Defining Ambition:

Views from the industry on achieving risk sharing

NAPF

Securing the future of pensions

This is the first in a series of research publications by the NAPF designed to promote discussion and debate about some of the key pension and investment issues of the day.

The NAPF is grateful for the contributions provided by the authors. The views expressed in this publication are those of the authors and not necessarily the views of the NAPF.

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Introduction

Nicholas Timmins surveys the recent history of the pensions market, and looks towards a new future

Over the past decade, defined benefit (DB) pensions in the private sector have entered what looks to be pretty much terminal decline – although not in terms of the liabilities that have been built up, nor in terms of the pensions that will still be paid out over many years to millions of beneficiaries.

But a mere 19 per cent of DB pensions[1] – usually final salary schemes – remain open to new members, and growing numbers are closing to further contributions from existing members. In their place have come money purchase, or defined contribution (DC), pensions.

The result has been to turn the once standard approach to workplace pensions on its head. Under DB, the employer took all the key risks – notably the investment risk as the pension built up, much of the inflation risk (and the continued investment risk) once pensions were in payment, and the longevity risk – how long the beneficiaries would live – once people had retired.

DC is a mirror image of that. In most schemes, all those risks are transferred to the employee, including the investment risk – which few individuals have the skills or knowledge to handle.

Individuals now take the risk over how large their final pension pot will be, and what it will then buy in terms of an annuity. They have to decide how far to forego income to provide protection against inflation, and similarly whether to provide the sort of survivor's benefit which is a typical feature of DB pensions.

Added to that, in a typical DC plan, much less money – from both the employer and employee – is being invested. Only 9 per cent typically goes into a DC pension[2] from combined employer and employee contributions, against 21 per cent into a DB pension[3].

As a result, almost any way it is measured, pension coverage in the private sector has declined – whether in terms of numbers with a workplace pension or in terms of how much is being saved a year. Whole generations of workers, if they are saving at all, are saving for a poorer old age than the current generation of retirees who have benefited from DB schemes and previous incarnations of workplace pension saving.

[1]NAPF Annual Survey, 2011
[2]ONS Pension Trends July, 2012
[3]ONS Pension Trends July, 2012

The decline of DB

Over the years, a host of reasons contributed to the decline of DB pensions. These included increased life expectancy, new accounting rules that put pension schemes on companies' balance sheets and required 'mark to market' valuations, poor investment returns, changes to tax credits and increased regulation that protected the pension pots of those who changed jobs and demanded inflation proofing of pensions in payment.

Calculations by the Pensions Policy Institute indicate that the cost of providing DB pensions doubled over 50 years[4], with employers bailing out in the face of rising costs and increased uncertainty about the financial liabilities they were taking on.

Pension ministers have, over the years, faced repeated pleas from the industry, and even from recommendations in reports that they commissioned themselves, that some of the burden of regulation should be lifted – that some greater flexibility should be permitted over the promises that companies have made, or been required to make – for example, allowing inflation increases once pensions are in payment to become discretionary, dependent on the performance of the fund.

Each time, with one or two mainly minor changes, ministers have ducked the issue; chiefly, it would appear, because they feared any change would accelerate rather than slow the stampede away from the 'gold standard' of a DB pension.

Now, however, while a number of DB pensions clearly will continue on for many years, something resembling the end game has been reached for DB pensions. And a new opportunity has arisen.

A new landscape

If – and it remains an 'if' – the Coalition Government goes ahead with its plans for a single state pension of around £140 a week, the nature of DB schemes will change. Contracted out status – and the national insurance rebates that such schemes receive for providing a pension at least as good as the individual would have received from the state second pension – will go. DB pensions will become entirely additional to the state pension, not a substitute for part of it.

Furthermore, as things currently stand, the single state pension will include a 'triple lock' to ensure that its real value not only does not fall but might even rise. The basic state pension will increase by either prices, or earnings, or a minimum of 2.5 per cent per year.

[4]PPI Research Report - the changing landscape of pension schemes in the private sector, chart 12, page 32

This changed landscape, as the Pensions Minister Steve Webb has set out, provides an opportunity to re-think the essentially binary split between DB – where the employer is tied to a set of rigid promises and takes all the risk – and DC, where in its standard form there is effectively no promise to the employee other than the employer's contribution.

In practice, of course, the picture is more complicated than that. There are already a range of hybrid schemes, including for example, cash balance pensions where the employer provides a guarantee of growth in the pension pot but does not guarantee what that will buy in terms of an income.

This is already a form of 'risk-sharing' pension – or, as Steve Webb has put it, one that offers a "Defined Ambition" for the pension outcome, rather than the comprehensive promise DB offers at its best. There are other examples. But the current regulatory system tends to force schemes that offer promises into the heavily regulated camp of DB pensions. And a mere 8 per cent of DB schemes in the latest NAPF survey[5] described themselves as "hybrids" – in effect, risk-sharing.

The question is how to provide a framework to make the creation of such Defined Ambition pensions easier. The goal is twofold. First that it might encourage employers moving out of existing DB schemes to move to arrangements that contain elements of continued risk sharing, rather than switching straight through to pure DC. And second that employers already in pure DC might prove willing to take some risk back as part of an improvement to their employee packages – aided it is hoped, by auto-enrolment encouraging employees to take a greater interest in their pensions.

Expert views

In the essays that follow a range of pension specialists open at least a window on how that new framework might be developed.

They set out, for example, the Dutch approach, which has moved from final salary to career average pensions; with the amount of uplift applied both to pensions in payment, and during the investment phase, being dependent on the financial strength of the fund. The chapter in question contains suggestions of how the UK could build "an even better solution".

There are a host of ideas about the way that risks could be shared – about what sorts of guarantees or partial guarantees could be offered, from something as minimal as a 'money back' guarantee, where the employee would be guaranteed to get back at least the total of contributions from themselves, their employer and the taxman, to much

[5]NAPF Annual Survey, 2011

larger degrees of risk-sharing. There is also debate about what the principle goal of defined ambition should be – merely some guarantee around the size of the pot, or more of a guarantee about the eventual income.

Employees, the authors note, will need to understand what is being offered. And here, Morrisons' experience spells out an approach to employee education and involvement that holds promise. But the contribution implicitly raises the question of how far companies would be willing to share 'what works' with others.

If there is a widespread consensus that the creation of Defined Ambition pensions is a good idea, the problem is how to get there. The challenge looks formidable. As Joanne Segars suggests, the answer is unlikely to lie in tweaking the existing 'binary' approach of DB and DC regulation. Rather, it needs to be re-thought and re-drawn in the round.

As Steve Webb underlines, risk-sharing has to cope with job mobility, when different employers may offer different forms of risk-sharing. And he asks a key question: to go down this road, what guarantees will employers need that new layers of regulation will not add new minimum duties to schemes? What will prevent the sort of regulatory creep to which, with the best of intentions, DB was subject? A government cannot legislate to bind its successors not to do something. But an entirely new regulatory regime that allowed for risk-sharing, rather than mere tweaks to the existing system, might achieve that effect simply by allowing for a much wider diversity of schemes. If that is to happen, however, as several authors note, good governance will be essential.

Employees will need to have faith in the promises made. Furthermore, a risk-sharing approach would clearly work best if the vast numbers of individual DC schemes could be consolidated in some way to achieve scale.

Both those factors strengthen the arguments for the creation of 'Super Trusts' that can cross companies and indeed industries. That in turn would help tackle the job mobility problem as the chances of an employee being able to stay with a single pension provider for much of their career would be enhanced. In addition, it could offer employees collective, rather than individual, investment risk.

That proposition leads to questions about what incentives, what regulation, what penalties, what legislation, or what mix of those levers would be needed to encourage consolidation into “super trusts”. Do they need to be created as “green field” sites? And if so, how? Or is there a way of creating them through some mixture or push and pull that leads existing schemes to join them?

In other words, the more you think about what is needed to make Defined Ambition pensions a widespread reality – one that is safe for employees and safe for employers – the larger the agenda gets.

The fact remains, however, that there is a huge opportunity here, given the degree of political and industry consensus that Defined Ambition is a good idea even if the definitions of defined vary – and given the other changes in the pensions landscape which mean that such a goal may be achievable. Furthermore, there is time to think through and enact the answers to the many questions that the idea raises.

Will that time be wasted? Not if sufficient momentum is put behind the idea – by politicians, policy-makers, the industry and its regulators, and by the employee. There are hard issues to tackle to make this a reality. The contents of this publication set some of them out and suggest how some of them might be solved. But much more will be needed if the ambition of Defined Ambition is to be realised.

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01

Defining Ambitions

Defining Ambitions

Steve Webb MP calls for the industry to work together with the Government to create pension models that are fit for the future

Workplace pension provision will always be diverse. It will reflect the size, financial health and attitudes of the employer; the size, composition and strength of the workforce; the industrial sector of the firm; and many other factors. It is not the place of government to prescribe a single preferred form of workplace pension provision, especially in a world where that provision is largely voluntary beyond the auto-enrolment minimum.

But it is the job of government to make sure that workplace pension provision is, at the very least, of a minimum standard and – if possible – to encourage firms who want to go beyond that minimum.

This is what Defined Ambition is about. In a world where very few firms will take on all the risks of pension provision associated with pure defined benefit (DB) schemes, Defined Ambition is about that very large middle space where firms are willing to bear some of the risks, or share part of those risks with the pension industry like an insurer, rather than leave them all to the employee. People sometimes say that firms are so scarred by the experience of running DB schemes that they are not interested in bearing any risk. But a look at the diversity of workplace pension provision in the UK today shows that this is simply not true.

Lying between the extremes of pure DB and pure defined contribution (DC) provision, Defined Ambition encompasses a wide range of models, some of which are already possible in the current legislative and regulatory framework while others are not. At the 'DB-lite' end of the scale are schemes where longevity risk is shared through a 'life-expectancy adjustment factor' or similar devices, where the investment risk is borne by the employer (as with cash balance schemes); or various forms of hybrid schemes such as capped DB with a DC top-up or DB schemes with conditional indexation. At the (less-developed) 'DC-plus' end of the scale, models include individualised DC pensions with guaranteed minimum rates of return or the collective DC schemes that are the norm in many other European countries. One attractive example of individualised DC with risk-sharing is the 'moneyback guarantee' where the very least that the pension fund will do is return the full value of the contributions made by employee, employer and taxpayer. I believe that developing products of this sort offers the potential to meet a real need in future pension provision.

Why does risk-sharing matter?

In considering why risk-sharing is so important it is worth considering where we have come from. Whilst the past was never quite as rosy as we sometimes paint it, for many people pension provision used to be one of the certainties in their life. For as long as they worked for the same large employer (in the public or the private sector) they could plan for their retirement with a great deal of certainty. They knew that their retirement income would replace a set percentage of their final wage, and – in many cases – that their retirement income was itself largely protected against future inflation.

Consider, by contrast, the situation facing growing numbers of private sector workers in the UK today. If they have a pension it will probably be a straightforward DC pension pot. If they are lucky, their employer will make a worthwhile contribution and the scheme will offer modest charges and high quality investment management. But the size of their final pension and their living standards in retirement are still hugely uncertain. They will work for an average of around a dozen employers over their working life who will have a diversity of pension provision of varying quality. Their pension fund will generally increase each year but some years their pension statement will show a cash fall. When they retire they will probably buy a pension with their fund but annuity rates are subject to great uncertainty and are on a long-term downward trend. And even in retirement their real living standard will be unpredictable because fluctuating inflation will erode the value of what is highly likely to be an annuity which is fixed in cash terms.

It is not hard to see why a measure of greater pension certainty than that afforded by pure DC could be a very attractive part of the workplace pension offer. The question I am asking within government and in partnership with the industry is: what do we need to do to encourage firms to offer risk-sharing or Defined Ambition pensions or, at the very least, what barriers to such provision do we need to remove? And what types of products would help to deliver the kind of risk-sharing that employees would most value?

Some people have argued that because we already have risk-sharing models we do not need to do anything. For example, firms are already offering pensions where adjustments are made for rising longevity or where the firm limits its risk exposure to pre-retirement investment risk. But we also hear that there is sometimes an uncomfortable fit between these schemes and the current 'binary' regulatory framework which tries to categorise benefits as either DB or DC. We need to understand better what those issues are and how we could change the regulatory framework to accommodate greater risk-sharing.

Some employers point to the rules on indexation of DB schemes as being an example of an overly-rigid regulatory framework. These rules were introduced with the best of intentions but mean that it is now not possible to offer salary-related pensions unless they are extensively index-linked. Given that we are planning to abolish 'contracting-out', with the result that workplace provision will be entirely additional to state provision, perhaps the state should be less prescriptive about benefits for new schemes and future accruals. Indexation is, of course, a very attractive and valuable benefit. But should it not be open to schemes to decide which elements of risk they want to bear rather than prescribing that they cover the post-retirement inflation exposure of employees who may have left their employment decades earlier?

Some have suggested that risk-sharing is a second-order issue, especially on the eve of auto-enrolment. Without doubt, getting people into pension saving, saving earlier and saving more is absolutely fundamental. But providing pension products that people want is pretty fundamental as well. In my view the industry has sometimes failed to see this issue through the lens of the consumer – and if consumers opt out of auto-enrolment because they do not like the product, we have a real problem. There is considerable survey evidence that large numbers of people of all ages and all income levels are risk-averse when it comes to their income in retirement, yet most will be offered a product which offers them absolutely no certainty. If, as a result, they opt out of workplace saving, then they do not just get a reduced return from a cautious investment strategy, they get no pension at all.

