INTERESTING IDEAS ABOUT THE FUTURE OF PENSIONS: AN INTERVIEW WITH ANDREW VAUGHAN

By Anna M. Rappaport and Andrew Vaughan

At the 2014 International Congress of Actuaries, I had an opportunity to talk with Andrew Vaughan, the chair of the Defined Ambition Working Group in the United Kingdom, chairman of the Association of Consulting Actuaries in the United Kingdom and also a former colleague of mine. The report from the working group "Reshaping workplace pensions for future generations" excited me for several reasons:

- It is focused on new directions to improve retirement security in light of the flight away from DB pensions.
- It is focused on what will work for two groups of customers: the individuals who need retirement security and the plan sponsors who may choose to sponsor plans or not.
- It provides ideas for improving security starting from both traditional DB and DC arrangements.
- The development of the report represents a collaboration of the private sector and government. The report was issued by the Department for Work and Pensions and was presented to Parliament.
- The concepts in the paper are seen as offering a foundation for a new regulatory system for pensions in the United Kingdom.
- Many people in the United States are thinking about the future of the pension system, and I believe that report will have valuable ideas for them. The challenges in the United Stated and in the United Kingdom seem to have definite parallels.

I am delighted that Andrew Vaughan is providing us a perspective on this report and the work that led up to it.

Anna Rappaport

INTRODUCTION

This paper reviews the effort to reinvigorate workplace pensions in the United Kingdom. It explores Defined Ambition (DA) pensions that complement traditional defined benefit (DB) and defined contribution (DC) structures. An underlying concern is that if traditional DC plans become the dominant workplace pension, then this may mean many people will have inadequate pensions. The paper sets forth how the issue was addressed in the United Kingdom and the emerging outcome of legislation announced in early June 2014.

Principles for development of DA pensions in the United Kingdom

Reinvigoration objective

Enable industry innovation and development of new products including those which will give people more certainty about their pensions and encourage more risk sharing.

A DA scheme should be:

- **Consumer focused**—address consumer needs (members and employers).
- **Sustainable**—affordable to the stakeholders (employers/pension providers/members) over the long term.
- **Inter-generationally fair**—not biased to pensioners, but also take on board needs of future pensioners.
- **Risk sharing**—incorporate genuine risk sharing between stakeholders.
- **Proportionately regulated**—the regulatory structure needs to be permissive to enable innovation in risk sharing, while protecting member interests.
- **Transparent**—there should be high governance standards with clarity for members about any promise made and any associated risks.

Source: Reshaping workplace pensions for future generations

Do you have any comments about the joint private sector/government process?

In the United Kingdom over the last two decades, reform of pensions has meant the addition of a huge amount of detailed regulation—usually driven by 'bad cases' such as the Maxwell plundering of pension schemes. This regulatory overload coupled with more rigorous accounting rules and the loss of some major tax privileges in the late 1990s placed huge additional cost pressures and liabilities on United Kingdom defined benefit scheme sponsors well ahead of the financial crash of 2008. However, the wave of defined benefit closures accelerated post-2008 and it became clear to the incoming Coalition Government in 2010 that if actions were not taken soon then the drift towards defined contribution arrangements with generally low levels of both employer and employee contributions (and outcomes) would continue.

We were fortunate that the incoming Pensions Minister in 2010, Steve Webb, has had a long interest in pensions and he has remained in post throughout the last four years. The ACA had long been arguing for legislation to encourage risk sharing in the United Kingdom, and shortly following his appointment as Minister he invited me to head a 'Defined Ambition' Industry Working Group to assist the Department for Work & Pensions (DWP) in identifying the options that might be available in what he described as the 'space between DB and DC'.

Following my appointment we established working sub-groups looking at ways to make DB schemes more flexible, ways to innovate in the DC market, including a separate sub-group examining Collective Defined Contribution (CDC) schemes. These groups were manned by volunteers from the pensions industry, including pension trade bodies, as well as representatives from the trade unions and consumer groups, with DWP officials also present.

The groups met regularly over an 18 month period and ultimately made recommendations to the DWP which were summarized in two separate consultation papers in late 2012 and 2013.

