We have entered the year 2000 in the UK with over 300 years of retirement benefit plan experience, and enough pension legislation to fill the Millennium dome. Yet still it keeps coming, with Government proposals currently tabled to further radically reform the State and occupational pension framework. Throughout the constant process of pension reform the DB v DC (defined benefits v defined contributions) debate has been, and continues to be, central to discussions as to the best way forward. In this paper I summarise briefly the relevant background and current reform proposals. I also add some personal comments – the views expressed are my own.

**Introduction**

The first UK pension pillar is provided by the State and has always been DB. Everyone with a full employment record in the UK is entitled to a fixed basic State pension which is intended to meet their basic needs in retirement. There is also an earnings-related addition on top of the fixed basic pension. This addition is currently being reviewed and is likely to become an additional State 2nd Pension (S2P) which is fixed in monetary terms for all employees, thereby favouring lower earners in future at the expense of higher earners.

There is a strong second pillar of both occupational and personal pension plans. Occupational pensions take the form of both DB plans, where the pension is generally related to the period of service and earnings close to retirement, and DC plans, with the more recent trend being away from DB and towards DC.

Personal pension plans operate as DC accounts. Some self-employed individuals have personal pensions as a second pillar, as do other employees who are not covered by an occupational scheme. “Stakeholder pensions” are being introduced by the Government as a new form of DC personal plan, intended to increase the overall second pillar coverage.
A third pillar of tax efficient savings vehicles also exists, although contribution limits restrict their potential for higher earners.

Table I summaries some of the most significant milestones in the history of UK pensions together with current proposals. It is by no means exhaustive – the last 30 years in particular has seen thousands of pages of legislation on State benefit design, occupational plan governance, personal plan regulation and tax relief eligibility.

**Occupational pension plans**

Both DB and DC occupational plans have been prevalent in the UK for more than a century. Fashions fluctuate between them, with, for example, DB favoured during the inflationary 1970s but currently out of favour due to perceptions of high costs, unsuitability to an increasingly mobile workforce, and the open-ended employer commitment. This last point is particularly ironic with the employer commitment being much less open-ended during a period of low, stable inflation.

The Government has encouraged DC provision through personal pensions, which suffer a lesser legislative burden, and its current Stakeholder pension proposals are DC.

In fact of course, the same aggregate contributions will ultimately provide the same aggregate benefits under DB and DC (assuming the same expenses and investment strategies) but not for the same people. Although the cost of running a DB plan may be high for smaller employers, there are economies of scale for larger plans, and the legislative burden in the UK is not so harsh for well-designed and well-run plans (although there remains much scope for simplification of the rule-book). Unfortunately DC provides less well-targeted benefits (for example: why should single men have better provision than married women?). The perceived “value-for-money” of DC currently in the UK also means some employers’ contributions have fallen and benefits must therefore ultimately be lower (less in equals less out).

The mobility argument is sometimes a case of the tail wagging the dog. Why should long-serving retirees receive unpredictable, poorly-targeted benefits in order to reduce the administration for early leavers? I realise that the proportion of long-serving employees has fallen in many UK industries, but I would prefer to see DB plans able to discharge early...
leavers' benefits cost effectively through a more flexible transfer regime (which is currently very rigid in the UK).

In particular, employers should be able to insist on transfers for short-serving or young leavers, with even wider powers upon a plan winding-up. (After all, the Government's Stakeholder proposals anticipate that almost everyone will have a suitable vehicle to receive such transfers in future.) Furthermore minimum transfer value legislation for DB plans already exists in the UK and rules on maximum transfer charges for DC plans seem likely to follow.

At the point of transfer the defined benefit promises fall away, of course, and the transfer value itself is effectively a defined contribution. However, transfer values from DB plans are still less volatile than DC transfers and represent fairer value of accrued retirement benefits in my view.

As for the perceived open-ended financial commitment under DB; the risks can be minimised by the adoption of an appropriate investment strategy. In any case, the alternative is open-ended risks for the employee under DC, which seems generally less appropriate (and the employer may have to top-up inadequate pensions anyway).

Ownership of surplus

One subject under much scrutiny in the UK currently is the ownership of surplus assets within DB plans. Once all of the defined benefits have been provided for, together with any reasonable allowance for discretionary benefit practices to continue, then any balance of the assets over the liabilities is the surplus (or deficit if the liabilities exceed the assets). The surplus or deficit is regularly assessed by an actuary, normally every 3 years in an on-going plan, and is crystallised upon the winding-up of a plan.

It is normally the sponsoring employer who has to foot the bill in the event of a deficit. If an employer goes in to liquidation then a DB plan would usually be wound-up, and a deficit in this case will normally result in benefits being scaled back. As with individual transfers, the border between DB and DC becomes blurred, as benefits will have to be redefined by reference to the assets available (which is a defined fund or “defined contribution”).
Conversely, one would normally expect the employer to benefit from any surplus. In an ongoing DB plan this normally means the employer paying reduced contributions, and under a winding-up it means the employer receiving a refund of the excess assets.