Risk-sharing models are, of course, only one way of dealing with this problem. The NEST Corporation has done extensive research[1] on the attitudes of many of today's un-pensioned population, with some surprising results. When looking at the attitudes of young workers it has historically been assumed that the young will have a positive attitude to risk, not least because of their long time horizons before retirement. But what NEST found was that, like most people, young people react badly to the possibility that their pension fund might decline in value. For that reason NEST's 'target date' funds will have a relatively cautious investment strategy in the early years for younger investors so that they experience a period of investment growth before they are exposed to a higher-risk investment mix.

[1]'Building personal accounts: designing an investment approach. Key findings of the public consultation', NEST, November 2009 www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/ investment-consultation-response,PDF.pdf

Problems to be tackled

a) job mobility

Any risk-sharing framework has to be consistent with the modern labour market and with the Government's wider pension reform strategy. And one tricky issue that would have to be resolved is what a pension guarantee looks like in a world where people regularly change jobs and, as things stand, change pension schemes at the same time. In particular, a world where, by default, smaller pension pots follow the member when he or she changes job, presents certain challenges if pensions have promises attached to them.

For example, if someone is going to work for a single firm and be a member of a single DC pension scheme for their whole working life, then providing a 'moneyback' guarantee over a period of decades might be relatively straightforward. But if someone leaves the scheme and wants to take their money with them after a few years, it would not necessarily be possible to guarantee that full contributions could always be taken with them. This is clearly an issue that would need to be addressed and on which we would welcome contributions. One option would be to focus pension guarantees on older workers who are less likely to change jobs frequently and who may be particularly interested in pensions certainty. Another would be to foster a smaller number of market-wide providers ('Super Trusts') so that moving job does not necessarily mean changing pension scheme membership.

b) Communications

Another challenge to this agenda is the difficulty of communicating with scheme members. Conversations I have had with employers have suggested that more complex risk-sharing models can sometimes be baffling to members and that this can in turn lead to reduced participation. On the other hand, in my view, there are forms of guarantee – such as the 'moneyback' pension – which are relatively intuitive and which it ought to be possible to communicate in a way which resonates with what people want from their pensions. One approach could be to 'kitemark' pension products according to their risk-sharing features so that scheme members can see that their pension is a 'moneyback guarantee' pension or similar.

c) Regulatory instability

One thing which might discourage firms from going down this route is the threat of 'regulatory creep'. In other words, we might create a 'light-touch' regulatory regime today in order to encourage risk-sharing, but what if a future administration decides to tighten up the rules, forcing firms to incur additional costs of pension provision?

This is a real issue and one that needs to be addressed. All too often, governments have – with the best of intentions – added layer upon layer of regulation to workplace pension provision with the result that few firms can now afford these costs and have instead opted for much cheaper alternatives.

Whilst no government can bind its successors, it may be that the Defined Ambition framework can be set up in a way that provides reassurance for those who will operate within it. If we specifically create a framework which encourages risk-sharing then it may be harder for a new government to change it in a way that made risk-sharing more expensive. But there may be other ways of providing reassurance to firms and we would be interested in hearing ideas.

The cost of guarantees

Pension promises clearly come at a price. For example, if a scheme has to guarantee that it will at least return the money that was put in, then this will have an impact on its investment strategy and on average will result in a lower pension. Whilst we need to do more work on exactly how much different pension promises would cost, recent work by the OECD has suggested that 'moneyback' pension promises could be provided over the long term at relatively modest cost. I strongly suspect that if most workers knew the wide range of possible outcomes they could face through their DC pension they would be very interested in being offered a kind of 'insurance policy' which narrowed that range of potential outcomes.

Another question is what exactly should be guaranteed – should it be the pot or the pension? In cash terms or in real terms? Ideally, of course, it is people's real retirement income that we are interested in, as in the world of pure DB. Sadly, guarantees in this space are likely to be prohibitively expensive. But it is an open question as to whether the guarantees we seek should be about pot size or nominal income in retirement.

Conclusions

There is no doubt that there are many very pressing issues in the world of pensions. The state of the global economy and the low interest rate environment present huge challenges for firms and for workplace pension provision. But the onset of auto-enrolment means that 11 million people are about to start thinking about pension provision, in many cases for the first time. We need pension products that are attractive and meet their needs so that they stay in pension saving rather than opting out. In an increasingly globalised and uncertain world, certainty in pensions will become an increasingly precious commodity.

I believe that firms who are willing to take on (or retain) some pension risk, or offer products with guarantees backed by other parts of the pensions industry, will be doing right by their employees and will be offering an attractive benefit as part of their overall remuneration package. I hope that the pensions industry will work with me so that we have the right products and the right regulatory regime to make sure that firms that want to share the burden of risk in pensions are supported and enabled to do so.

Steve Webb MP is Minister of State for Pensions

02

Motherhood, apple pie and risk-sharing

Motherhood, apple pie and risk-sharing

The NAPF believes that a new and flexible regulatory platform is the first step towards encouraging risk-sharing and innovation

Rather like motherhood and apple pie, risk-sharing in pensions is one of the things that many people – at least the kind of people who read monographs like this about pensions policy – think is a good idea.

Ask almost anyone in the pensions industry whether they agree it is a good idea to create a permissive regime that would allow those employers and employees who wish to share the risks involved in pensions to go ahead and do so – and the answer is 'Yes, of course, *but.....*'

So why is it that the debate about risk-sharing has not advanced much beyond the motherhood and apple pie stage? Why has it not been taken forward? Why do we have no matching consensus about what risk-sharing schemes should look like or how we should deliver them?

The answer may be that, while risk-sharing could have a role to play in future pension provision, there is a wide range of views about the problems it is intended to fix.

And for many employers it may be a case of déjà vu all over again. They may take the view that they used to provide risk-sharing schemes. They may take the view that they used to run Defined Ambition schemes, but that successive Governments added new requirements and new costs in the shape of mandatory indexation, for example. So for them, it may be a case of "once bitten twice shy." They may be sceptical about the willingness of future governments ability to resist the temptation to change the rules. Not unreasonably, some employers will now just want the certainty that a defined contribution (DC) scheme gives them.

To some people, however, risk-sharing is the answer to the cost and volatility that defined benefit (DB) pensions impose on employers. A 'core DB ' kind of risk-sharing could make DB-type provision sustainable.

For others, risk-sharing is all about helping the employees who face the uncomfortable prospect of shouldering all the risks in DC schemes. A ‘DC plus’ approach could share some of those risks with employers or insurers and boost confidence in pension saving.

And at both the ‘core DB’ and ‘DC plus’ ends of the spectrum, there are countless ideas about how the risks would be parcelled out.

So we have a debate that starts with consensus around an idea and then moves quickly to divergence. Agreement on the basic principle very soon becomes disagreement on the challenges and the practicalities.

A fresh approach

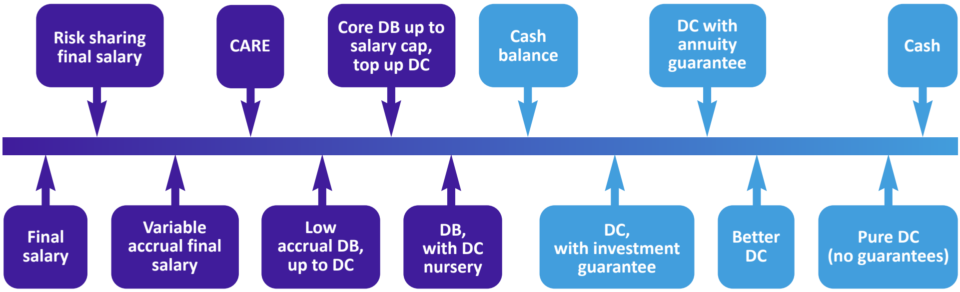
We need to embark on a consideration of what risk-sharing could look like with the right mind-set.

The problem with previous reviews of risk-sharing is that they failed to give themselves the room for creativity and free thinking. In particular the 2006-7 ‘Deregulatory Review’ suffered from three key failings.

- It proceeded ‘inch-by-inch’, considering individual candidates for deregulation one at a time. In almost every case, it was easier to find reasons against deregulation rather than in favour of it.

- It started from the assumption that the current framework of regulation would remain fit for purpose – if only a few parts of it could be reformed.

- It continued to see pensions as either DB or DC, rather than recognising that there is a wide variety of risk-sharing models for pension schemes, some more closely based on DB, some more closely based on DC and others at intermediate points on the spectrum in terms of where risks lie mostly with the employer or employee. Escaping the artificial limitations that arise from trying to pigeon-hole every type of pension as either DB or DC is crucial if we are to develop a new landscape of risk-sharing pensions.



The 'spectrum' of risk-sharing pension schemes

So we need a fresh approach. And the Pension Minister's support for risk-sharing has given us an opportunity to develop it.

The time is now

It is the sheer scale of change in the pensions landscape that demands this fresh thinking.

In 2000, 88 per cent of DB schemes were open to new members. By 2011 this had fallen to just 19 per cent, with 23 per cent of schemes now closed to future accrual. This shift has been driven by rising operational costs due to increases in longevity, the regulatory burden and increasing employer sensitivity to the scale of pension scheme liabilities. And further rapid decline is likely: a third of schemes currently open to new members are likely to close that scheme over the next five years, whilst a further third are likely to take the final step of closing schemes already closed to new entrants to existing members[1].

The move from DB to DC has fundamentally shifted the balance of risks from the employer to the employee. In a DB scheme investment and longevity risk are borne by the employer. This is reversed in DC. However, the shift from DB to DC also passes on the decision-making risk to the individual: in DC the employee needs to decide, for example, how much to contribute, what fund to invest in, how to take the pension; and has to cope with significant uncertainty around the final outcome. While there is much good quality DC provision in place, many DC schemes have lower contributions and less effective – or no – scheme governance.

[1]NAPF 2011 Annual Survey

With auto-enrolment set to bring between 5 and 9 million new people into pension saving, the vast majority of them in DC, and who – with all the complexities of today's pensions system and the a-symmetries of information between consumer and provider – will be ill-equipped to navigate and manage the risks of DC. Instead we need to create a framework that will enable the development of a genuine mixed economy of pension provision so that employers are free to provide the form of pension provision that is right for them and their employees, whether core DB, DC plus or options at some other point on the risk-sharing spectrum.

It is important to be clear about what we are proposing. The NAPF does not envisage a new, third regime in between the existing regulatory regimes for DB and DC – this is not the answer. Rather, we want to reshape the existing prescriptive regulations that force employers to provide either DB or DC, so instead we have a continuum of regulation that allows pension schemes to be created – and properly regulated – at any point on the risk sharing spectrum. It would be a far more flexible and sustainable approach to pensions policy.

Neither are we proposing that risk-sharing should be mandatory, or that employers should be forced to risk share. Rather the the Government's role has to be one of facilitation, to create the right environment for risk-sharing to take place.

Barriers to a mixed economy

The pensions economy is far from mixed at the moment. Although a wide range of risk-sharing models is available in theory, little use is made of them in practice. The 2011 NAPF Annual Survey found that only a small proportion of DB schemes offer some form of risk-sharing: just 8 per cent of 849 DB schemes described themselves as hybrids. 78 per cent were final salary and 11 per cent were CARE, the remainder used a mixed approach. And of course most employers who alter their pension arrangements tend to switch from one end of the spectrum to the other – from full-blown DB to 'pure' DC.

Many of the reasons lie in our regulatory system, which tends to classify schemes with any type of promise as DB – with all the regulatory burdens that go with it (such as the scheme-specific funding regime and payment of the PPF levy). In fact a key problem is that employers who offer any kind of pension promise find themselves hit by the full panoply of DB regulation. We need a more proportionate regulatory regime that adjusts automatically to reflect the degree of risk held by employer and employee. And we need the regulators and tax authorities to better understand risk sharing-type arrangements. As one manager of a cash balance scheme recently highlighted his scheme *"is not well liked by the regulator or HMRC"*[2]

[2]Workplace Retirement Income Commission Final report: Building a strong, stable and transparen pension system, page 59

But there are 'soft' barriers as well. They include a lack of flexibility to allow future changes to the scheme; fear of future regulatory change; the complexity of risk sharing schemes, which makes them more difficult to communicate to members; and concern that it could be difficult to find the right advice or advisers.

If we are to create a genuine risk-sharing landscape on which the pension schemes of the future can flourish, then all these barriers will have to be surmounted. It is quite a challenge.

DB-based risk-sharing

Whilst it is unlikely that we will see employers who have already moved from a DB to a DC arrangement move back to DB, risk-sharing could help slow the exodus from DB and give employers more freedom to offer their employees the pension benefit that is right for them.

Of course, risk-sharing is not for everyone. Some employers might see little attraction in it. But others would, so why not develop a permissive regime that would give them the opportunity to embrace it?

So what would risk-sharing at the DB end of the spectrum look like in practice?

One option could be to allow schemes to go 'back to basics' and permit scheme sponsors to provide single life, level pensions. Benefits such as indexation in deferment and in payment and spouses' benefits would no longer be a legal requirement. This would be a 'core DB' and in effect reflects what is on offer for DC.

In the new pensions world where every working person will have the right to build up a workplace pension with an employer contribution, together with a more generous, simpler, state pension paid equally to women and men and indexed in line with the triple guarantee[3], there is less call for inflation protection and spouses' benefits to be paid by the scheme as a legal right.

