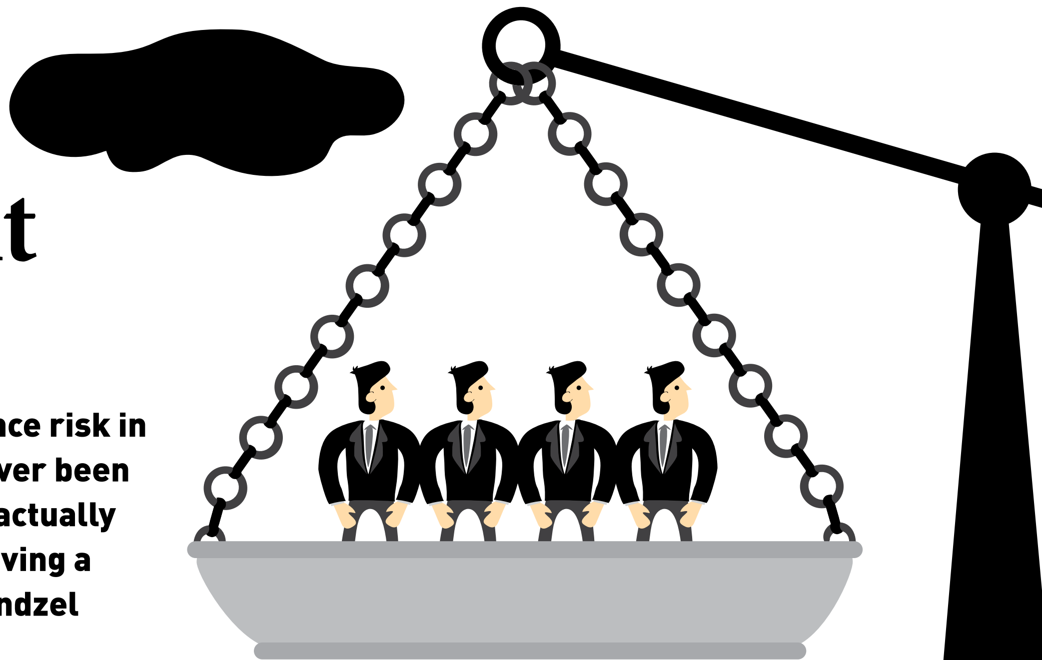
Summary

- Baby boomers are expected to receive back nearly 20 per cent more than they contribute to the welfare state, while younger generations will have less at every point in their lives than the generations before them.
- There have been calls for a new, more flexible approach to DB benefit design so that schemes could be sustained and ensure that risks and costs were better shared between scheme members, sponsors and across generations. Ideas to achieve this include a move to CPI or conditional indexation.
- Compulsory contributions could help to improve DC pot size.
- As all the risk within DC sits with the member, there had been calls for the development of a 'defined ambition' system, incorporating more risk sharing. However this idea has subsequently floundered.
- As a response to future generations being unable to retire due to inadequate pots sizes, the UK may swing back to a form of DB or a hybrid DC model.



A difficult balance

The need to better balance risk in pensions provision has never been more acute. But is the UK actually getting any closer to achieving a middle ground? Marek Handzel finds out

Ask a baby boomer if they think that life is fair and they'll give you a clear hard-nosed answer. Of course it isn't, they'll say. Never has been, never will be. Everyone knows that.

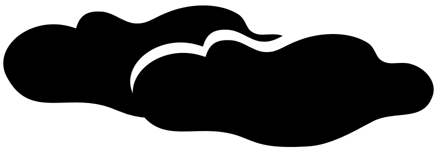
Everyone that is, apart from a wave of millennials who aren't prepared to stoically accept a fragmented and uncertain jobs market, unaffordable housing, and an inadequate retirement savings model that clashes with both their approach to financial planning and their career plans.

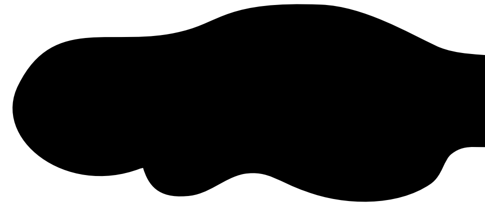
One of their main gripes with pensions, as Squire Patton Boggs pensions lawyer Catherine McKenna points out, is not just that over half of the UK's total wealth sits with the baby boomer generation. It's that it seems completely unattainable.

