Employers to look again at DB? Two sides of the debate

Laura Blows hears the industry's opinions for and against private-sector DB schemes potentially having a resurgence in popularity with employers

Summary

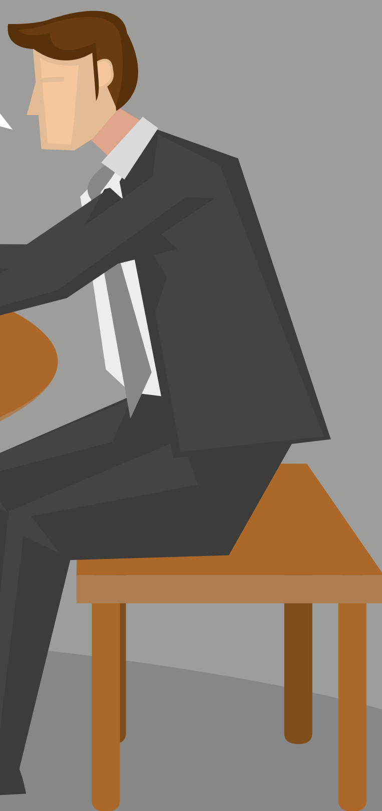
- Concerns about DC, its attractiveness to employees, and the many possibilities DB surpluses can provide are all cited as reasons for potentially increased interested in DB schemes from employers.
- However, the financial considerations and regulatory burdens may mean that 'the ship has sailed' for DB schemes in the private sector.
- CDC could be the 'compromise' between DB and DC schemes.
- In contrast to the private sector, public-sector DB schemes look set to remain for the foreseeable future, due to the funding challenges of winding them up and the unions' pressure against doing so.

A few years ago, the notion that private-sector DB was on its slow journey to the history books seemed inevitable and the idea of a resurgence in it being offered by employers fanciful. And yet…

The case for

The shortcomings of the DC model, particularly in terms of contributions, engagement and outcomes, are a concern as savers will increasingly reach retirement with only DC savings.

"As younger employees become more aware of the value of workplace pensions, employers with open DB schemes become a very attractive option.



"And with some schemes in significant surplus, this could offer more predictable and affordable future costs for employers. As a result, open DB schemes may have more scope to invest in higher risk/return assets, if taking a longer-term view with younger members," Royal London director and policy and communications, Jamie Jenkins, says.

Another attractive reason to keep DB schemes open is that they are now just half as expensive to run as they were 18 months ago, Cartwright director, Sam Roberts, says.

Even reopening DB could be a strong positive to recruit and retain desirable employees, he states, and could "particularly appeal to paternal strong employers that do not need the surplus returned as cash (net of tax)".

This surplus currently enjoyed by many DB schemes could be used to pay for extra DB for existing active members or (selective) new entrants, Roberts adds.

Legislation to help change the position on surpluses may help with this, Zedra director, Colin Richardson, says.

However, this is to potentially continue existing DB schemes, rather than new ones opening, he states.

Richardson does however suggest that multi-employer DB could be created, with a more modest aim and cost compared to conventional DB, (less than 1/60th accrual) under a central, well-governed structure. "If these schemes are open to members and accrual then the costs reduce through a much longer-term investment strategy. This could be attractive to some employers, as costs are contained through the multi-employer structure."

WTW GB head of retirement, Rash Bhabra, thinks that closed DB schemes are not about to reopen and mature DB schemes will not go back to investing primarily in return-seeking assets.

However, "after years of worrying costs to employers and the security of members' benefits, attention is shifting to the upside that DB schemes can provide", he says.

"If policy made it easier for DB pension scheme surpluses to be put to use, DB pensions schemes could have extended lives and invest more productively. It should be made easier for schemes to use surpluses to benefit pensioners, sponsoring employers and current employees, so that they see value in pursuing higher investment returns. This would also allow surpluses that have emerged already to be used sooner," Bhabra explains.

"The current regulatory framework incentivises schemes to predominantly de-risk once they are well funded, rather than continue to invest more productively. Shifting that balance to change the environment in which schemes operate in, so that there is value in generating surpluses, could deliver a new lease of life for DB schemes," he adds.

The case against

So, with the new environment of lower operational costs and surpluses, what's stopping DB schemes from having a new lease of life?

According to Van Lanschot Kempen executive director, fiduciary management and institutional solutions, Arif Saad, "DB pension schemes can certainly experience a new lease of life, but the reality is that few probably will take advantage of the opportunity.

"Trustees and sponsors have spent decades working on a path to de-risking, de-costing and de-linking pension activities as part of their sponsors' businesses – the window created by surpluses and both regulatory and political openness to making DB more productive is unlikely to be open long enough to be seized against the tide of bulk annuities."

For Roberts, it is still "too soon" for any meaningful change.