A more flexible regime would allow employers to fund these benefits if they wish to do so – or employees could purchase them with extra contributions. Indexation could be 'conditional', ie paid when the scheme's funding position so permitted.[4]

[3]Earnings, prices or 2.5 per cent, whichever is highest

[4]The introduction of Conditional Indexation would require changes to Article 51 of the Pensions Act 1995, which introduced Limited Price Indexation

In all these 'core DB' models, employers would continue to bear investment, salary escalation and some longevity risk, whilst scheme members would bear some inflation and longevity risk. So whilst from a regulatory perspective DB would be placed on a level playing field with DC, there would be one important difference: it would continue to provide more assurances for the scheme members than DC as scheme members would continue to benefit from a pension related to their salary at the point of retirement.

In such a model there would, of course, as now, be a key role for trustees in protecting members' interests.

Altering the benefits DB schemes would be required to provide as a legal minimum would have the effect of reducing the employer's accounting liabilities, and would also improve the scheme's funding position. For example, removing indexation requirements and spouses' benefits for a typical DB scheme with 500 members, an accrual rate of 1/60th, and an average pensionable salary of £20,000 per year could reduce costs by 50 per cent[5]. By containing the liabilities and the costs of providing defined benefits, it is more likely DB schemes still open to new members and/or future accrual will continue to remain open. Any changes to benefit structures should apply to future accrual only and not affect benefits already earned.

One important step towards creating a continuum of regulation would be to ensure that the Pension Protection Levy reflects the degree to which employers make a promise. At present, a scheme with any element of DB has to pay the Levy in full. This should be replaced by a sliding scale, so the levy would be lower the further schemes are removed from final salary-based DB.

DC-based risk-sharing

Making DB-type pensions more sustainable would represent a significant advance, and would help those schemes and employers who still provide DB pensions to continue offering similar benefits to their employees for the foreseeable future.

But with the majority of people saving in pensions in the private sector saving in DC schemes, the real prize to be won from the risk-sharing agenda lies at the DC end of the spectrum.

The key DC risks are annuity rate risk and investment risk. There are a number of ways these risks could be mitigated in DC, including guarantees, advanced lifestyling, target benefit funds, or Collective DC (CDC). Good communication and governance also have a central role to play.

[5]Fit for the Future: Vision for Pensions, NAPF, 2010

Guarantees could be offered on annuity rates and/or investment performance:

- A guaranteed annuity rate would remove members' uncertainty about the amount they would need to save in order to be able to secure the kind of income level they wish to have in retirement.

- A guarantee on investment would put a floor under the fluctuation of DC investments. This might, for example, mean guaranteeing that the members' 'pot' would – at the very minimum – be equal to the sum of contributions paid. Similarly, there could be a guarantee of the return to be achieved on investment.

Of course guarantees would come at a cost to employers or pension scheme members – just as any other kind of insurance requires a premium to cover the risk. But it is possible that many members would be content to make higher contributions or accept a lower return if the arrangement did not involve the uncertainties that can be a disincentive to saving in a DC pension.

A further option would be CDC – where contributions are invested in a collective fund, rather than in individual accounts. In CDC, the trustees would be able to control the size of the benefit liability to keep the scheme's financing in balance.

The pension earned would be calculated as a percentage of earnings in each year of service and revalued each year to ensure that it maintains its value in real terms. However, revaluations would not be guaranteed but would be subject to the scheme's funding levels (and the basic level of pension might also be cut back in extreme situations).

The design of CDC, with pooled investments and conditional benefits, means that the risks are shared between members, rather than between members and employers. Employers would have complete certainty over their contributions. So the schemes would be purely DC to the employer but offer some of the benefits of DB to the employee.

The DWP ruled out the legislative changes required for CDC in 2009, due to concerns relating to likely employer take-up, compatibility with EU legislation, fairness between generations and the implications for employee confidence in CDC schemes. As indicated earlier in this article, we need a different, more creative mindset from our policy-makers, and there are good reasons to think we might now have it.

Scale and good governance

Much of this essay has concentrated on the changes in attitude and law required to clear a way for risk-sharing schemes. But we need two more ingredients – particularly at the DC end of the spectrum: scale and good governance.

The NAPF has campaigned for some while for 'Super Trusts' – large-scale, multi-employer DC-type schemes with trust-based governance. Super Trusts would have the size needed to drive serious economies of scale, with all the cost savings that would bring. They would have the governance arrangements to ensure the members' interests are safeguarded, so members would not be left 'on their own' – as they are in some DC schemes at the moment.

But perhaps most importantly, Super Trusts would have the capacity and expertise to innovate.And their large scale would mean they would be better placed to share and pool risks. Super Trusts are, therefore, the final – and crucial – piece in the risk-sharing jigsaw.

Don't sweat the small stuff

We argued at the start of this article that the many supporters of risk-sharing all have their own particular problems that they want it to fix, and this has made it difficult to generate consensus around what risk-sharing schemes would look like.

The answer of course – as the psychotherapist Richard Carlson put it – is not to sweat the small stuff. In other words, policy-makers should look to create a simple platform of law and proportionate regulation on which a wide variety of risk-sharing schemes can be built. The mistake of the past has been to design prescriptive legal frameworks that only allow certain highly-specified forms of risk-sharing. This approach rules out flexibility and strangles innovation. It is the opposite of the flexible continuum of regulation that the NAPF would like to see in place. And of course, any such system should also recognise that good governance can provide equally effective protection for members' interests – if not better.

So the next step should be a review of pensions regulation with the objective of creating a regulatory system that facilitates and encourages risk-sharing and innovation. We should be prepared to place our confidence in the capacity of good governance and scale to drive up quality, all backed by a risk-related approach to regulation where necessary. And we should be looking to create a system that will last, replacing endless chopping and changing of regulations with stability and certainty. This certainty is the key ingredient in facilitating an environment where risk sharing is allowed to develop – we cannot make the same mistakes of the past and change the goalposts, if that happens then we can forget about employers wanting to even contemplate sharing risk.

We have the political support and the industry consensus that we need to create room for risk-sharing schemes in our pensions landscape. Let us clear away the barriers and allow a new generation of pension schemes to flourish.

Joanne Segars is Chief Executive of the National Association of Pension Funds

03

Risk-sharing in Dutch pension schemes

Risk-sharing in Dutch pension schemes

Adri van der Wurff, Stefan Lundbergh and Ruben Laros give an overview of the Dutch system, and highlight lessons the UK can learn

The Dutch model is often described as one of the best in the world. Mercer (2011) ranked the Dutch pension system as the best in their annual rankings for the last two years. Among other factors, the strength can be attributed to the (quasi-)mandatory participation, the high contributions rate, the low implementation costs, the collective risk-sharing and the governance of the Dutch funds. Of course, there are also weaknesses that accompany the strength. Careful calibration keeps the system sustainable.

Before outlining how risk-sharing pension schemes operate in the Netherlands, we will provide a short description of the Dutch model. As in most countries, the Dutch system is characterised by a three-pillar system. The average Dutch employee can expect 40 per cent of his/her pension income to stem from the first pillar, 50 per cent from the second pillar and 10 per cent from the third pillar.

The first pillar consists of a flat rate defined benefit (DB) scheme on a Pay-As-You-Go basis that is operated by the Government and financed via the state budget. The first pillar is called the Algemene Ouderdomswet (AOW) and is meant as old age income insurance for all inhabitants of the Netherlands. Accumulated pension rights are based on years of residence. The AOW grows with the minimum wage and is not means-tested.

The second pillar is the workplace pension offered by the employer. It is a funded system and the large majority of the schemes are average wage DB pension schemes, although there are a growing number of individual defined contribution (DC) schemes.

The third pillar consists of individual DC products that are mostly meant for additional income on top of first and second pillar income. The self-employed are not covered by the second pillar and have to resort to the third pillar in order to save for their pension.

The second pillar

The second pillar is what distinguishes the Dutch system, and it is known for its adaptability. Over the years the system has evolved into a more sustainable pension deal without resorting to individual DC. We will highlight a number of characteristics that form the foundation of the Dutch system.

Governance

The Dutch model is a product of a long history of collaboration among the triangle of stakeholders: the employees, the employers and the Government. Social partners (appointed employees and employers or their organisations) are the trustees of pension fund boards and together they decide on the policies of the fund. This gives the system the trust and legitimacy required for operating risk-sharing schemes as the interests of the members are safeguarded. The trustees decide on i) the investment policy and the exposure to certain risks (inflation, interest rate and currency among others); ii) the indexation that is provided to the participants; and iii) the level of contributions. In addition, the trustees procure services such as asset management and administration.

Contributions

The notion that an average Dutch employee works one day a week for his/her pension is a widely accepted one. On average, an employee pays 20 per cent of his income in order to get a decent pension income from the retirement age of 65 onwards. Of course, rates can be lower if retirement age is higher. Pension schemes can be well designed, but without a realistic level of contribution rates the targeted level of replacement income will never be achieved.

Mandatory participation

A crucial characteristic of the Dutch pension system is its mandatory participation. Employees are obliged to participate in the pension scheme of their employer. For certain industries industry-wide pension funds exist where the employer is obliged to offer that pension scheme to its employees. Over 90 per cent of Dutch employees participate in a pension scheme through their employer. The mandatory participation is beneficial since it eliminates all marketing costs for pension schemes, as they do not need to compete for participants. This is a significant cost-saver when compared to other countries which have a market-based solution. In addition, larger industry-wide pension funds can exploit economies of scale in both administration and asset management.

Mandatory annuitisation

In the Netherlands, the aim of a pension scheme is to provide a stable income after retirement. The annuitisation phase is just as vital as the accumulation phase. This mandatory (by law) annuitisation applies to every pension product in both the second and third pillars. The advantage of integrated annuitisation is that the participants get an insight into the income they can expect to receive. This is in contrast to most individual DC solutions where the asset mix and accumulated pension wealth are reported.

Risk-sharing
The Dutch second pillar has evolved to its current form over the last decennia. The majority of the large industry-wide pension funds and company pension funds were founded after World War II. All of them, at the end of the 20th century, were characterised by operating final salary DB schemes conditional but in practice full indexation in the pay-out phase, comparable to British DB schemes.

This system, while very advantageous for the employee, turned out to be unsustainable for the employer. The employer bore all the open-ended pension risks: inflation risk, longevity risk and financial risk. International accounting standards forced companies to put pension liabilities on their balance sheet, making it less attractive to operate a company pension fund. This caused a shift away from company pension funds to either industry-wide funds (as this relieves companies from the pension liabilities on their balance sheet) or to insured solutions such as individual DC schemes.

All the risks are borne collectively among the participants in an industry-wide fund. Risk-sharing in those schemes has the advantage that there is no adverse selection and that it allows for return smoothing over generations. The funding ratio is used to absorb temporary shocks. In other words, if the fund is well funded and a shock hits the pension fund causing the funding ratio to decrease, it will still continue to pay out benefits fully in the expectation that the markets will recover. When a fund is in a state of severe underfunding the pension fund board has three instruments to use to recover: increasing contributions, reducing inflation compensation, and lowering benefits as an 'ultimum remedium'.

Recently, industry-wide funds have been faced with some issues: longevity seems to be an irreversible trend (and thus impossible to hedge), and exposure to the financial markets leads to volatility in the funding ratio. The latter issue became even more explicit when the prudential supervisor changed the discount rate of pension liabilities from a fixed average discount rate of the liabilities (4 per cent) to a market rate (a swap curve to discount future liability cash flows).

Renegotiating the pension deal – shifting risks
After the IT bubble at the start of the 21st century, final salary DB deals became unsustainable: the costs were too high for employers and their willingness to support final salary DB schemes decreased. The triangle of stakeholders – employers, employees and the Government – got together and renegotiated the pension deal. The new deal was based on the average wage principle and introduced conditional indexation during the accumulation and pay out phases. Conditional indexation means that the inflation compensation that participants receive is based on the funding ratio – the financial strength – of the fund.

The changes to the pension deal have meant a shift in pension risk from the employer to the employees. As we have mentioned, all pension risk was previously borne by employers, but in the current situation the risks are shared between both employee and employer. For the employer this risk implies that contribution rates can increase. For the employee, this risk means conditionality of indexation, varying contribution rates and potential reduction of benefits.

However, in 2008 the combination of increasing longevity, low equity returns and falling interest rates hit the funding ratios hard. This showed the need for better communication about the risk-sharing mechanisms and their consequences. At the time of writing this paper, the pension deal is again being renegotiated. While the exact changes are unknown right now, the authors expect the pension age to increase in both the first and second pillar and that it will be linked to longevity at some point in the future. It is also likely that the new pension deal will have incremental mechanisms for reducing/increasing benefits in the case of increasing longevity or shocks that hit the financial markets.

Lessons for the United Kingdom

The Dutch pension model has very positive characteristics, but there is room for improvement. The UK, with its introduction of Defined Ambition, has a chance to build an even better solution by starting from scratch. Since Dutch industry-wide pension funds are mature it is very difficult to change their fundamental design. Due to inter- and intra-generational risk-sharing mechanisms large changes have a problematic transition process. For example, the Dutch system has a uniform contribution rate and a uniform accrual rate. This implies that the younger generation subsidises the older generation. Changing this system requires a very careful transition that will likely include a group of participants who will be worse off than they had expected. While these transition problems are significant it is still useful to observe a number of principles based on Dutch experience of collection pensions which could be of use in designing a strong Defined Ambition framework.

Risk-sharing

Risk-sharing can be achieved between employers and employees. A clear trend is that risk is transferred to the employees, but it can be shared among the employees in a collective. The collective will then bear the open-ended risks, such as longevity risks.

