Shared risk pension schemes

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November 2020

Introduction

In the UK, most pension schemes fall into being a defined benefit (DB) or defined contribution (DC) scheme. Over the past couple of decades, the trend has been for DB schemes to close and be replaced with inferior DC schemes. In the main, outside of the public sector it is rare for an employer to operate a DB scheme that is open to new joiners.

The main issue with this is for members is the shift in risk from the employer to the employee.

Not only are the benefits provided from DB schemes generous, they are also relatively secure. Risks inherent in providing pensions such as poor investment returns and increasing life expectancy are borne by the employer. If the cost of providing the pension turns out to be higher than originally expected, any shortfall is made good by the employer rather than the member. So, for example, while the financial position of pension schemes has fluctuated greatly in line with market conditions, recently these fluctuations have not had any impact on the level of benefits members of these schemes can expect in retirement.

Even in the event of the failure of a scheme's sponsoring employer, if the scheme assets held are not sufficient then the lifeboat fund for pension schemes, the Pension Protection Fund, may step in to pay out a higher level of benefits than the pension scheme's assets would otherwise have secured.

In a DB scheme the members' benefits do not depend on the performance of investments, mortality expectations on retirement or other such variable factors. So long as the employer remains solvent and/or the pension scheme has enough assets to pay the benefits, the member receives the promised pension regardless of the cost of providing it. The level of benefits is very secure.

The opposite is the case in defined contribution schemes. The risks of providing benefits fall on the member and this can lead to great uncertainty in the level of benefit provided. While the scheme provides annual projections of the benefits that a member can expect, these depend heavily on the underlying assumptions, and the actual benefit paid can vary greatly from the projections.

While placing the risk on members can result in higher than expected benefits (if, for example, investment returns are much higher than assumed) they can obviously also lead to lower benefits than expected. Members generally prefer to have less risk associated with something as important as their pension and the greater uncertainty

Latest revision of this document: https://library.prospect.org.uk/id/2020/01210
This revision: https://library.prospect.org.uk/id/2020/01210/2020-11-16

associated with defined contribution schemes is therefore usually considered to be a further disadvantage compared to DB schemes.

The investment risk borne by members of defined contribution pension schemes can be particularly significant. For example, members can even find that due to changes in financial markets, the value of their pension fund can fall over time even though they and their employer have been contributing to the scheme over that period. This level of risk is generally unavoidable when contributions are allocated to funds invested in the stock market and similar asset classes.

Collective defined contribution (CDC) schemes

Collective defined contribution (CDC) pension schemes are new to the UK but have been in place in other countries for some time. CDC schemes have the potential to be an improvement to a traditional defined contribution scheme as there is a sharing of risk rather than this falling entirely on the individual member. In this sense it has similarities to a defined benefit scheme although the risk is being shared with other scheme members, rather than the employer.

A CDC scheme is much closer to a defined contribution scheme in design than a defined benefit scheme. In a CDC scheme, employees and employers pay contributions into the pension fund and rather than members having an individual pot, the member has a share in a collective pension fund.

The main positives of a CDC scheme are that longevity risk is shared and investment returns have the potential to be higher and more stable which should mean that the scheme provides a better outcome for members than a defined contribution scheme.

When a member joins a CDC scheme, they, along with their employer, will pay contributions into the scheme and depending on the level of contributions being paid; the member will have a “target” retirement income. This target income is payable for life like an annuity or defined benefit scheme pension; however, the amount payable is not guaranteed. A member’s target income will be payable if investment returns are as expected and other assumptions, such as those for longevity, are accurate.

If actual experience is different than those assumptions, the pension scheme can amend the income payable to members whether that be through a reduction in pension payments or a reduced level of increases being applied. Although this may be seen as a negative of a CDC scheme, the theory is that by pooling funds on a large scale, the scheme will be able to achieve greater investment returns and that because of the collective nature of the scheme, it will be able to provide members with a higher retirement income when compared to a defined contribution scheme, if the same level of contributions are paid in.

An agreement has been reached for the first CDC scheme to be introduced in the UK for Royal Mail employees and the necessary legislation to enable this is contained in the Pension Schemes Bill which is currently progressing through Parliament. Once the legislation has been passed, other employers will be able to set up a CDC scheme if they wish.

Cash balance schemes

Cash balance schemes from a member’s perspective look like DC schemes because they provide a fund of contributions. The difference is that there is a guaranteed rate of return and the target benefit is a cash sum at retirement that can be used to purchase an annuity or be used with any of the pension freedoms such as

drawdown, taking lump sums etc. Some schemes offer guaranteed terms for converting the fund into a pension or it may work the same as an ordinary DC scheme in that it will depend on annuity rates at the time of retirement.

Unlike traditional DC schemes, the contributions and funds are pooled and individual 'member accounts' are hypothetical. As previously stated, there is normally a guaranteed rate of return or alternatively a guaranteed final fund value. The actual rate of return on the investments could be higher or lower than the guaranteed notional return that members are promised so the employer carries this risk in a similar way to a DB scheme.

From a member's perspective, the benefit of a cash balance scheme is that the investment risk is negated. The member is still left with longevity risk as ultimately, they will have to use their pension pot to fund their retirement, however the risk imposed on a member is lower than a defined contribution scheme. Members will also have a degree of certainty over the size of their pension fund at retirement and can therefore plan their retirement with greater clarity than they can in a defined contribution scheme.

Summary

Broadly there are three possible categories of pension scheme:

- Defined contribution schemes – where there is no promise at all as to the level of retirement benefits that will be provided to members
- Defined benefit schemes – where there is a full promise as to the level of retirement benefits that will be provided to members
- Shared risk schemes – where there is a partial promise as to the level of retirement benefits that will be provided to members

Where an employer operates a DB scheme, an ideal situation is for this scheme to remain open to new members. If this is not possible, the next priority is to negotiate a scheme whereby all the risk is not transferred to the member.

If members are continually placed into poor quality DC schemes then they are not going to be able to enjoy a comfortable retirement and may be forced to work for longer which is not an ideal outcome for either the member or the employer as this can lead to an unmotivated workforce.

Shared risk schemes offer the potential to provide members with a better outcome in retirement than a traditional DC scheme whilst reducing the amount of risk that an employer takes compared to a DB scheme.

As mentioned earlier, Royal Mail have agreed to close their DB scheme on the proviso that a CDC scheme will be implemented. The DB scheme has already closed and to cover the period between the DB scheme closing and the CDC opening, a cash balance scheme has been created. In the cash balance scheme that Royal Mail operate, they guarantee a minimum cash sum payable at the normal retirement age for the scheme which is age 65. Members build up a cash lump sum at a rate set by Royal Mail which is currently 19.6% of each year's pensionable pay.