IN THE BIG SCHEME OF THINGS

WHICH IS BEST FOR YOUR FIRM? A FINAL SALARY PENSION SCHEME OR A MONEY PURCHASE ALTERNATIVE? **DAVID JONES** OF LANE CLARK & PEACOCK LLP EXPLORES THE DIFFERENT FEATURES.

Pensions have been hitting the headlines in unprecedented fashion over the past few years. In many cases, the reason for the publicity has been the closure of a company's final salary pension scheme. Why are companies making these changes? Are the new money purchase arrangements really better for the modern employee? Pensions are often the most costly but least understood benefit provided by companies to their employees. This article aims to give the treasurer an understanding of the relative merits of these different pension vehicles, and how each type of arrangement interacts with the treasury function.

TWO TYPES OF SCHEME. There are two fundamental ways companies can provide pensions to their employees: either by defining the level of benefits the scheme provides, and then paying to the scheme whatever contributions are needed to meet those benefits; or by defining the level of contributions paid into the scheme, in which case the benefits will be whatever can be provided using the accumulated fund.

DEFINED BENEFIT (DB) SCHEMES. Employees can be promised a defined level of benefit when they retire, leave service or die. In a typical case, a pension scheme would offer 1/60th of a member's 'final salary' for each year of pensionable service. So, Mr Smith, retiring on a salary of £30,000 after completing 20 years of pensionable service would receive a pension of £10,000 per annum (that is 30,000 x 20/60). Mr Smith may have paid contributions equal to 5% of his own salary to the pension scheme during his membership, but this does not directly affect the benefits he receives. The company's side of the bargain is to meet the balance of the cost of the benefits, whatever that may be. The company's contributions are usually set every three years following an actuarial assessment of the pension scheme's financial position. For obvious reasons, this type of arrangement is known as a final salary scheme – and is just one example of a DB scheme.

DEFINED CONTRIBUTION (DC) SCHEMES. In a DC scheme, contributions are invested and then, on retirement, the accumulated fund is typically used to buy an annuity from an insurance company, to provide a pension for life. The benefits that a member or his or her dependants will receive on retirement, leaving or death cannot be known in advance.

They will depend on a number of factors: the investment returns achieved on invested contributions, the annuity terms available on retirement and so on. Historically known as 'money purchase' arrangements, company DC schemes come in several forms. The most common, in decreasing order of employer involvement, are occupational DC schemes run by trustees, group personal pension plans and stakeholder schemes.

KEY FEATURES

RISK TRANSFER. DB and DC schemes lie at opposite ends of the risk spectrum for pension schemes. In practice, there are also a range of hybrid schemes, neither purely DB nor DC, that aim to strike a balance somewhere in between.

In a DB scheme, the company is exposed through its contribution commitment to the possibility that future experience will be worse than expected. The key areas of exposure are investment risk (that the scheme's investments will not perform as well as expected) and mortality risk (that scheme members will live longer than expected). It is not uncommon for pension schemes to hold more assets than the market capitalisation of the company itself, and so these hidden risks should not be overlooked or underestimated.

In a DC scheme, most of the risk is passed to the employees. The vagaries of scheme experience directly affect the level of pension that a member can buy at retirement. Whether the company is truly immunised from risk in a DC scheme has yet to be properly tested, as retirements in DC arrangements have yet to come through in significant numbers. Will a company be able to walk away when, after a period of poor investment experience, employees find themselves retiring on pensions much smaller than they expected or were led to believe they would get? If a paternalistic approach is taken, the company will find itself carrying downside risk, even though it will not benefit in times of better than expected investment conditions.

CASHFLOW PLANNING. By definition, contributions to a DC scheme are largely stable, although there are often some factors that are difficult to forecast. In some DC schemes, the level of company contribution increases with a member's age and/or length of service. In addition to a basic level of contribution, the company may also promise to match members' contributions up to a certain limit, to encourage their participation. The cashflow requirements on the company are, nevertheless, reasonably predictable.