Defined Ambition offers the possibility of introducing risk-sharing, but this must be designed carefully. It is important to make sure that all the transfers within a collective are carried out on a fair value basis. For example, if active participants provide ‘volatility insurance’ for the retirees, the cost of this ‘insurance premium’ should be determined ex-ante and it should be priced using the financial markets. In other words, risk transfers should be valued on a mark-to-market basis. The idea behind this concept is that it is still possible for groups of participants to share risks with each other, but those participants that provide the 'risk insurance' must be compensated fairly. Some risks, such as individual longevity risk, should be borne by the collective. To manage systemic longevity increases it is probably best to make the pension rights and pay-out dependable on longevity, as this is too expensive to insure.

Governance

The regulation should be designed and implemented so that the rules of the game are clear, as well as the consequences of breaches. A necessary condition for the long-term success of Defined Ambition is that the regulator is credible and enforces the regulation. For example, every pension fund board should know what the regulatory consequences are in case of a deficit (surplus) when the fund is underfunded (overfunded).
The main task of the pension fund board is to safeguard the participants' interests. The Dutch have solved this by having non-profit pension funds governed by social partners. Every decision that is made is the result of negotiations between employers and employees. The UK pension mis-selling scandal is infamous as an example of how things can go wrong when the interests of the participants are not protected by social partners and market forces get a free hand in providing products directly to participants. An alternative solution that might work in the British market is to set up mutual companies where the participants elect the board members. The American company TIAA-CREF serves as an important example of such a system.

Efficient pension delivery

Pension delivery needs to be organised in an efficient way. Two factors that contribute to effectiveness are low costs and high participation. The Dutch system is praised for its low costs[1]. A key factor is the mandatory participation in the Dutch system as it results in scale effects and removes marketing costs for pension funds. However, scale effects can be achieved in other ways as well. Consolidation can play an important part in making the British pension sector more efficient. For example, industry-wide funds can be set up, or other forms of multi-employer funds, or Super Trusts. An advantage of an industry-wide pension fund is that the risk of bankruptcy of all the employers in an industry sector does not exist.

Regarding participation rates, it can be observed that people in general are not interested in their pension, let alone in saving for it. In the British private market, the participation rates hover around 50 per cent. From a lifecycle optimising point of view it is optimal to save for your pension, so theory suggests that participation rates should be higher. Unfortunately, most people do not act rationally and therefore it is essential for the Government to introduce some strong incentives to participate. This has been done in the UK with the introduction of auto-enrolment, which is a great step forward, but the minimum contribution rates accompanying auto-enrolment legislation seem too low from a Dutch perspective.

[1]Research by the RSA (2010) shows that an average British employee will receive a 33 per cent lower pension after retirement compared to an average Dutch employee because of cost friction. In RSA (2012) it was shown that many British pension providers do not report the hidden costs that cause the cost friction.

Meaningful consumer interface

A pension is an integral product: it includes both the accumulation and annuitisation phase. Viewing the product like this means that you save for an income after retirement instead of a certain amount at retirement date. This prevents the participant from being exposed to conversion risk. In addition, it allows for clearer communication with the participant as he/she finds it easier to understand an annual or monthly income than a certain amount that needs to be converted into an annuity. If the pension provider is able to answer three questions the participant should be able to get an insight into his/her purchasing power after retirement and how to take action if required. The questions are: i) what can the participant expect at retirement, ii) what is the minimum that the participant can expect; and iii) what can he/she do to change these amounts.

Conclusion

The British pension sector is going through significant changes. Steve Webb and the DWP have announced their Defined Ambition framework and are looking for ways to set this up properly. This is an ambitious project, but it offers the United Kingdom the opportunity to start with a clean sheet. While setting up a proper framework and legislation is one thing, attracting employers that wish to adopt a Defined Ambition type of scheme is another matter. Even more challenging, perhaps, is to restore confidence in the British pension sector and its providers: the banks, insurance companies, pension funds and Government.

In this paper, we have identified some principles that should be kept in mind when designing the Defined Ambition framework. We hope it shows that British employers can offer a more attractive pension deal to their employees when adopting a Defined Ambition scheme. If so, the employees can get a better pension deal and the United Kingdom gets a great opportunity to increase the standard of living of its future pensioners. That is a deal that is hard for any British company and government to pass up on.

Adri van der Wurff is Chief Client Officer, Stefan Lundbergh is Head of the innovation centre, and Ruben Laros is Innovation coordinator at APG Group

Sources:

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04

Defined Ambition and the Lost Generation

Defined Ambition and the Lost Generation

Ruston Smith heralds Defined Ambition as the ideal opportunity to change British attitudes towards saving for retirement

Defined Ambition, if done well, provides the perfect opportunity to reinvigorate UK pensions – creating a framework to give individuals the confidence and encouragement they need to save more for retirement and enable employers to better support individuals in achieving this goal.

By encouraging long-term saving, a well thought-out Defined Ambition framework gives the Government a way to address the increasing pressures it faces in relation to spending on pensions. The consequences of not making changes to encourage people to save more for their retirement will have far-reaching implications for the future of our economy.

This thought-piece explores the scale of the UK pensions problem, how Defined Ambition could help address the issues and what needs to change to make Defined Ambition a success.

What is the predicament we face?

It is no secret that over the last five decades legislative change combined with years of turbulent and negative economic developments has increased the costs of defined benefit (DB) pensions – latest estimates are that costs have doubled[1] in the past 50 years.

As a result, the majority of employers have closed their defined benefit (DB) schemes – only 10 per cent of private sector workers are currently in a DB scheme.
This decline of DB provision, a move towards defined contribution (DC) and the uncertain economic conditions have transformed a nation of savers for retirement into a nation of short-term survivors:

- Less than 50 per cent[2] of people currently pay into a pension scheme
- Average total contributions to a DC scheme are only 9.1 per cent compared with 20.9 per cent to DB schemes[3]
- The average retirement income in the UK is only 48 per cent of pre-retirement salary compared with an average of 72 per cent across the OECD countries[4]

[1]PPI research report – The changing landscape of pension schemes in the private section, chart 12 , page 32
[2]ONS Annual Survey of Hours and Earnings 2011, page 26
[3]ONS Pension Trends Survey: Chapter 8, July 2012

Adding to the problem, the UK faces the challenge of an ageing population[5]:

- By 2051 a quarter of the population is expected to be over age 65 and there will be around 350 people over State Pension Age for every 1,000 people of working age
- People are living, on average, an extra 7 years longer compared with 30 years ago and this is predicted to increase by a further 5 years by 2051

Consequently, the UK faces a potential pensions crisis, with fewer people saving for retirement and those who do are contributing much less – people will be living longer on much reduced incomes. If nothing changes, the UK Government is likely to have to pay higher levels of state benefit or risk seeing more of our pensioners living in poverty.

What's the size of the challenge?

The UK has an ageing population, which will have significant impact on public finances – more people claiming retirement benefits, at a time when growth in government revenues is expected to slow down.

At the end of 2010, the value of the cumulative pensions built up in the UK was estimated at £7.1 trillion, nearly five times the UK's Gross Domestic Product (GDP)[6].

- £5.0 trillion relates to pensions payable by the UK Government – £3.8 trillion in state pensions (over 2.5 times GDP) and £1.2 trillion in state-sponsored workplace pensions.
- Of the remaining £2.1 trillion, £0.4 trillion is personal pensions and £1.7 trillion is private sector company provision – around only a third of the amount to be provided by the UK Government.

The Office for Budget Responsibility estimates that the annual Government spend on old-age-related benefits is expected to increase from 35.6 per cent of GDP to 40.8 per cent of GDP over the next 50 years – an increase of £80 billion a year in today's money[7].

The OBR also estimates that over the same period Government revenues will only increase slightly from 37.3 per cent of GDP to 38.2 per cent of GDP. A relatively smaller working population will mean lower tax and national insurance revenues, whilst continuing globalisation of business and trade will put pressure on other forms of income such as corporation tax and VAT.

This mismatch between expected Government revenues and expenditure highlights the need for a sustainable private sector pensions system that bridges the gap by encouraging long-term retirement saving.

[4]OECD report – Pensions at a Glance 2011, net replacement ratios
[5]ONS Pension Trends Survey: Chapter 2, February 2012
[6]ONS report: A fuller picture of the UK's funded and unfunded pension obligations March 2012
[7]2012 edition of the Fiscal Stability Report

Why aren't people saving for retirement now?

The move towards purely defined contribution (DC) pension provision, the transfer of risk to members and consequent economic conditions has reduced confidence in the pensions system – less than 5 per cent of people surveyed by the NAPF[8] said they were very confident that their pension would provide for their needs in retirement.

This, combined with increased volatility in market returns and rising annuity costs, has developed a perception of poor value-for-money for those retiring with only DC benefits. Projected income from the average DC scheme is only £1,436[9] in today's money and just 20 per cent[10] of the average income from a DB scheme.

Auto-enrolment is a positive step to encourage pensions saving as less than half the working population are currently in a pension scheme. This will raise awareness of the need to save and will provide a more positive and conscious opportunity for people to save for retirement.

The proposed reforms to establish a single-tier state pension would give people more certainty and help them to better understand the benefits of saving more for retirement. It also lays the foundations for private sector pension reform. These are important steps to build strong foundations to encourage a stronger culture of long-term savers – however, more can be done.

The lost generation

Based on the Workplace Retirement Commission's analysis[11] of the Wealth in Great Britain survey, over 50 per cent of those aged 16 to 34 do not have a private pension. Some of the key reasons for this are:

- It is estimated that almost 1 million people under the age of 24 are now unemployed[12]
- Those leaving university will have record levels of debt – on average £26,000, equal to one year's salary for a new graduate[13]
- Wage inflation has been stagnant for the last few years as the UK economy has suffered a double-dip recession
- The housing market is distorted – the current average house price for first time buyers[14] is now over 6 times the average graduate wage but lending is severely restricted

[8]NAPF Workplace Pensions Survey March 2012, figure 10, page 9
[9]Pensions World, annuity rates as at 2nd July 2012 – Aviva (no escalation – average of men and women)
[10]Average DC (see footnote 9) over average DB pension = 1,436/7290 (DB taken from NAPF Annual Survey)
[11]The Final Report by the Workplace Retirement Income Commission, August 2011, Chapter 1
[12]House of Commons Library – Youth unemployment statistics, September 2012
[13]Association of Graduate recruiters
[14]ONS House Price Index, July 2012

The above means that young people have less disposable income which, combined with the low confidence in the pensions system, means that we now have a disaffected generation who have little interest in pensions and are saving much less towards their retirement than their parents. This is reflected in the fact that fewer than 1 in 10 young people understand even basic pension terms[15].

What is more, there seems little indication that this trend will reverse – the likelihood of someone starting to save reduces the longer you haven't been saving and young people are therefore leaving it later and later in life before starting to save for retirement.

As a result, not only are this 'lost generation' expected to be working for longer, but they face the very real prospect of inadequate retirement incomes.

How Defined Ambition can help us rise out of the ashes

To increase voluntary retirement savings, especially amongst the young, we need to rebuild confidence in the pensions system by providing a simple framework that is easy to understand, and which provides some certainty for both individuals and employers alike. Only by addressing the underlying psychology of saving can we hope to influence the behaviour of saving.

Behavioural finance theory[16] suggests that while at a basic level people 'understand' the benefits of a specific behaviour, they often have difficulty implementing their intentions. Too often, they struggle to take action, and when they do act, their behaviours are often half-hearted or ineffective – often due to a lack of confidence that they can achieve their desired outcome. This is especially true of saving for retirement.

Defined Ambition provides a fantastic platform on which to build more confidence and greater optimism, which will result in higher savings and an ability to move away from minimal savings in a pure DC environment. Encouraging individuals to save even just 1 per cent more each year could increase their projected pension by 13 per cent[17].

Higher levels of private pension provision could also have significant benefits for the UK Government – namely, a more manageable long-term spend on pensions and the opportunity to better target resources to those most in need.

[15]MRM young money report
[16]Wharton Financial Institutions Center: Lessons from Behavioral Finance for Retirement Plan Design
[17]Pensions Policy Institute, "Closing the gap: the choices and factors that can affect private pension income in retirement", P25

Defined Ambition also presents the Government with a great opportunity to re-engage employers in the concept of high-quality, voluntary pension provision, which has been on the decline for many years.

So what is Defined Ambition?

Defined Ambition is a reinvention of the pensions landscape, to develop a legislative framework that enables a sharing of risks and reward – whether it's a more flexible DB scheme or a beefed-up DC scheme that provides more certainty, there are clear options and solutions to bridge the gap between the current extremes. For example:

- DB schemes with truly discretionary pension increases, death benefits and adjustments to pension accrual to reflect improving life expectancy
- Cash balance with or without internal conversion rates
- DC with a minimum single life pension (ie an underpin)
- DC where the minimum fund at retirement is no less than a prescribed level of cash balance or the combined member and company contributions excluding interest
- DC where a minimum average rate of interest is provided on contributions
- DC where, at retirement, a minimum annuity rate is offered – which might be linked to a percentage higher than the best market rate at retirement

Whilst much of the focus is likely to be on strengthening DC to provide more certainty for members and encouraging employers to share some risk, it is important not to forget the merits of the more traditional forms of DB provision which, with appropriate reform, can achieve the same objective.

Whatever the exact form of benefits, the vision should be for a core level of sustainable benefit provision complemented by a voluntary tier that aims to provide a low-risk, flexible and affordable way for members to increase their core benefits. Regular, clear communication to members regarding the amount required to top up their benefits to a target retirement income will help encourage voluntary saving.