"It is normal for wealth to build up at older ages," she says. "But the problem comes when the ability to accumulate wealth is threatened by more expensive housing, more expensive pension provision and fewer workers to support an ageing population."

One mechanism that exemplifies this perceived unfairness is the state pension triple lock. EY director Jason Whyte says that since it was introduced, pensioner earnings have outpaced inflation and pensioners are now no more likely to experience poverty than any other age group.

"As a result, baby boomers will receive back nearly 20 per cent more than they contribute to the welfare state, while younger generations will have less at every point in their lives than the generations before them," he says.





Preserving DB

This disparity has become so serious that it is now being directly addressed by the pensions industry itself.

In October, the Pensions and Lifetime Savings Association's (PLSA) defined benefit taskforce published its interim report. It called for a new, more flexible approach to DB benefit design. This way, it said, schemes could be sustained and ensure that "risks and costs were better shared between scheme members, sponsors and across generations".

One of the changes to DB that has been touted around for some time now is to switch pension increases from RPI to CPI. This would cut about 1 per cent off benefit increments each year. Lane Clark & Peacock pensions partner Jeremy Dell says that swapping indices has become a tempting option for many trustees.

"If you have an employer with a really weak covenant, then you've got a really interesting question," he says.

"Because if there's a reasonable chance that later generations are not going to get benefits at all – or get them through the PPF – then you might be able to restore the pension fund to a reasonable level of health by cutting back to CPI. And that means that later generations of members have got a better chance of receiving the benefits they have been promised, albeit at a slightly lower level.

"That's the nub of the issue for many trustees. By reducing benefits for everybody, do I secure benefits for later generations?"

Aon Hewitt senior partner Kevin Wesbroom says that it is a very genuine question for trustees to ask. However, his preferred way to restore some balance to DB is to work on a conditional indexation basis.

"So you check each year to see what the scheme can afford," he says. "And if we're living through years of ultra-low interest rates, then you probably won't be able to afford too much by way of an increase.

"If things get back to normal, then things will be able to pick up."

Sackers partner Helen Baker says that as well as looking at their inflation benchmarks, DB trustees may consider scheme alterations such as reducing the salary cap for pensionable earnings, or changing the accrual rate for benefits.

"You could also examine the funding side," she says. "Should there be scope for some flexibility on when liabilities are calculated? If one year is very bad one for gilt yields, that makes a huge difference to the deficit. So could there be some leeway in how that is managed so that DB is a bit less burdensome?"

The PLSA has said that employers put £31 billion into DB schemes last year, more than nine times the amount they spent on DC pensions.

Figures like that, says Baker, show that any help with juggling DB deficits could free up capital to improve DC offerings.

DC options

One simple way to create better DC schemes, and give millennials a better chance to build decent-sized pots, is to escalate contribution rates, says Standard Life head of pensions strategy Jamie Jenkins.

By doing so, millennials may eventually – and suprisingly – find themselves in a stronger overall position than the wider baby boomer generation.

"Undoubtedly, those people who previously enjoyed DB accrual were better off than younger people today with DC pensions," says Jenkins.

"However, not everyone had access to DB, and many worked for smaller firms where no pension was offered at all. At least with auto-enrolment, all employees will have access to pensions. So coverage will be much broader."

For Wesbroom, increasing contributions through legislation is the elephant in the room.

"We're already seeing people saying that even the current modest increases should be pushed back due to difficult economic circumstances," he says.

