

Briefing

The 10 steps to create a sustainable benefit design for a DB scheme

RISK | PENSIONS | INVESTMENT | INSURANCE



11% of UK Defined Benefit (DB) pension schemes still remain open to new entrants, despite the challenges faced by employers operating such schemes. Whilst the flexibilities of DC schemes can be a good choice in many situations, there appears to be a persisting demand in some areas for a pension scheme that gives more certainty to employees.

This note looks at ways those employers can create a sustainable pension scheme for their employees, helping to manage the risks that a pure DB scheme creates, whilst still providing more DB-like security for members in retirement.

STEP 1

Separate past and future

While closed schemes only have past service costs to worry about, open schemes need to consider and balance both past and future service costs. A significant (usually) DB benefit has already been built up and this brings challenges. Nothing you do about future benefits for existing members will change that, and you need a plan to manage the costs and risks inherent in the “past service” liabilities.

The costs in relation to the past service are likely to be volatile – so you cannot have a sustainable future service benefit if it comes out of the same budget as the past service cost. Otherwise, if past service cost increases, you will automatically reduce the money available for future service.

STEP 2

Manage future DB cost volatility

There are a number of ways to manage the volatility of past service costs, and a lot of advice and regulation is focussed on just that. Having separated that out (see step 1), you then need to think about managing the future service cost volatility as well, and this is much harder, and given much less focus generally.

Normally speaking, future service costs are more volatile than past service costs, mainly because everything is much further into the future. Future service costs cover the active employees only, whereas (usually) past service costs cover members in retirement as well, so on average, future service cost members are younger, and so their payments are further away.

This longer duration makes costs more volatile as things change –for example, a fall in expected investment return has a bigger impact on the cost of benefit payments 25 years away than on benefits 20 years away.

On top of this, there are fewer options to manage the volatility. You have no assets to match future service costs, and they need to be paid in full as they arise (as opposed to a past service deficit that can be spread over a recovery period – which can be extended if necessary).

The only real option available is to adjust benefits to manage the volatility, which can often be quite painful, with emotive consultations with employees who are worried about their retirement provisions. Perhaps a better way to manage this is to set a budget for future service benefits in advance. A fixed percentage of salary (perhaps with an allowed range around the central budget). If the cost of benefits moves outside of that range, then benefits are adjusted to fall back within the range.

This is not without its challenges, as ideally it would be based on an objective view of whether benefits have increased in value or not.

In practice, however, there is a wide range of reasonable views about the future cost of pensions because of the significant uncertainties involved. So the mechanism for deciding whether the cost of benefits has increased or not needs careful consideration to avoid it being manipulated, or leading to undesired consequences. However having this agreed plan at the outset can reduce a lot of the pain in future, if benefit costs do increase.

STEP 3

Determine risk budget

Defined contribution benefits do not have a guarantee behind them from the employer. Any benefit type that has some form of guarantee from the employer is effectively a type of “defined benefit”, and comes with risk. Risk that the amount paid in will not be enough, and so deficits may arise in the future, leading to additional costs.

The question for employers, then, is how much more of the risky DB-style benefit can be built up each year, whilst keeping the risk at a manageable level.

The answer to this then determines how much DB-style benefit can be afforded from the risk budget.

STEP 4

Efficient allocation of resources

The outcome of Step 3 (based on risk tolerance) could be a noticeably lower level of DB benefit than is currently the case, and is affordable. Just because you can afford a given level of benefit this year, doesn't mean you can manage the risk of it.

The point here is that DB by itself might not be the right answer. Firstly, you might not have the risk budget to build up enough DB benefit to give people a decent retirement income by itself. But – perhaps more importantly – because DB by itself is not necessarily an efficient way to provide for members' needs in retirement.

Yes, it does very well at providing members with protection, and a base level of protection is very useful, but there comes a point at which you've got enough protection, and the benefits of more protection are outweighed by the downsides of the very rigid structure that a DB scheme must adhere to. DB pensions must increase in line with (capped) inflation for life, whereas people's needs for income in retirement are usually quite a different shape.

Any mismatch between the shape of people's needs and the income stream provided is essentially wasted money that could be used in a different way.

Therefore there are significant benefits for all parties of having a combination of DB and DC-style benefits – combining the protection from DB with the flexibility of DC.

STEP 5

Overall budget

Making use of this hybrid DB/DC approach opens up quite a powerful way of deciding on the type of benefit to provide. You can set the overall cost of benefits at a level that is affordable, and should provide sufficient benefit for members. Then decide on a DB/DC split based on your risk budget, with the aim of providing enough protection for members that they can really take advantage of the flexibilities of DC on top.

STEP 6

Allocation by member

If you have decided on an overall split of your budget between DB and DC (50:50, say), you then need to think about how that split is applied to individual members. In this example, it would be quite simple to apply that same 50:50 split to all members, but actually maybe lower paid employees need proportionately more protection than the higher paid. Applying a salary cap to the DB benefit so members earning at or below the cap get 100% DB, and those earning noticeably more get proportionately less DB, can be a good way of trying to ensure a minimum level of protected income for all, as well as allowing flexibility for those that can afford it.

STEP 7

Help members engage with DC

DC benefits work quite differently to DB benefits. The flexibility they provide means lots more choice for members, and a need for them to engage much more with their pensions. This may feel quite new to people used to a DB scheme, which they don't really have to think about. It is therefore important to have a good plan for how you are going to help people understand and get the best out of any DC benefits being offered. Without that, they will not be able to see the value of the new flexibilities being offered.

The flexibility also means trustees need to think about what options are available to members, to help them structure their retirement income to meet their needs.

STEP 8

Help members deal with later life risk

One of the real challenges with DC benefits is the uncertainty for members about how long they are going to live. It is relatively easy to plan how to draw a DC pension if you know it only needs to last for 20 years, but very difficult when there is a noticeable chance that you could live a lot longer.

There are things that can be done to help with that later life risk, for example finding ways to take account of longevity pooling which can have a really big impact on this part of the benefit.

One way to do this in a hybrid DB/DC scheme is to provide an extra DB benefit covering the later life part only (such as a pension that commences at age 85). This would mean that members would have certainty over the maximum period their DC pot needs to last for (until the later life pension kicks in).

STEP 9

Flexibility for member contributions

Employees will have lots of different priorities for their savings. Paying off debt, or saving towards property purchase may be more important than providing for retirement at a given point in their life. DB schemes tend to be all or nothing for members – there is a fixed contribution rate, and either you pay that or you get nothing (though some schemes have introduced a few levels of benefit to give members some choice over contribution rate).

Introducing some DC benefit creates more opportunity to offer flexibility to members on their own contribution levels. This can be done by creating tiered contributions possibly with some element of matching from the employer, but the right structure needs careful consideration to avoid unintended consequences and ensure fairness.

STEP 10

Risk benefits

Finally, you need to check that the benefits provided work in all scenarios. DB benefits usually provide targeted cover for death before retirement, or ill-health retirement, but a DC scheme would not always work for deaths or ill-health retirements at a young age (where the DC pot built up could be very small). Depending upon the structure and mix of the DB and DC benefits, there may need to be extra insurance to cover some of these benefits, and that would need to be factored into the overall cost budget.

You're ready!

Following these steps should mean you can create a benefit that provides cover to scheme members at the times that they need it, but in a flexible way – targeting the cost to need, rather than just using the rigid DB structure. You can do this in a way that allows you to set the right balance of employer risk, and the right budget that should mean that the benefit is sustainable, flexing to meet changing situations.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

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