Structuring the benefits in this way will protect employers against any unexpected increases in cost as a result of growth and employment, whilst at the same time giving enough up-side potential to employees to provide meaningful benefits in a clear and transparent manner.

The essential ingredients

From a member's perspective Defined Ambition would mean being offered a pension benefit, with some level of certainty, where the terms are clear and well understood. This, combined with the financial incentive of a better pension in retirement, will help build trust and improve understanding, which is crucial if we are to succeed in encouraging people to save more for retirement.

What good Defined Ambition looks like, for an individual company, is a scheme that provides a level of certainty to members that is truly sustainable and flexible so that it doesn't affect the growth or viability of the business. Essential features of an effective Defined Ambition framework are:

- the ability to choose affordable and sustainable benefits that best meet the needs of the workforce and the employer – without being shackled by inflexible legislation;
- the ability to adjust benefits in response to changes in financial markets or the socio-economic environment, such as stock market crashes or increases in life expectancy;
- proportionate regulation that is conducive to sustainable pension scheme funding (eg proposals for Solvency II and GMP equalisation all add cost) and which reflects the nature of the promise being given (eg short-term investment guarantees should have a lighter touch regime than the current substantial regulation for longer term benefit promises: and
- there is sensible long-term accounting treatment that does not create inappropriate volatility, unintended consequences and therefore a disincentive to offer risk sharing.

The lack of these essential ingredients explains why companies have moved away from risk-sharing DB schemes to pure DC schemes. Only a total commitment that any new form of benefit provision will be protected against future legislation will start to encourage companies to think differently about risk-sharing in their schemes. Without these ingredients Defined Ambition will remain a notion – not a reality.

What needs to happen to make Defined Ambition a success?

In the current challenging economic environment people are understandably finding it hard to think 30 years ahead when they feel their incomes are being squeezed now. The theory of behavioural finance suggests that investors are generally risk-averse and require additional security in order to overcome these short-term barriers and commit to long-term savings. Defined Ambition presents an opportunity to provide individuals with the certainty they are looking for, which in turn should encourage them to focus on their retirement needs and commit to saving for retirement.

To get employers engaged in the process, the Government needs to create an environment in which companies have clear control over cost, allowing them to share some of the risk that is currently being transferred entirely to members in the form of DC provision. Without some form of change in regulation there is little incentive for employers to find a new way of sharing risks.

The key elements that are likely to encourage the provision of a relatively better pension scheme are:

- there is a shared sense of risk and reward across all parties;
- individuals recognise the value provided by the scheme and are encouraged to save; and
- the employer can decide the level of cost and risk at the outset – without the fear of the cost and risk being involuntarily changed in the future

Defined Ambition offers a framework for innovation and creativity, to find a better way of sharing risks that makes pensions more sustainable and more attractive to individuals. It also offers an opportunity to design a scheme that overcomes some of the perceived barriers to saving that are currently discouraging individuals from saving more.

Defined Ambition will mean different things to different people, so the Government should avoid being overly prescriptive – the focus should be on defining the objective (i.e. encouraging long-term savings) and setting out a framework that clearly supports this.

Our future

Public confidence in the current pensions system is low. Efforts to boost saving, including auto-enrolment, are a great start but we need to use the momentum to go further. Defined Ambition presents an excellent opportunity to remind employers and individuals of the benefits of good quality, affordable pension provision and provide a catalyst to make us all behave differently.

Defined Ambition should be a forward-thinking framework, underpinned by sustainable and supportive legislation which naturally leads to a breadth of creative solutions that meet the very individual needs of companies and their people.

Without question, the ability to successfully implement the Defined Ambition vision will require a change in attitude from individuals, employers and the Government alike. Making Defined Ambition a success will require cross-party support for major reform and relaxation of some of the current legislation. We hope the Government is willing to take up the challenge of seeing its vision put into practice!

Defined Ambition may not lead us to a perfect ending, but it does give hope – and it is hope and hard work that fuelled the success of our courageous and successful Team GB at this year's Olympics and Paralympics! Defined Ambition presents us with the opportunity to develop a gold medal-winning pensions system that can be the envy of the rest of the world.

Ruston Smith is Chair of the NAPF Retirement Policy Council

05

Defined Ambition a chance to rethink the future of DC

Defined Ambition: a chance to rethink the future of DC

Lord Hutton of Furness argues for a change in mindset and focus

Steve Webb's call for a rethink of conventional defined contribution (DC) arrangements could not have come at a better time. The transition of UK pension schemes in the private sector from defined benefit (DB) to DC is all but complete and, before long, virtually every worker in the country will have a personal vested interest in their living standards in retirement through auto-enrolment.

The minister has correctly highlighted the general shortcomings of existing traditional DC arrangements and his call for Defined Ambition arrangements suggests a will to overcome them. Money-Safe and Collective DC have been suggested as alternatives, but both have significant drawbacks. To settle on a viable alternative to today's DC arrangements, it is essential that we are clear about the problem we are trying to solve – the risk that increasing numbers of people will retire on inadequate pensions – and then find the best possible way to alleviate this real and present danger.

We all know that DC members do not have the certainty of retirement income that DB members enjoy, and we all know the causes of this. But it is not just the lack of an employer guarantee that puts DC members at a disadvantage; for all their good qualities, many conventional DC arrangements are not designed to ensure members meet their retirement goals. They are simply not set up to deliver what retirees need: a reliable stream of inflation-protected income to maintain their standard of living throughout retirement.

If the single aim of a pension is to provide income, then this new debate on the future of DC needs to do more than just focus on managing investment and wealth accumulation. Of course, wealth accumulation provides members with the means to buy an income when they retire, but the connection between the two is not always clear. Throughout their working lives, DC members are motivated to save and earn a good return to build assets, not target a desired level of retirement income.

The result is that the best schemes work tirelessly to engage members; offer generous contribution rates; provide education and communication; and provide a range of investment options or carefully designed default funds. But there is little assurance that

any of this activity gets members any closer to their retirement income goals or, indeed, really helps them to manage their accounts towards achieving those goals.
The debate about Defined Ambition should hopefully change this; by encouraging the redesign of pension schemes around retirement income from the outset. It needs to turn the member's focus on its head so rather than being a distant intangible, the income stream is at the core of the design and running of the plan.

Under present arrangements members, plan sponsors and policy-makers are focusing on the wrong concept of risk. They are focusing on the volatility of assets and returns rather than the risk of not realising the inflation-protected incomes that members need to maintain their standard of living in retirement. As a result, little more than pure chance gets a person all the way through their retirement with the desired amount of purchasing power. All three groups would benefit from looking at DC through the prism of income, rather than asset accumulation.

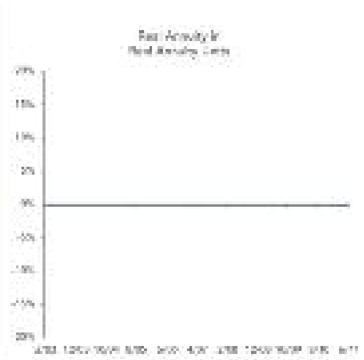
Members

The transition from DB to DC is usually framed as a transfer of investment risk from employer to employee. While this is true, the transition also marked a shift of focus from income to assets and returns. Ask a DB fund member what their pension is worth and they will reply in terms of future income; they might say "two-thirds of my final salary" in reply. Ask a DC member the same question and the response will be today's cash value; perhaps "£50,000" followed by a footnote about what it was worth last year and before the financial crisis. The typical DC scheme encourages members to focus on the size of their pot and, inevitably, the volatility of that figure, not on the purchasing power they hope to derive from it to maintain their living standard in retirement.

The focus on assets and returns and the volatility thereof hangs over DC schemes at every level. Plan sponsors assess members' attitude to risk by asking how they would feel if they lost a certain amount to a market crash; members live in fear of that market crash throughout their working lives, especially as they approach retirement; and default investment funds are designed around an interpretation of members' attitudes to risk. But is any of this anxiety and activity directly contributing to improving the likelihood of the member achieving their retirement income goal? I think not. This should be at the centre of the debate.

Some DC schemes offer guidance about how much should be saved to achieve an income in the future. But they typically rely on the assumption of a fixed rate at which the member's DC pot may be converted into a stream of income at retirement and ignore that this conversion rate is in fact extremely variable and uncertain. Beyond highlighting the need to accumulate a large pot of gold, such guidance can be almost pointless and, in any case, there are few options available to plan sponsors and members to help them manage conversion risk.

If schemes were designed from the outset to deliver a retirement income stream; if they engaged with and reported to members on that basis throughout, attitudes to pensions might change dramatically. The two charts below illustrate this simple idea clearly. The first (left) is an illustration of the price volatility of a deferred annuity; the second (right) is an illustration of the volatility of income one would receive from the same annuity over the same period of time[1]. They show that while market prices can be volatile; income streams are not.



[1]Copyright © 2011 Robert C. Merton – for illustrative purposes only

If Defined Ambition schemes enabled a shift in members' focus from the growth in their DC pots to whether they are on track to achieve their income targets, we might reasonably expect that members will be less likely to opt out of their occupational scheme because they are concerned about the unpredictability of the market. We might also hope that the improved link between workplace saving and retirement income might be more engaging or reassuring for DC plan members.

Plan sponsors

Before the flight from DB, plan sponsors' primary concern was keeping their promise to members and managing the risk of making up for funding deficits. Since the widespread introduction of DC, the key risk for plan sponsors is the risk of not realising good outcomes for members; in other words, members reaching retirement without the purchasing power required to maintain their standard of living.

This risk is managed through decisions about contribution rates; increasing engagement through member education and communication; and the trustees' efforts to get the default and self-select investment options right – picking the right manager and the right investment strategies, for example.

But again, these efforts focus only on the accumulation of assets. The income stream to be derived from it is an afterthought in the design and execution of the plan. Lifestyle investment funds are usually designed with a dynamic asset allocation strategy that reduces market risk as the unit holder reaches a certain date in the future. These funds are a good example of how focusing on investment outcomes alone is at odds with the desire to achieve a reliable income stream.

The key issue is that these types of lifestyle funds base their asset allocation on just age or time until retirement. They do not take into account the many factors that have a bearing on the ability of a member to realise their retirement goals. Among those factors are gender, state benefits, future contributions, projected changes in interest rates, and longevity. More importantly, these funds determine asset allocations irrespective of whether the members are on track to realise their retirement goals.

The overarching point is that focusing on the risk of members not reaching their retirement income goal brings the trustees' interests much closer to members'. This too should be front and centre of the current debate.

Governments and regulators

Governments and regulators are also yet to make the connection between plan design and improving the chances of achieving targeted income streams in retirement, favouring a focus on investment and asset accumulation. There seems to be little awareness that information about the size of a member's DC pot and the returns from it is not very meaningful to members and may even be misleading.

Existing suggestions will not realise objectives

Among the alternatives to conventional DC are the Dutch idea of collective DC and providing guarantees to return at least the value of contributions to members dubbed Money-Safe. Both ideas have serious weaknesses.

The collective DC structure can be considered akin to DB without the employer guarantee. Collective DC proposes to reduce each individual member's exposure to investment risk by risk-sharing and offsetting deficits by intergenerational transfers. That system of robbing Peter to pay Paul will inevitably prove to be unsustainable when plans mature and funding deficits increase. It may shield older members for a while, but ultimately does not provide the improved assurance to employees that the minister rightly seeks to achieve.

Another suggestion is the Money-Safe idea of guaranteeing the value of DC members' contributions. Such a guarantee might persuade some people to continue making their contributions when their confidence in investing is low; but it does not provide assurance about pension pay-outs and the cost of buying the guarantee could be wasted.

Money-Safe is a symptom of the fixation on investment performance and volatility. Why should pension fund members pay to protect the value of their contributions when their aim is to receive a future income stream? It is like buying a motorbike warranty to cover your car. Surely the only guarantee of any value to someone saving for retirement is one that protects their retirement income. And we know from the experience of DB that such guarantees are unsustainable.

All guarantees come at a price and, very often, their cost is better put to use in the form of higher contribution rates.

What could Defined Ambition look like?

There is an alternative – a scheme design that targets an inflation-protected income and manages the risk of not achieving it for every member.

Such a scheme can manage asset allocation for every member individually aimed at reaching “minimum” and “aspirational” targets defined by the plan sponsor. It does not rely on member engagement, but members who do engage with the plan can customise their targets without the need to manage their own assets.

With the centre of gravity being the retirement income stream, everything else revolves around income and not wealth or the volatility thereof. Members receive meaningful information about their progress towards achieving their real goal and are able to make sensible adjustments along the way. Members' decisions are directly influenced by their progress towards their goal and the risk of not achieving it.

Schemes designed along these lines would help to overcome the issues of current DC arrangements. The risk of not achieving the desired retirement income goal is managed transparently between employer and employee with a virtually continuous cycle of opportunities to review the status of the account. No expensive guarantees erode the value of assets so all available capital can be put to work to achieve the goal. Members' and sponsors' interests are aligned around the real retirement goal of achieving an inflation-indexed retirement income, rather than a goal that is once-removed from the point of the scheme. This must surely be fundamental if we are to achieve meaningful reform. These are the real issues at the heart of the debate about Defined Ambition.

The good news is that this is not hypothetical. Such managed DC schemes exist today. Their merit is obvious and is increasingly recognised. Wider recognition requires a fundamental shift in thinking about what it really takes to deliver good pension outcomes.

Steve Webb has defined his ambition for DC schemes as a desire to provide greater assurance about meeting members' expectations in retirement. I believe that the only realistic way to achieve this is to define members' ambitions in terms of income, determining strategies to improve the chances of realising those ambitions and managing the risk that they will not be met. This needs to be accomplished while seeking, but not relying on, member engagement and providing more meaningful information when members do engage.