Was there anything particularly interesting that you heard from the stakeholders who gave input to the process?

Throughout the process it was clear that employers were concerned that any new type of risk sharing scheme must not, by future Government action, lead to extra costs and guarantees being placed on them again, as had been the case with defined benefit schemes. It was clear a number of large employers were interested in considering new risk-sharing models—quite a number met with the Minister during the process to indicate their interest.

The pensions industry itself had mixed views throughout. Whilst many consultants were keen to explore new ideas, others were skeptical that employers would move back from traditional defined contribution schemes, particularly as larger employers from 2012

were all having to auto-enroll their employees into workplace pension arrangements under an earlier Government policy, which almost universally were defined contribution in nature.

Employee and consumer groups not unsurprisingly were keen to see existing defined benefit schemes retained where possible and were supportive of risk sharing in so far as it offered greater certainty in pension outcomes than traditional defined contribution. Concerns about the charges associated with many legacy defined contribution schemes also encouraged support for 'scale' trustee-based solutions.

There was a broad consensus that accrued pension rights should not be affected by the reforms, although there was some pressure from consultants and employers that the reforms should allow sponsors flexibility to re-structure their accrued benefits as they complemented their future pension arrangements.

Which of the ideas could have the biggest impact?

Early on in the considerations it became clear the Pensions Minister was particularly interested in solutions that offered greater certainty of, initially, the emerging pension 'pot' at retirement and, then, following the work of the group, greater certainty of the income in retirement. Pension charges in the defined contribution area were also a concern, which pushed considerations towards 'scale' solutions.

Following the consultation exercises, the Minister became increasingly convinced that there was the opportunity to construct a new risk sharing regime between DB and DC and to lead the way with the legislative reforms, he became convinced the 'scale' solution of CDC schemes should be available—probably from 2016.

Do you have any opinion about which ideas are most likely to be implemented?

In June 2014 the Government announced in the Queen's Speech (the U.K. announcement on legislation for the year ahead) that it would be introducing legislation to enable CDC schemes to be established. Their introduction would be as part of a new 'risk sharing' pensions regime—the details of which (at the time of writing) are yet to be tabled.

However, hopes that at the same time legislation would ease the legislation surrounding defined benefit schemes—for instance, removing the requirement in the United Kingdom to index benefits up to 2.5 percent per annum to reflect movements in prices, were not pursued. This was justified on the basis that the Government did not feel the consultations had shown enough employers would take up these reforms, although survey evidence and face to face meetings have shown support for flexible DB. The proximity of the 2015 General Election and the importance of the 'grey vote'—in that the reforms might bring headlines like 'Government proposes to cut pensions'—may have had an important bearing on matters.

In the United States, many actuaries and economists favor increasing retirement ages, while consumer advocates are often very opposed to this idea. Do you have any comments about retirement ages and ideas for adjusting them?

In the United Kingdom, the Government has already announced movements in the State pension age from what is currently 65 for both men and women to 67 by 2028, and a further increase to 68 is planned for the mid-2030s. Legislation passed this year will see the Government periodically review State Pension Age in the light of longevity improvements, but taking account of the social impact of extending ages and giving reasonable advance notice.

The DA Industry Working Group expressed the hope that the Government would act to enable private sector sponsors to easily adjust pension ages in the light of longevity improvements, perhaps introducing a statutory override to by-pass restrictive scheme rules written years ago, but it would appear the Government feels that no changes in legislation are needed to enable employers to adjust scheme ages. However, whereas in the United Kingdom the State is permitted to adjust pension ages encompassing accrued rights, because of U.K. trust and contract law this is not possible in the private sector without individual agreement from members. It is clearly inconsistent that as longevity extends, private sector employers are restricted in their ability to increase pension ages in order to mitigate the increasing cost of pensions, whereas the State can simply adjust the age from time to time.

How will the proposals make it easier to offer defined benefit plans using a defined ambition approach?