In a DB scheme, the company will have some choice over when contributions are paid into the scheme and the funding process can be used to smooth contributions over time. However, recent falls in equity markets, combined with other factors that tend to increase the long-term costs of providing benefits, have seen many DB schemes move from a period of low or no contributions in the 1990s to relatively high levels of contribution now. The longer term cashflow requirements on the company are therefore more difficult to predict.

EMPLOYEE PERCEPTION. Whether employees will perceive DC or DB to be better will vary from business to business. DC has been portrayed by many firms which made the switch from DB to DC as being 'more portable' and better tuned to the needs of the modern worker, who typically will work for several companies in a full career and may not have a traditional dependent family. DB was seen as the pension dinosaur, designed for an age when people stayed with one employer for life. However, the press message seems to have reversed recently, and there have been dramatic headlines of employees being 'ripped off' as final salary schemes are closed. Clearly, an employer needs to be aware of the reputational risks of making a change.

EMPLOYEE INVOLVEMENT. DB schemes are run by trustees who, working with the company, take most of the pension decisions on behalf of the schemes' members. In a DC scheme, members have to take a much more active role. They need to decide how their contributions are to be invested, what level of contributions to pay and, on retirement, what type of annuity to purchase.

People often say that members understand DC schemes better; that they are similar to bank accounts and members like to know the value of their own pot. But while the value of a DC fund is immediately clear from an annual statement, it is not so easy for a 45-year-old member to assess the pension that a fund of £20,000 is likely to provide in 20 years' time, nor what level of contributions he or she should pay to maximise their chances of achieving a desired level of retirement income.

Going back to Mr Smith, he knew on the day he joined his DB scheme that if he stayed until retirement, he would receive a pension equal to one-third (20/60) of his salary. One of the great challenges for DC schemes is to find simple and cost-effective ways of educating members so that they can make appropriate decisions about their contributions and investment choice.

WHICH TYPE OF SCHEME PROVIDES BETTER BENEFITS? The most important factor in determining the level of benefits that a scheme will provide is not whether the scheme is DB or DC, but rather the level of contributions that is paid in. A DB scheme with total contributions of 20% from the company and members will, in simple terms, on average, provide pensions about twice as large as a DC scheme with contributions of 10% – and vice versa.

Many employers have taken the opportunity to cut their pension contributions at the same time as moving to DC. A recent survey found that employer contributions to DB schemes are, on average, about twice that to DC schemes. Employer contributions to the government's new flagship stakeholder schemes are particularly low. This does not bode well for the size of pensions for people retiring many years into the future, nor for the government's objective of reducing pensioner dependency on State benefits.

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FACTORS DRIVING THE MOVE FROM DB TO DC

COSTS. DB arrangements have suffered a series of blows in recent years from legislative changes that have greatly increased compliance costs and have forced schemes – that good employers have voluntarily offered – to provide more generous benefits. Falls in equity markets over the past few years have reduced scheme funding levels and increased contribution requirements. The investment gloom has been compounded by the Chancellor's removal of pension schemes' ability to reclaim advance corporation tax on dividends received. To make matters worse – from an actuarial perspective, at least – life expectancy continues to increase.

RISK MANAGEMENT. There has been a growing awareness of the level of risk that a DB scheme imparts on a company. This is partly because of the size that some schemes now bear relative to the sponsoring employer, and also a result of the adoption of market based methods of assessment that greater reflect investment market volatility. The new pensions accounting standard, FRS 17, whose mandatory adoption has been postponed for the moment, brings this volatility straight onto the company's balance sheet.

WHAT WILL THE FUTURE BRING? Whether the trend from DB to DC will continue to grow or reverse is not yet clear. DC schemes, while on the face of it removing most of the employer's pension risk, bring their own list of issues to tackle. They have not been fully tested yet. It is only when large numbers of people reach retirement, potentially on inadequate pensions, that we will get a clearer picture of their success.

Armed with these ideas, the treasurer can take a closer look at the company's pension arrangements. Why does the company have this particular type of pension scheme? Is it working well, or should it be changed? Can the treasury function modify its practices to take better account of the scheme's features in the financial management of the company?

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