This is not wishful thinking. It is possible today.

Lord Hutton of Furness is former Secretary of State for Work and Pensions, Chairman of MyCSP and an adviser to Dimensional Fund Advisors.

06

Forwards, backwards, sideways

Forwards, backwards, sideways

Alan Rubenstein believes ATP's approach in Denmark could be successfully emulated in a Defined Ambition framework in Britain

Sometimes you have to look backward before you can move forward.

Over the last 20 years we have seen the seeming certainties of defined benefit (DB) pensions and the golden age of retirement they represented transformed into a world of deficits and uncertain futures. Historians may well argue in the future about when the peak was or when the tipping point was reached – or if indeed final salary based defined benefit schemes were simply an aberration (though a rather pleasant one for the fortunate cohort who enjoyed them) – but the facts are incontrovertible. In the last seven years alone, the PPF7800 index of DB scheme funding has moved from a £35 billion to a £283 billion deficit, via a surplus of over £120 million.

When the Pension Protection Fund and The Pensions Regulator published the first Purple Book, containing detailed data and analysis on the DB pensions landscape, 36 per cent of DB schemes in the private sector were open to new members. Today that percentage has more than halved. By the time the sixth edition was published last year, just 16 per cent of schemes remained open. So it comes as no surprise either that the number of DB schemes is shrinking rapidly – down from 7,800 schemes in 2006 to around 6,400 schemes now. 475 schemes with nearly 150,000 members have already transferred to the PPF. Another 150,000 are currently going through the PPF's Assessment process. So I think the time has come to accept that we are on a one-way street to the gradual wind-down and disappearance of DB schemes. It will not happen overnight of course, but sooner or later all DB schemes will have matched their liabilities, bought themselves out or become clients, unwilling or otherwise, of the PPF.

Defined contribution (DC) has traditionally been seen as the obvious replacement for DB, but it too has its problems. According to the Office of National Statistics, contributions made to DC schemes are equivalent to less than half of the average contribution to a DB scheme. And while as a scheme member, what you put in is just as certain as it is with DB, what you get out is liable to swing as wildly as the PPF7800 deficit. Your employer may well take little or no interest in how your contributions are invested or converted to income. Those are subject to decisions you might not fully understand, financial markets you cannot control and a selection of fees you have no choice but to pay. So contributions are lower, while what you get at the end of it is uncertain. That does not sound like a particularly potent prescription for saving, so it's no wonder that DC membership has fallen from nine per cent of the working population to seven per cent over the last 15 years.[1] Yet everyone agrees that more people need to start saving more money for retirement.

Focus on the saver

For any kind of saving to work it has to be worth it to the saver. Those of us who work in financial services well understand the long-term importance of saving. But most people do not have that level of financial literacy and arguably, for those earning around average UK earnings, complex personal financial management should not be a necessity. What this really means, then, is that for saving to be worth it, the consumer has to understand why it is worth it. People have to understand what they are paying into and what they will get out of it. That, for me, is what Defined Ambition should be all about.

Before setting out what Defined Ambition might look like, it's important to be clear who our target audience is; who these people 'who need to save more' actually are. Arguably, they are the same group NEST is aimed at, which means, according to NEST's own research,[2] they are people with median earnings of £19,800 and of whom 60 per cent are aged between 22 and 40. Compare that with median earnings of £30,600 for those in a pension scheme, who are also more likely to have other savings and the scale of the challenge starts to become clearer.

For me, this means that in designing a Defined Ambition system, we should ignore those at the wealthier end of the spectrum, for some of whom a DB pension may still be a reality. Equally, those at the opposite end of the spectrum, with low earnings and almost exclusively without a private pension are, or will be, dependent on the state for their retirement income. So if we are to develop a new system of private pensions we must focus on that group in the middle and in doing so we must have regard to the changes that the Government is planning to introduce to create a simplified, single tier State Pension.

1www.ons.gov.uk/ons/dcp171766_270744.pdf

2www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/member-research-brief,PDF.pdf

The State Pension has evolved into a very complex system, with different types of pension, means-tested top-ups and additional one-off benefits such as Christmas and winter fuel payments. This complexity has been viewed as a disincentive to saving, as workers are unclear about what benefits they will receive in retirement and believe any modest savings simply offset what they would receive in means-tested benefits. The Government's proposals to reform the Basic State Pension would sweep this complexity away. This is clearly laudable and necessary; however any new system must be even more radical, guaranteeing from the start that any savings workers make into a Defined Ambition pension will be protected and will not and cannot subsequently be means-tested away.

So if clarity of outcome and simplicity of operation are key to Defined Ambition, what might that mean? For me, that means a pension with two aspects: a clear contribution from employees and employers matched to a clear outcome in retirement; and some form of pooling investment and longevity risk with the ambition of providing something in addition to that guaranteed outcome depending on economic conditions.

Great Danes

Creating such a pension vehicle might sound like a challenge. Fortunately for us, we do not need to invent one entirely from scratch; a similar model already exists, in the shape of the core product of ATP in Denmark, the Livslang Pension.

ATP's pension is in essence a collective DC model, but DC with a twist. A proportion of each individual's annual contribution is applied to secure a guaranteed benefit and the balance is pooled with other contributors and invested in riskier assets. The returns on these non-guaranteed assets are then applied to provide an annually-assessed uplift to the basic benefit, typically in the form of indexation of payments. In some senses the approach actually looks backward to the history of pension provision; the actuaries of fifty years ago would immediately recognise this as a form of with-profits deferred annuity.

The system has undergone some changes since it was first introduced in 1964, so we have the benefit of learning from ATP's refinements. Over time, ATP has moved from providing the guaranteed pension on the basis of a fixed (low) discount rate to a position today where 80 per cent of contributions are now applied to 'secure' a deferred annuity for each member at whatever level current market rates and longevity assumptions, at his or her age, will allow. The balance of contributions goes into the investment pool of riskier assets, which can have a higher risk/return objective. The use of modern portfolio management and hedging techniques mean that for the same level of risk, better returns can (in theory) be delivered.

Just as in an insurance company where decisions on bonus would need to be made (ultimately involving a level of judgement) so every year ATP has to assess the performance of its risky asset portfolio, adjust for any improvement in longevity assumptions and then decide whether it can provide full or partial indexation to all members.

Looking sideways

It would be nice to say the ATP approach is the perfect solution to our Defined Ambition dilemma. The simplicity (at least on the surface) is attractive – you know from the start what you are guaranteed and you hope to get inflation linked increases on that if the fund manager is any good. But it does have some drawbacks. For example, "behind the scenes" (at least behind the scenes as far as the average member is concerned), there is a heavy reliance on swap markets and derivative strategies, and so a meaningful exposure to liquidity and counterparty risks, along with the use of significant leverage. It also needs, in this country at least, to get over the unfavourable comparison with unloved with-profit assurance products such as endowment mortgages, to say nothing of stirring memories of Equitable Life.

Finally, there is the question of how to allocate returns to savers and how much to keep in reserve (or even over-extend by). While in the perfect world, each year's investment returns on the risky asset pool will be sufficient to provide for longevity improvements and indexation of benefit, the real world does not operate so smoothly, which can produce significant issues, similar to those encountered historically by Constant Proportion Portfolio Insurance. But despite these issues, I believe ATP's approach provides a solid model for a product that could offer a sound blend between individual circumstances (the guaranteed element) and pooling of risk (the approach to sharing longevity and investment risks among members).

Most importantly, from a consumer perspective this is a relatively simple, unambiguous product – and one based on an approach that seems to deliver. It does not seem too optimistic to me to think NEST could design and offer something like ATP's pension as a UK answer to the Defined Ambition question. They might think of either a single pooling product or perhaps a range of funds, with low, medium and high risk, which could be reflected in the percentage of contributions actually invested in risky assets and the level of risk within those asset pools. I would hope this would spur commercial providers to offer competing products, with either better levels of guarantee or some stronger risk participation on the non-guaranteed element, possibly backed by some of the provider's own capital.

That brings me back to what I said earlier: the member, the consumer, has to know what they are saving into and to have confidence in what they will get out of it at the end. For me, a funded collective DC scheme with insurance-style guarantees like ATP's model would do that. Sometimes you don't only need to look backwards to look forwards; you need to look sideways too.

Alan Rubenstein is Chief Executive at the Pension Protection Fund

07

Defining Ambition in occupational pensions

Defining Ambition in occupational pensions

Gregg McClymont MP questions the Government's efforts to reinvigorate UK pensions

The Coalition Government has set itself the vital ambition of "reinvigorating" occupational pensions[1]. This is an ambition which the Labour Party is also determined to pursue. The Government's view appears to be that this can be achieved by permitting pension schemes to offer DC products which include some limited guarantees for savers[2]. It may also be the case that the Government will widen its consultation to include a review of whether collective DC schemes should be permitted in the UK. The latter, in particular, would be a welcome step – for the reasons that have been put forward eloquently by the Royal Society for the Arts[3]. However, in our view, these developments on their own are too limited. A government with a real desire to reinvigorate occupational pensions would take much bolder steps for the purpose of controlling costs and facilitating better returns for savers.

Government should be very concerned to ensure "reinvigoration". Pension-saving is in decline in the UK at the same time as the ratio of pensioners to workers is rising – a trend that will continue[4]. Successive British administrations have opted for the policy of auto-enrolment as the solution to widening participation in pensions saving[5]. If this is to be realised, pensions products will have to be seen to deliver value in a period where investment returns are generally low. This means products will have to be as efficient as possible: minimising costs and ensuring that as much of the value of investment as possible is delivered to savers and not intermediaries.

[1]HM Government (2010) "The Coalition: our programme for government", p.26

[2]www.guardian.co.uk/money/2012/feb/19/defined-ambition-pensions-dutch

[3]www.thersa.org/about-us/media/press-releases/going-dutch-how-to-double-the-value-of-british-pensions

[4]Michael Johnson (2012) "Put the saver first. Catalyising a savings culture", p.33

[5]It is regrettable that the Government have raised the income threshold for participation to exclude over 1 million low-paid workers, over 75 per cent of whom are women. The Government claims that this is intended to ensure that there are no de minimis levels of saving that bring auto-enrolment into disrepute. This claim does not bear much scrutiny. Research by the House of Commons Library has found that someone who was auto-enrolled at the age of 22 and earned the equivalent of £7,000 in today's money throughout their career could accumulate a pension pot equivalent to £9,627 by his or her retirement. (The latest upward revision in the income threshold has been set at £9,205). A pot of £9,627 could be turned into a useful lump sum. It also ignores the point that auto-enrolment is intended to encourage persistency in pension saving despite employees moving between full-time and part-time work and back. It is also regrettable that the Government has moved the staging dates for auto-enrolment. This means that no employee will receive the full benefit of contributions into NEST until 2018 – which will make returns look low for all participants in the early phases.

A question of scale

The key to controlling costs and facilitating better returns for savers is to have pension providers with scale whose operational policies are determined by independent trustees. I very much share the NAPF's perspective that Super Trusts are the way forward[6]. Indeed, I think any actual move to collective DC is unlikely to be feasible without scale. The advantages of collective DC lie in risk-sharing and the possibility of holding more volatile and possibly illiquid assets; numbers are required to achieve acceptable levels of risk.

The NAPF's perspective on the need for scale is supported by international best practice. In a recent presentation, Jeremy Cooper, author of Australia's review into superannuation funds, pointed out that the United States Thrift Savings Plan with 4 million members managed through scale effects to achieve annual fees of 0.025 per cent[7].

This example provided by Jeremy Cooper illustrates his more general point: "Pensions are not a cottage industry." [8]This point is also backed by research conducted in Canada by the Ontario Expert Commission on Pensions[9]. It found that the cumulative advantages of scale were large. Pension schemes with scale had advantages over small schemes: lower investment fees, in-house investment expertise, private placement participation capabilities, ability to spread investment risk through diversification, reduced administrative unit costs, and enhanced availability of education, information and service. These advantages translate into material differences in retirement income. Evidence from the UK in the surveys conducted by the Pensions Regulator underline that the capacity of trustees to engage with the financial aspects of their duties varies considerably by size[10]. The differences in capacity engendered by scale translate into material outcomes for savers' pension pots. Some estimate that scale could deliver pension pots that are 13 per cent larger[11].

[6]www.napf.co.uk/PolicyandResearch/DocumentLibrary/0174_Enabling_good_member_outcomes_in_work_based_pension_provision_a_response_by_the_NAPF.aspx
[7]Jeremy Cooper "DC from Down Under" Investment Conference 2012, Investing for success 7-9 March, EICC, Edinburgh, p. 8.
[8]Ibid, p.5.
[9]Ontario Expert Commission on Pensions, "Final Report of the Commission: A Fine Balance – Safe Pensions Affordable Plans – Fair Rules" (2008) pp183-185.
[10]Occupational pension scheme governance – A report on the 2011 (fifth) Scheme governance survey, May 2011, p. 46.
[11]Dyck, A. and Pomorski, L. (2010) Is Bigger Better? Size and Performance in Pension Plan Management, October 2010.

If we look at the UK pensions panorama, it is incredibly fragmented. There are currently between 1 and 2 million workers in 46,540 trust-based and hybrid DC schemes in the UK. 95.9 per cent are in schemes with less than 100 people. The NAPF estimates that there are a further 134,000 GPP and stakeholder schemes with 3 million people and another 3 million people with individual pensions. In addition, there are 6,850 DB schemes with about a million active members, many of which may switch over time to DC provision. As a consequence, annual fees of 0.5 per cent are at the low end of what is on offer in the UK in terms of the annual management charge.