"The high cost and risk of DB to employers is still a recent memory, so employers are likely to be reluctant to choose to again expose the company to this yet. Most employers are currently breathing a sigh of relief when the DB scheme is off their balance sheet," he explains.

A key issue is the financial burden of DB schemes for employers.

"At the moment employers on average are paying around 3-5 per cent of contributions to DC schemes, whereas, even in the post 'Liz Truss world', they have been paying around 20-25 per cent into existing DB schemes. Few employers will want to significantly increase their costs by returning to DB," PMI president, Robert Wakefield, explains.

"The often talked about 'Holy Grail' of a bulk annuity deal (and the ongoing question of whether superfunds can play a role) is perhaps final nail in DB schemes' coffins as sponsors look to get their scheme (and future costs) off the books," he adds.

For many employers, managing DB

schemes, "there is a sense of relief that the end is in sight", Russell Investments head of UK fiduciary management, Simon Partridge, says.

Along with the financial costs, another barrier is the regulatory burden of managing DB schemes.

"Having spent considerable money on DB deficits there is no employer fashion to take on risk; it goes against all corporate textbooks," Richardson states.

"With ever-increasing regulatory demands, as well as ongoing market and reputational risks, it's hard to imagine employers will decide to reopen DB schemes or start new ones," Partridge says.

Roberts highlights the "significant" political and regulatory risk for employers, which include investment restrictions, stricter funding requirements, or employer covenant actions restricting the employer's normal activities with personal director liability.

And then, in terms of employment principles, it is not clear why an employer should provide a pension for life after retirement for employees, especially given typically lengths of employment with one employer, Richardson says.

As Roberts puts it, "DB worked well when employees spent long periods with one employer, but many people now work for many different employers during their career".

Therefore, Wakefield states: "With a heavy heart, I have to say, it may be too late for a shift back to DB, as we are too far down the line."

Broadstone head of policy, David Brooks, agrees. He says: "For the resurrection of DB schemes, we would need the combination of a settled regulatory environment (we don't have that yet; see TPR code and Mansion House), an extended period of high gilt yields, a strong employer and competitive pressure. I won't be holding my breath."

Public-sector DB schemes

In contrast to the private sector, open DB schemes dominate the employment landscape within the public sector. Does this look set to continue?

The logic for many years has been that (off UK government balance sheet and unfunded) higher public-sector DB pensions have compensated for (on balance sheet) lower public-sector salaries Cartwright director of investment consulting, Sam Roberts, says. "Therefore, the clear short-term incentive for politicians seems to be to continue with the status quo."

This is despite public-sector DB schemes being "totally unaffordable", Zedra director, Colin Richardson, states, due to their £2 trillion of unfunded liabilities.

"However, because all policymakers in government and politicians have public-sector pensions, and the union pressure against pension changes, the current form of public-sector pensions will never change," he adds, "so, unfortunately, they are set to remain."

Demographics mean that public-sector DB will eventually become unaffordable, Roberts warns, "but this could take many years and will be paid for stealthily via higher price inflation by issuing and monetising the extra government debt needed (i.e. gradually converting off balance sheet debt into on balance sheet debt)".

Because of how they are funded, it would be particularly difficult to wind up public-sector DB schemes, Royal London director of policy and communications, Jamie Jenkins, warns.

"As they don't hold assets to cover liabilities, pension costs are met by current taxpayers. With no existing fund to secure future liabilities, the amounts involved to change this would be vast. Moves have been made to reduce the burden on taxpayers in recent years, but any plan to move entirely away from DB for the public sector will be politically challenging, and is likely to take many years, if not decades to implement," he explains.

Despite frequent reforms, the public sector will continue to enjoy DB pension scheme provision for some time, Isio director, Paul Moffat, agrees.

"The McCloud judgment and subsequent remedy tells us that large scale reform is fraught with risk. Balancing the interests of a long list of stakeholders, including public service workers, their unions, employers, the taxpayer, and politicians) will require a great deal of care over the next round of reforms when it inevitably comes," he adds.

"Therefore, DB is likely to stay part of the public-service pension offer beyond 2040, but innovation is imperative," Moffat says.

However, local government DB could come under pressure sooner as they are funded, Roberts suggests. "A tempting solution for central government could be to centralise and convert to unfunded schemes, bringing the assets onto its balance sheet and putting the pension liabilities off balance sheet. This will postpone any pain," he says.

Bridging the gap

However, one "glimmer of hope" could be collective DC (CDC) schemes, Wakefield suggests. "While challenges persist, a carefully administered CDC model might bridge the gap between traditional DB and DC extremes," he explains.

"The renewed focus on CDC schemes may provide a more attractive half-way house between DB and DC, for employers who want to provide more certainty," Jenkins agrees.

While CDC "remains untested in the UK and comes with a shaky international record", Brooks says, it "looks the more likely step *[than a return to DB]* for employers that have DC for current employees".

Written by Laura Blows