schemes
- Sponsors need not be exposed to so much cost escalation and could get surpluses back more easily
- Everyone would benefit from simpler legislation
- Trustees would have a reduced personal burden
- Occupational pension schemes would be more sustainable