The British Government currently has no plans to encourage scale. In Australia, legislation will require new duties of trustees. These include a specific duty to deliver value for money as measured by long-term net returns, and to consider annually whether the fund has sufficient scale[12]. In the United Kingdom, perversely, the Government has drawn back from steps it would otherwise like to take for the benefit of savers – and precisely because they would be disruptive for the current scale of production. For example, it is not minded to pursue automatic consolidation of stranded small pots in aggregators because this would create "market distortion"[13].

In other words, this Government takes the view that cottage production of pensions should be protected[14]. This is also likely to lie behind its lackadaisical efforts in pursuit of the lifting of the restrictions on NEST. I have heard the argument that if the restrictions on NEST were lifted it would dominate the industry. This is deeply implausible for a number of reasons – one of them being an assumption that private providers would be static rather than galvanised to consolidate, if faced by a NEST that was achieving scale.

It is deeply regrettable that the Government is yet to act to lift the restrictions on NEST. The Government suggests that EU state aid law prevents it from lifting the restrictions. I understand the Ggovernment wants to seek the protection from litigation provided by obtaining a clearance from the EU Commission. However, to obtain that clearance, it needs to actually notify the Commission with a cogent case. The fact that it has not already done so suggests that outcomes in occupational pensions are not really at the top of the list of its priorities. NEST is, after all, a provider of low cost, high quality pensions with independent trustees and has been designed with the potential to achieve scale. It could be an important catalyst for change in the industry as a whole.

[12]Section 9 of the Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012 (Cth)

[13]www.dwp.gov.uk/docs/gov-response-small-pots-automatic-transfers-consultation.pdf, p.12.

[14]A view it has taken despite the contrary view taken by the majority of respondees to its consultation.

Labour's ambitions

Labour has campaigned for the costs and charges drawn from pension savers' pots to be transparent. This is important for ensuring confidence in pensions products. It will help drive out poor practice. It will also assist those providers who wish to compete on low costs – something which has not been practicable when the true costs are obscured due to the absence of full disclosure[15]. And it is important to note that competition around costs will also be an important driver to consolidation. It is highly noticeable that the Government has avoided getting fully involved in the debate about transparency; restricting itself to threatening a cap but not explaining how it would ever make that operational in an environment where the true costs remain obscure[16].

We will go beyond promoting transparency. In our talking points document for Labour's policy review *Pensions People Can Trust* [17]*,* we pointed to the need for there to be independent trustees with the capacity to truly act on behalf of the members of the scheme. Transparency requires that there is someone to react positively to the information provided. We know from recent DWP research that two-thirds of employers who currently provide pensions to their employees do not understand the charging information with which they are provided[18]. Many employees will similarly struggle. It is therefore critical that there is someone to act on behalf of the employee vis à vis their investments and who faces no conflicts of interest. The independent trustee is the mechanism long recognised by British law for achieving this objective.

We also know, as referred to above, that scale is important for enabling pension schemes to support trustees who can deliver. The UK's regulatory scheme for occupational pensions needs to be revisited to ensure that the regulators are equipped to promote both scale and the skills which are intended to be delivered by scale. There is merit in examining whether positive incentives can be designed. There may be regulation which needs to apply where there are no trustees of requisite skill but which could instead be lifted where there are such trustees. This is a point Professor Kay has made more widely regarding the investment industry: we end up with detailed intrusive behavioural regulation when we try and constrain institutions to act in a different way from the manner in which the market is structured. His view is that regulation "…should focus on the establishment of market structures which provide appropriate incentives, rather than the fruitless attempt to control behaviour in the face of inappropriate commercial incentives."[19] I hope to hear more from industry on how positive incentives to obtain scale can be constructed.

[15]A point most recently made by Martin Wheatley, Managing Director of the FSA in a speech entitled "My vision for conduct regulation and how it will affect asset managers" at the FSA's Asset Management Conference on 25 September 2012

[16]www.moneymarketing.co.uk/politics/webb-warns-government-may-cap-pension-charges/1033669.article

[17]www.labour.org.uk/pensions-people-can-trust,2012-07-16

[18]research.dwp.gov.uk/asd/asd5/rports2011-2012/rrep804.pdf, p.2.

[19]bis.gov.uk/policies/business-law/corporate-governance/kay-review, p.11.

The intention of the Labour Party is to ensure that the British people have the option of saving into pensions which they can trust to deliver. Our view is that the Government's actions in those areas of policy where it has already dealt with occupational pensions and the likely ambit of its consultation on "reinvigorating private pensions" suggest only one conclusion: in this field, the Government is defined by a lack of ambition.

Gregg McClymont MP is Shadow Minister for Pensions

08

Defined Ambition – whose ambition?

Defined Ambition – whose ambition?

Lars Rohde and Ole Beier Sørensen question what kind of real value can be attached to the idea of ambition in a pension system

Old age security has long since become a basic building block in any modern welfare system. Likewise it has long since become a standard element in the battery of expectations held and shared by citizens towards society. Pension systems are the vehicles by which these expectations are catered for. Their effectiveness and reliability are extremely important to individuals as well as societies.

Pensions have become a key element of public debates in many countries in Europe and elsewhere. Against the backdrop of demographic change, increasing longevity, declining real retirement ages and weak incentives to work in old age etc. the sustainability of pension systems has been called into question. Many countries have launched major pension reforms with the view of securing long-term financial sustainability within their systems. In some cases the reform process has been extremely painful.

Some common denominators can be identified between nations in this process: retirement ages are increased or they will increase; the relative importance of savings-based components is increased, thereby strengthening the role of deferred consumption at an individual level vis à vis intergenerational transfer at a national level; exit routes for early retirement are closed or they are made much less attractive; prolonged working lives are encouraged and incentivised.

Pension policies around the world are in a process of sobering up, but the fundamentals are still in place: pension systems will continue to be a cornerstone of modern welfare and they will continue to be the key providers of financial support in old age. On average pensioners will spend around one-third of their adult life in retirement, where the most long-lived retirement may be 30 or even 40+ years. Getting it right certainly matters.

What exactly is it a pension system should do?

With this in mind, it is worthwhile pausing for a second and reflecting upon the fundamentals – what exactly is it, that a pension should do? What characteristics should a well-designed pension system have?

Thinking about this you will be amazed by the complexity. This point was well reflected in the 11 criteria defined by the EU a few years back. The 11 criteria were organised under three main headings – adequacy, sustainability and adaptability. These headings encompass absolute poverty protection as well as relative income replacement, both financial and social sustainability, intergenerational equity, affordability, transparency, efficiency, labour market policies, social security coordination, work incentives, flexibility and adaptability.

A well-designed pension system is financially as well as socially sustainable, it presents a reasonable sharing of burdens between generations, it is dynamic and can be adapted to fit individual needs and it can adapt in response to changes in the society around it.

Multi-pillarism

The many different objectives of a modern pension system can hardly be met in a single uniform system. Rather they should be served by building a conglomerate or pyramid of sub-systems – a public basic system supplemented by workplace pensions and private individual pension schemes.

Without being prescriptive in the detail and as regards the format and design of sub-systems, multi-pillarism has been marketed as the preferred approach to overall pension system design by the World Bank and others.

The benefits of multi-pillar approaches are obvious as they relieve public systems from otherwise massive and complex burdens, divide responsibilities between the state, labour markets and individuals, and allow for a tailored variability according to social groups.

Multi-pillarism serves the best interests of the individual by keeping the eggs in several different baskets, so to speak.

In order to serve the overall complexity of pension policy objectives successfully, the different subsystems need to be designed specifically to meet those objectives. Arguably, clarity as regards the definition of respective roles is an important feature of any successful pension system. Some of the allegedly strongest pension systems in the world – including pension systems in countries like the Netherlands, Sweden, Canada and Denmark – may illustrate that particular point.

If you buy into this line of thinking, a workplace pension cannot be understood as the pension per se but rather as just one element – albeit an important element – among others in the overall pension package.

Defined Ambition

The theme of this monograph is that of Defined Ambition. What does it mean, and how could it work in practice?

The concept Defined Ambition was first coined as a new term in the Dutch pension debate a few years ago. The idea is to introduce a concept parallel to the classic concepts of defined benefit (DB) and defined contribution (DC).

The Dutch debate takes place in the context of long-lived, mature, and well-founded labour market pension schemes in the form of relatively generous DB schemes. These are being confronted – and challenged – with low interest rates, unstable financial markets, the challenges of fair value regulation, increasing longevity, the inability to increase pension contributions paid by employers, and roller-coaster-like solvency ratios.

The Dutch system is faced with serious challenges and it needs amending. The traditional design is simply deemed unsustainable.

However, the legacy around the Dutch pension system is extremely strong. The Dutch love their pension system and tampering with it does not come free of charge. Hence the new term seems to be paraphrasing an idea for parametric reform rather than proclaiming the introduction of a whole new set of principles and methods.

The idea is to escape the burden of hard commitments and promises and replace them with soft ones. Instead of telling people what financial resources they can look forward to as a minimum in old age, people are provided with an intentional promise. To put it crudely: "The ambition is to provide a pension of this size from a given age – but if things go wrong, you may be looking at something significantly different."

Most pension experts with some knowledge of the Dutch system and its legacy will probably agree that the debate around Defined Ambition has some resonance in this specific and very complex context, but taken outside the Dutch context, the concept – Defined Ambition – signifies an amazing paradox.

The paradox

By value, a pension is one of the biggest and most important financial transactions in the lifetime of an average citizen. People may – directly or indirectly – forego 15, 20 or even larger percentages of their current income in active years in order to shift some of their consumption into their retirement. It is rivaled only by home ownership.

The idea behind the concept of Defined Ambition is that the product delivered in return for this massive investment by individuals and households should be intentional rather than written in stone. Significant and very complex risks are shifted onto the individual. Imagine the same principles implemented into other industries – computers, utensils or automobiles, or other consumer goods?

"When you buy this car the ambition is that it will drive – if it does not, we will assure you that we are sorry for your inconvenience." Would a producer presenting such a proposal survive in the marketplace? Would consumers accept such a proposal? Probably not. Then why should they, when it comes to the much bigger and much more far-reaching investment in their old age security?

Is Defined Ambition really the best answer that can be offered to the question of how pension design best serves the interests of individuals and society?

We think not, especially not when the discussion is taken out of the specific and very mature Dutch context and transplanted into a UK context where the design exercise related to workplace pensions is not tied closely to a similar legacy.

Whose ambition?

Defined Ambition? Whose ambition are we talking about?
That of the individual, that of pension providers, or are we focusing on the broader political interests of government and state? And are these interests aligned? And if they are not, who needs to move?

The ambition – or rather expectation – of the individual is to have a predictable, affordable, cost-efficient, secure and adequate pension for as long as he or she lives. The key values are those of adequacy, reliability, predictability and security.

The expectation towards government and the pensions industry is to provide systems that can deliver on these ambitions. The expectations of individuals are actually well aligned with the overall interests of government. If pension systems default on the key values, the pressure on targeted social assistance benefits will increase and the intergenerational gap may widen.

Workplace pensions supplement and top up public pensions – they do not replace them. If designed carefully and managed successfully they link aggregate pension income and previous work income and produce a sufficient pension and a reasonable replacement rate.

They even do that with a clear view to a reasonable distribution of purchasing power over the entire pension age – a sensible pension system does not allow over-spending as a young retiree at the expense of the individual's well-being as an old retiree. Fulfilling this role effectively does not require very complex products or expensive free choice options – we are simply not that different – but it does require a strong element of lifelong annuities and it does require some sort of guarantee.

The equation cannot be solved without taking account of its context. It is indeed defined by the interplay of public and private pensions and the strength of redistributive features of public welfare. The greater the emphasis on private pensions, the greater the need for guarantees and other protective measures – and vice versa.

Put the needs of individuals first and make the fundamental ambition of the individual the starting point.

Some sort of guarantees are needed

The pension debate is often structured along a dichotomy contrasting DB (employer sponsored final pay pensions) and DC (personal account savings plans turned into an annuity or other decumulation vehicles at retirement), often construed as a confrontation of social needs and market realities.

However, the idea that it is simply a dichotomy is false. This completely omits the much more interesting and highly relevant array of hybrid forms in between the two. It is possible to create a workplace pension that emulates many of the most cherished features of DB schemes, providing predictable, secure, guaranteed benefits. This can be done without taking on the downsides of strained solvency and risks being passed onto employers or other sponsors of last resort.

It is possible to mould such features into a DC-based fully funded model where rights are accrued by the individual based on his or her contribution payment and the returns yielded. It can be done without buying into simple savings account models with poor risk management, insecure results and expensive and opaque annuitisation at age. Such schemes have dominated the pensions industry in Denmark and Sweden for decades.

The Danish experience – challenge and renewal

Historically the standard practice was to translate incoming contributions into guaranteed pension promises – with-profits deferred annuities – based on a fixed guaranteed minimum interest rate.

During the 90's this practice turned out to be unsustainable against the backdrop of declining and low interest rates, increasingly volatile markets, tighter product regulation and much tighter solvency regulation. The maximum allowed guaranteed interest rate was lowered gradually during the 90's.

A further strain was put on the pensions industry in 2003 with the introduction of fair value accounting principles, an absolute solvency at all times requirement, and traffic light stress testing. Fair valuation changed the foundations of the insurance industry and turned pension management upside down.