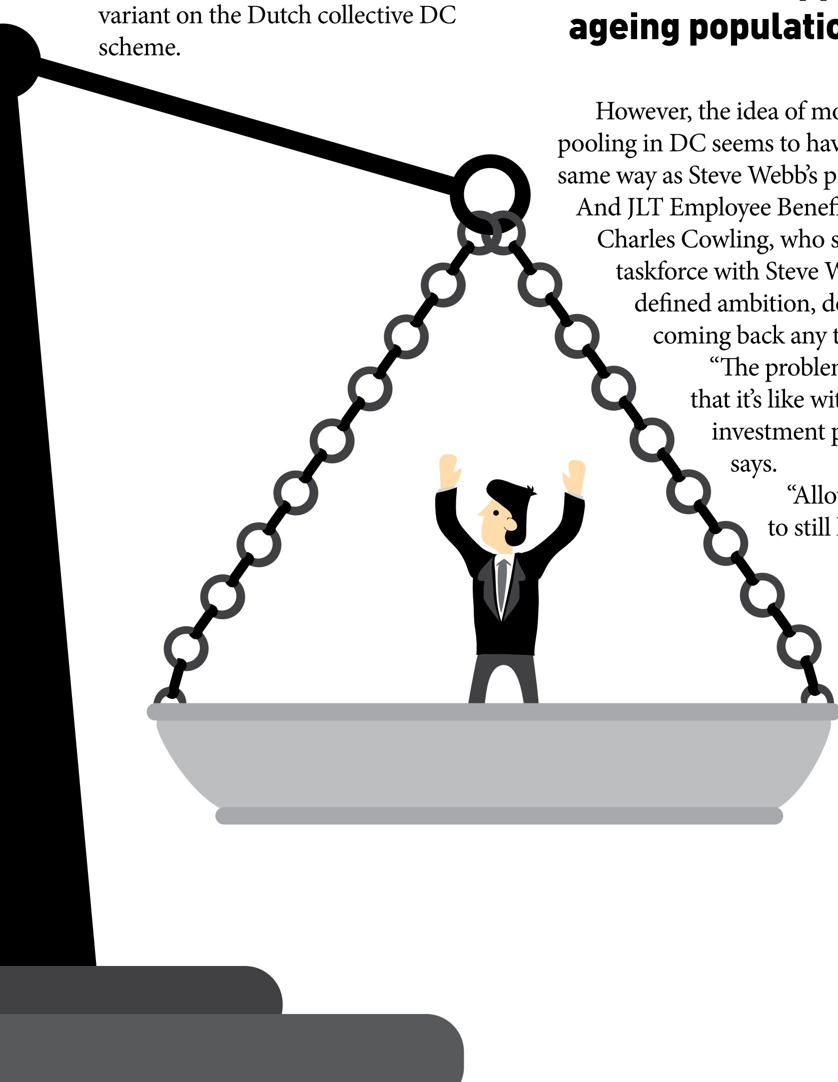
"But if you look at where the money goes in DC, it goes primarily to young

people. They're the ones who can gain the most from compulsory contributions."

Dealing with risk

Nevertheless, the risk in DC remains with the member. Although some default investment funds have been, and are being developed, to mitigate investment hazard, they remain out of reach for the majority of savers at present.

Under the previous government, it looked as if risk sharing for DC savers was going to get better with the introduction of defined ambition, a variant on the Dutch collective DC scheme.



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However, the idea of more risk pooling in DC seems to have gone the same way as Steve Webb's political career. And JLT Employee Benefits director Charles Cowling, who sat on the taskforce with Steve Webb to create defined ambition, doesn't see it coming back any time soon.

"The problem with it is that it's like with-profits investment policies," he says.

"Allowing people to still have access to risky assets, but in a way that smoothes out volatile returns sounds great in theory, but the demise of with-profits investment sort of suggests that it's not so attractive in reality.

"We're nearer the US than the Dutch when it comes to our outlook on these things and it's hard to see how we will move in that direction."

Longer term, however, the UK may be forced to ditch its cultural preferences, says Dell. Economic realities, he says, may force us to reconsider whether individual DC pots are the best way to service retirement incomes.

"What we might see, in 20 years or so, is that employees will be coming up to retirement age with very limited pension provision and suddenly realise that they can't afford to retire," he says.

"And these days employers cannot retire people on the basis of age. So we'll find ourselves in a situation where employees will be hanging onto their jobs well into their normal retirement age, because they can't afford to retire.

"That's not good for the employee and it's certainly not good for the employer."

In response, Dell can see a day when the UK is made to swing back to a form of DB or hybrid DC model.

"That's happened before. DB schemes became popular in the early 1970s because the early version of the DC funds were coming out with variable outcomes and I can very much see that happening again."

That may be too late for the millennials, but it may give the generation that follows them a fairer stab at pension saving.

Written by Marek Handzel, a freelance journalist