Very few defined benefit schemes in the United Kingdom are now open to new members—fewer than 10 percent of the 6,500 private sector schemes that once had over 8 million active members. Latest figures suggest around a half of these schemes are continuing accrual for existing members—covering around 1 million private sector employees.

The reluctance to legislate in favor of more flexible defined benefit schemes is likely to mean that there will be more closures, particularly as all schemes have to be reviewed ahead of 2016, when schemes ability to 'contract out' of the Government's earnings-related element of the State pension scheme ends (from then, the State scheme will pay a higher flat-rate benefit with no earnings-related supplement for future accrual). It may be that some larger employers and groups of smaller employers will take the opportunity to move to a risk sharing model in the shape of CDC—we simply don't know whether the take up will be modest at first or not.

In fact, the end of contracting out in 2016 may mean that for those employers prepared to persist with defined benefit, there are some easements (e.g., they will no longer be required to automatically offer spouses' benefits and there may be some simplification of administration), but the concern must be that the swing towards traditional defined contribution schemes—with generally low contribution levels—will persist.

How will the proposals improve certainty in defined contribution plans?

The introduction of CDC may well prompt traditional DC providers to re-examine both their charges and overall package in terms of the certainty of outcome, but it is likely other reforms underway in the United Kingdom will also have an impact.

To date, for the majority of defined contribution scheme members, the only realistic option at retirement—aside from an ability to draw 25 percent of their pot as tax-free cash—has been to buy an annuity at some point between retirement and age 75 (with a minimum retirement age of 55). The Government has announced changes this year—to be fully effective from April 2015—so DC members will be able to draw on their pension pot pretty much how they want from age 55 subject to their marginal tax rate (with the minimum retirement age likely to rise so it is 10 years below the State Pension Age). This major change is presenting the provider market with huge challenges as to how they should respond to retain business. If this was not enough, we are also seeing the regulation of defined contribution schemes becoming more rigorous, which is likely to add to costs—pulling against the policy intent to reduce charges and to increase certainty in returns. The argument runs that the impact of all these pressures

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will be a rationalization in the number of schemes which—again—may foster the growth of another range of CDC solutions, such as funds that allow members to pool their retirement savings together to reduce costs and gain access to a wider range of investment strategies and retirement income drawdown options.

What actions will be most important in making it possible to implement change?

A big concern with all U.K. pensions legislation is that reforms are simple and regulation proportionate. Unfortunately, the U.K. Parliament has a habit of adding complexity during the passage of Bills and via both legislation and regulation, adding still further complexity based on addressing a few 'bad cases' when the majority of sponsors and schemes are working well and effectively in the interests of members.

Clearly as the U.K. Coalition government comes to the end of its current term of office, it is important that the Parliamentary process does not get in the way of finalizing the proposed legislation.

What role is the actuarial profession playing in moving the retirement system in the United Kingdom?

While there have been genuine concerns that the decline in defined benefit arrangements must impact both on the influence of actuaries in the United Kingdom and employment opportunities in the consulting sector, evidence to date does not support this. Yes, to some degree activity remains at a high level in the short term because of the scale of ongoing, often closed provision and work associated with buy-out and buy-ins, but the skills of consulting actuaries remain in high demand from sponsors, trustees and—of course—the provider market.

CDC in all its forms will certainly require actuarial involvement and actuaries will be prominent in assisting providers of pensions in this highly competitive environment to design new pooling or risk-sharing features. An increasing number of our members are also involved in providing investment advice to both sponsors and trustees.

What advice do you have for us?

Never give up! Actuaries must make their case on what they believe is needed and keep repeating the message. Eventually somebody will listen. Importantly, as well as pursuing arguments in the public arena, actuaries and their representative bodies need to engage with politicians in all parties that show an interest in pensions and other matters of interest and also build strong working relationships with public officials advising Government. By so doing, there is a better chance that public policy can be influenced so mistakes are minimized and actions are taken that are supportive of good pension provision. That said, be realistic. Unfortunately, the political timetable is often very short and not conducive to making decisions that will take a long time to mature. The lesson here is to push for reforms as early in a Government's term as possible—which may be more difficult in the United States than the United Kingdom because of your election timetables. ■