The traditional focus on asset allocation was shifted for a new focus on risk allocation. The predicament was obvious and the search for a replacement for the models of the past was indeed a pressing challenge. Skipping the details and the multitude of variation, the process has given birth to two different strategies.

Many pension providers have chosen to either lower their guarantees or to replace hard guarantees with soft promises – intentions or defined ambitions, if you will. The model is not completely unlike the Dutch idea of defined ambition and it certainly shifts risks onto the individual and makes the pension outcome much less predictable.

The other strategy was developed by ATP and seeks to rethink the concept of pension guarantees in light of the new regime. The business model links guarantees to the realities of the marketplace by hedging liabilities in full and by offering guarantees based on the actual hedgable interest rate.

In the context of pension design a particular strong point of this latter model is that it links investments and pensions, it provides a very attractive pension deal to the individual and it caters to the important values of reliability, predictability and security. It provides a clear answer to the ambition, the needs and the aspirations of the individual.

The ATP model may not be a blueprint for a plug and play solution to be adopted by others just like that, but it does prove a very important point: providing a very attractive guaranteed pension deal is indeed possible – even in the present financial regime.

The defined ambition of the pension industry

So, on the one hand, the idea that guarantees cannot be met in the marketplace is a fallacy. On the other, a pension system without guarantees is not really a pension system. It cannot provide the sound everyday economic basis for the livelihoods of senior citizens. Nor can it provide a rational framework for financial planning for middle-aged and older workers.

Guarantees in one form or another are needed and they should be a key element in the DNA of a modern pension system. Previous models may prove unsustainable or obsolete, but rather than discarding the idea of guarantees and defaulting on key expectations, innovation is needed in order to design efficient guaranteed systems better adapted to the realities of markets and regulation.

For the insurance industry such an endeavor would signify a highly relevant and well defined ambition.

Lars Rohde is CEO and Ole Beier Sørensen is Chief of Research & Strategy at ATP

09

Actively sharing risk – the key benefits of risk sharing and the challenges of getting there

Actively sharing risk – the key benefits of risk sharing and the challenges of getting there

WM Morrisons share the challenges they encountered while successfully introducing a new approach to retirement savings among their workforce

Morrisons is the UK's fourth largest food retailer with over 475 stores and our business is mainly food and grocery – centred on the customer's weekly shop.

Uniquely, our vertically integrated business means we source and process most of the fresh food that we sell through our own manufacturing facilities, giving us close control over provenance and quality. Every week, 11.5 million customers pass through our doors and more than 131,000 colleagues across the business work hard each day to deliver great service to them.

Morrisons is proud to be able to demonstrate savings for our customers every day; and in return it's important we deliver a great deal for our colleagues too.

As an employer, the Morrisons philosophy is one of a partnership with its colleagues for life. Our focus is on growing our people, developing them from shop floor to the top floor of our business, helping them to perform at their best and supporting them throughout their career with us. From the day they join, to the moment they leave, we aim to look after our colleagues; something we believe helps them to do the best for our customers.

People and pensions

When the Government announced auto-enrolment legislation as part of the biggest set of pension reforms for over a generation, we looked at what could have been seen as a compliance exercise and instead saw an opportunity. We believe in building life-long partnerships with our people, and with around 600 people achieving 25 years' service with us every year, we wanted to use auto-enrolment to make sure we looked after our committed colleagues beyond life at Morrisons.

Pension reform legislation was an opportunity for us to reconsider the role of our pension scheme in our people proposition. We have a big focus on skills development and a wide range of HR initiatives to support our colleagues and their families with industry-leading policies including maternity and paternity. Our pension has always been a feature of our reward culture. Morrisons replaced our defined benefit (DB) pension scheme with a Stakeholder Scheme in 2002, and whilst contributions to the Stakeholder Scheme are competitive the level of participation in the scheme is disappointing.

As a major employer the demographics of our workforce reflect the country as a whole. The diverse nature of our colleague base means that auto-enrolment represented a real challenge for Morrisons. Many of our colleagues work variable hours, part time, some are salaried, some paid hourly, many receive a large proportion of their wage as variable pay, while our colleagues represent the diverse nature of the communities in which our sites are based – and English for some, is not their first language.

In addition, Morrisons faces a similar challenge to the one the UK faces more generally. People are living longer and longer and the workforce is also getting older. We fully support flexible working practices and have thousands of colleagues who are beyond their state pension age, and we expect this trend to continue; however we also want to support colleagues in being able to afford to stop working and have a dignified retirement without needing to extend their working lives purely for financial reasons. In order to achieve this it is important that our colleagues are saving adequately for retirement.

There is widespread recognition that a major drawback of defined contribution (DC) pensions is that members need a reasonable degree of financial awareness in order to accept the fluctuations of long-term investment strategies, or make investment decisions themselves. This is exacerbated by widespread lack of trust in financial markets and institutions. These sentiments are echoed by our own colleagues and are contributing factors in our current levels of pension participation.

Auto-enrolment into workplace pension schemes is an important step in increasing pension participation, however if the root causes of low engagement are not addressed we fear high levels of opt-outs and a risk that auto-enrolment would not ultimately be as successful at Morrisons as it could be.

Key risks

We considered all of the major pension design options available in the UK and how these would impact on colleague engagement and participation. A key differentiator between scheme designs is the division of risk between employer and employee. There are two primary risks in relation to pension schemes. The first is the pre-retirement investment risk. Pensions are long-term saving schemes and need some exposure to growth investments, such as equities, in order to achieve meaningful returns above inflation. However, such investments are volatile and this leads to significant swings in value on the approach to – and more damagingly at the point of – retirement. The second risk is in relation to the conversion of the accrued retirement fund into a sustainable income in retirement. This is impacted by life expectancy in retirement and the yield available from income-producing investments.

In a traditional DB scheme both risks are borne by the scheme (and therefore the employer), whereas in a DC scheme both risks are borne entirely by the member. We learned that, like much of the UK, our colleagues do not generally feel comfortable making investment decisions and are concerned about pre-retirement investment risk – particularly the fear of investment loss.

When reviewing potential scheme design options we explored the practicalities of sharing the risk with employees in order to address these concerns. We concluded that the company was well placed to take responsibility for investment outcomes before our colleagues reached retirement age, although it was impractical to revert fully to a traditional DB model. Therefore a risk-sharing approach whereby Morrisons takes the pre-retirement risk and colleagues take the post-retirement risk was attractive. We therefore concluded that a cash balance scheme was the best overall fit for what we wanted to achieve for our colleagues. There were many reasons why cash balance is an optimum fit for us, however the key benefits of this approach are:

- For colleagues the scheme gives a predictable outcome at retirement, therefore the member is shielded from investment fluctuation and decision-making. This makes the scheme much more straightforward for members to understand and less financially daunting than the current Stakeholder scheme. The predictable retirement pot facilitates clear communication of the core benefits of the scheme and provides a strong foundation for employees to build on.

- For Morrisons, a cash balance solution provides an attractive pension proposition which delivers consistent retirement outcomes and demonstrates our commitment to long-term partnerships with our colleagues by taking the pre-retirement investment risk on the colleague’s behalf. Supporting colleagues through every step of their career with us in a partnership is very much aligned to our wider cultural objectives.

The virtues of a cash balance scheme

For years, the trend amongst UK employers has been to replace DB schemes with DC schemes in order to reduce the burden of financial risk.

DB schemes have also been subject to increased regulatory burden. Therefore whilst the introduction of a cash balance scheme is a great fit for our culture it is completely contrary to the direction of travel of UK private sector employers and therefore not a decision that was taken lightly by the business.

The cash balance option was not a widely known pension design internally here at Morrisons, however after initial exploration there was widespread acknowledgment by senior management that a cash balance scheme would be an excellent solution for our colleagues, tempered by a natural wariness in relation to the underlying financial risks that lie with any form of DB scheme.

We undertook a systematic review of the nature and size of financial risk inherent with a cash balance design with regular input and feedback from the management board, chairman and non-executive directors, with constant cross-reference to other design options.

Morrisons has extensive experience of DB schemes and the financial and regulatory commitments that these entail. Unlike a traditional DB scheme, a cash balance scheme is not exposed to member longevity after retirement or the financial risks of generating an indexed income in retirement. Instead the commitment is to provide a known capital fund value at normal retirement age.

Ultimately the business was confident in managing the financial and regulatory commitments and it was therefore concluded that the positive features of the cash balance scheme for both the business and our colleagues outweighed other factors.

Getting the message across

Launching a new pension scheme and going through an auto-enrolment process we felt was a step too far for many of our colleagues without spending some significant time and energy in helping them understand their finances more generally. We felt this was critical before we tackled the general nervousness and lack of understanding around pensions.

Our research told us colleagues did not understand why saving for retirement was important: many felt, given the economic climate, having enough money for today was their main focus, without worrying about saving for the future. Others heard the word 'pensions' and given recent media headlines, public sector strikes and suchlike, simply didn't trust any changes associated with existing scheme arrangements to be positive. While these views represented a significant challenge, auto-enrolment, an aging demographic and low pension participation rates meant our strategy to engage with our colleagues required significant investment.

In March this year we developed and launched an engaging colleague financial education programme called Save Your Dough. This is a three-year programme and it represents a long-term investment by Morrisons designed to help colleagues understand their finances, why it's important to save, and importantly, how they can do this by making small changes in their lives.
To keep it engaging and relevant, we teamed up with independent financial expert Alvin Hall, who's been working with us on our financial education programme.
Our research told us that when it comes to pensions and other finance-related matters, colleagues don't feel comfortable talking to their line managers through fear of feeling inadequate, so we established Save Your Dough champions in each of our sites and stores nationwide.

Our champions received special training, support materials and also dialled into regular conference calls hosted by Alvin and our HR Director so they felt included as an integral part of the process and could act as a friendly and knowledgeable local point of contact for their teams, without stepping into financial advisor territory.

We've developed a comprehensive mix of information, self-help tools, and real-life case studies. For the case studies, we ran a competition to select three brave colleagues with financial challenges to undergo money makeovers with Alvin. After submitting their detailed finances, these underwent a rigorous review from Alvin before an action plan was put in place for them to follow. We have shared their experience and progress with all Morrisons colleagues via some short films and follow-up video diaries. We've also experimented with Aurasma – a first for Morrisons – for colleagues to watch videos directly on their smart phones.

A series of mini booklets have also proved popular in helping colleagues become more financially savvy. Alvin's 52 top life-changing money-saving tips was so well received by our colleagues we undertook two print runs as colleagues took to sharing it with their families and friends.

In response, we ran a 'four weeks for free' competition whereby colleagues could share their own top money-saving tip and be in with a chance of winning their four-weekly pay packet on top of their usual salary. This was a two-way engagement hook to encourage colleagues to think about their finances in a fun and creative way, while also representing an opportunity for winners to choose to kickstart or boost their retirement fund with their winnings. Colleague tips, as well as those from Alvin, were then shared via a specially-established twitter account – @saveyourdough.

Bonding with Alvin

Save Your Dough and Alvin have been regular features in all our internal communication channels and we've also developed a dedicated website ensuring colleagues can access all the information and money-saving toolkits at home with family members – an environment where we believe most financial decisions are made. Alvin's payday podcasts – an audio and visual podcast – were made available for colleagues to hear directly from the independent financial expert on a variety of money-related topics. Very deliberately, the first six months of the Save Your Dough programme focused on money-saving and finances generally, with Alvin working hard to establish a trusted bond with 131,000 colleagues and their extended network, before touching on the subject of pensions or retirement planning. A monthly survey of 15,000 colleagues carried out in August will establish to what degree Save Your Dough has helped improve their financial awareness and decision-making. Anecdotal feedback through our champions network, however, is high.

Having done so and established rapport between Alvin and our colleague base, we developed 'Alvin's little book of retirement planning' and a special podcast on saving for retirement for all colleagues six weeks ahead of the new pension scheme launching. Having focused heavily on the financial education programme, the two other strands of the communication strategy should not be underestimated in their complexity and importance.

Firstly there was a 90-day consultation programme for members of our current pension arrangement, plus those with eligibility to join. In addition to the sheer complexity of helping colleagues understand the different pension arrangements and what this meant for them personally, the key challenge was the number of different communications required for colleagues with different circumstances – we identified 14 variations on the consultation letters alone. It involved a lot of hard work, large spreadsheets, and no small number of process flow maps explaining how auto-enrolment works and what it means for each individual colleague.

The final strand has been the communications for the launch of the new pension scheme – called Morrisons Retirement Saver Plan. This went live on 24th September 2012. Colleagues have been given access to a special Retirement Saver website which includes modellers for colleagues to 'try before they buy' and podcasts on what joining could mean. Joining the scheme, managing a colleague's account and personal details or leaving the scheme will all be done via the website in the majority of cases.

Existing colleagues meeting earnings and age criteria on 1st October 2012 will have until 2017 to join the Retirement Saver voluntarily. This will enable them to become as financially savvy as possible through the Save Your Dough programme ahead of auto-enrolment in five years' time. That said we anticipate interest in the scheme in the first year of launch to exceed current pension participation levels.

New colleagues meanwhile, plus those colleagues tipping into the earnings and age threshold set by the Government after 1st October 2012, will be subject to auto-enrolment and we are using numerous communication methods to ensure they understand what this means for them.

Our main union USDAW has been involved in and is fully supportive of our approach and delivery. While it is too early to ascertain levels of success both in terms of scheme take-up or auto-enrolled colleagues choosing to stay in the Retirement Saver, we're confident we've invested heavily and done all we can to help our colleagues save for their future with a degree of certainty and financial acumen.

Wendy Taylor, HR Director at Morrisons.

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