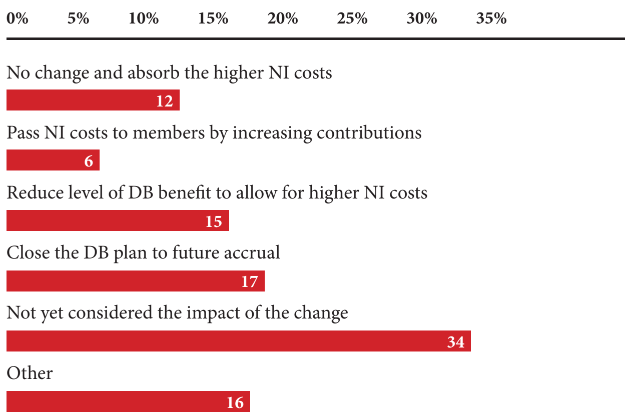
Time for change

John Cockerton explores the impact the recent Budget may have on scheme design

Figure 01. What changes are you planning to make to your DB plan in response to the ending of contracting out in 2016?



What is happening?

Apart from the usual influences for changing traditional final salary pensions plans, there are two further significant drivers now coming in to play:

1. Contracting out is ceasing within the next two years, so that without action from employers, pension costs will increase.

2. Defined contribution (DC) (including cash balance) has just become more attractive following the 2014 Budget.

So how does the budget change plan design?

In the 2014 Budget the Chancellor announced that from April 2015, no member of a DC scheme will be compelled to purchase an annuity. We have yet to see the legislation but believe that this flexibility will extend to cash balance schemes.

The pension impact of the Budget is expected to be attractive to many people, especially as annuities are often perceived to be 'bad value'. As a result we believe that some members will find opting for a DC scheme an attractive alternative to defined benefit (DB). In addition, if transfers of accrued benefits from DB to DC are banned (which is currently being consulted upon) there may be employees who prefer having the flexibility offered by DC.

Of course, whether DC is attractive depends on the contribution rates in comparison to the benefit levels in their existing plan. And making the voluntary decision to move from a DB plan to a new plan (typically DC) is almost certain to be a one way move. Whilst this may seem scary, it is an option that is currently available to the majority of DB plan members although most are not aware of it. As with many issues in pensions, communication, education and understanding become key ingredients in any action taken by employers to support employees with their pension decisions (especially to avoid any regret risk (or mis-selling risk)).

But how many organisations will really reconsider their DB plans in the next few years?

Towers Watson research shows that virtually all sponsors will reconsider the future of their DB plans in the next two years. At the end of 2013 Towers Watson surveyed their clients to ask what they are going to do in response to contracting out ceasing in April 2016 (see Figure 01).

The changes introduced in the 2014 Budget raise additional considerations for organisations when deciding what (if any) change to make in response to the ending of contracting out in April 2016. As noted above, DC or cash balance plans are now potentially more attractive, and we expect this will have an impact on future pension design. This could mean that DB plan closure and a move to DC is a real possibility for some organisations who would otherwise not have contemplated it – whether it be on a compulsory or voluntary basis for the member.

It remains to be seen whether the Budget will really change organisations' views of what they will do before April 2016, but what is clear is that in order to prevent a cost increase in April 2016 some form of change must be made.

What action is needed?

The 2014 Budget introduces a new dynamic into pension plan design. This will bring new influences and considerations to those who are considering changing their plan. Further change is imminent: it is now less than two years to contracting out ceasing which is the point at which a change to control cost must be in place. Given the communication and consultation requirements and the limited windows for these to occur, planning for action needs to start now.

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