However, in many cases (including some high profile recent court cases) it has transpired that the rules of the plan are such that the plan trustees are required to spend some or all of any surplus disclosed at regular actuarial valuations on providing extra benefits for members. This has been another nail in the coffin of DB as far as many employers are concerned although in my view it is just a deficiency in the rules of existing DB plans. This can be a difficult problem to walk away from, as quite often the winding-up rules will also require surplus to be spent on members. (Indeed, sometimes the winding-up rule is even more generous to members in this respect.)

In my opinion the lesson to be learnt is that in setting up a DB plan one should be careful to be absolutely clear as to the ownership of surplus at the outset. Normally one would expect the employer to own surplus (and also to be responsible for any deficit). The alternative is that surplus should be spent on benefits (in which case there should also be a facility to scale back benefits in the event of deficit). This alternative effectively creates another type of hybrid DB/DC plan. In my view an employer concerned with open-ended costs should consider this type of arrangement which retains some of the advantages of DB, rather than a pure DC plan.

This hybrid “defined funding” plan, where pension costs are fixed in advance DC-style, but the allocation of assets between individuals is made according to DB-style rules, is actually not uncommon in the UK for Small Self-Administered Schemes (SSAS). These specialised plans are often used as retirement trusts for small businesses or groups of executives.

**Sex discrimination**

Another topical issue is indirect sex discrimination. All DB plans in the UK now provide the same benefits for men and women (at least in respect of service after the date of the Barber judgement in the European Court – 17 May 1990). Similarly all DC plans have the same contribution rates for men and women. However, it has been argued that other elements of
the benefit design may lead to indirect sex discrimination. For example, exclusion of part-time employees from the pension plan (perhaps on the grounds that pension contributions in respect of part-time earnings are too small to manage) could have a disproportionate effect on women rather than men (as more women tend to be in part-time employment).

The next logical step for these arguments is that DC plans will have to operate equal annuity rates for men and women in future so that, all other things equal, men and women with the same contribution history would also receive the same level of pension income. (Indeed this is already the case in respect of DC funds arising in respect of opting-out of State pensions.) This would have wide-ranging implications for the UK pensions industry and would, in my view, detract further from the attractions of DC.

In my opinion a better alternative would be to replace all requirements for DC plans to purchase annuities with income withdrawal arrangements, thus recognising that DC plans are really savings accounts, not true pension plans. (Only a DB plan can properly claim to be a pension plan – and labels such as “personal pensions” and “Stakeholder pensions” have only served to add to public confusion over the DB v DC issue.) Steps in this direction have already been made, as it is now possible to defer the purchase of an annuity until age 75, and simply draw income from the DC fund in the meantime.

**Divorce**

A further subject in the news currently is the sharing of pension benefits upon divorce. Currently courts in the UK are expected to take account of pension benefits when sharing marital assets upon divorce. Although most courts will try not to break up the pension benefits accrued to the divorcing parties, in some cases the size of the pension assets means that this is unavoidable.

In these cases a pension plan will be asked to allocate part of a divorcing member’s pension for the benefit of the former spouse. In due course further legislation is expected to enable pension plans to split in two a member’s pension and pay a partial transfer value in respect of the former spouse. These issues are administratively complex under either DB or DC, although a particular problem may arise for DC if it is necessary to identify the accrued
benefits in respect of a period of marriage which may be shorter than the full period of pension plan membership.

**Communication**

The Government is hopeful to have (defined) benefit statements covering all pension plans in future. In suggesting this it is assumed that actuaries can somehow convert DC in to DB for presentation purposes. This concerns me, because we can not be expected to do this in any meaningful way (except perhaps for immediate retirement illustrations) - one only has to think of two DC accounts invested differently to realise there can be no uniform illustration (or even reasonable approximation) as to the benefits that may result.

In my view it would be better to recognise that DC arrangements are really tax-efficient savings plans with long-term withdrawal rules, not pension plans, and are therefore not directly comparable with DB plans.

I believe that the UK DC balloon is about to deflate somewhat as a generation of members face retirement from plans with inadequate contributions, expensive annuities (compared to the actuarial costings at the outset) and high-risk investment strategies. If the Government still sees the future as DC-based then it must concentrate on educating employees as to adequate contribution rates and appropriate risk-controlled investment strategies, rather than relying on misleading benefit statements. I subscribe to the increasingly widely-held view that this education should start at school.

**Investment**

Setting investment policy for DB plans, or securing an appropriate range of fund choice for DC, is perhaps one of the most responsible roles for trustees.

Professional advice has historically centred around setting either median (relative to peers) or index (relative to markets) benchmarks for active investment managers. It is slowly dawning on consultants and trustees that the resulting investment strategy is often either "herding" or "closet passive" respectively. As a consequence true passive strategies are becoming more
common (although there is still scope for costs to fall) and many DB plans are considering more appropriate core-satellite passive-active approaches.

A wider question being addressed by actuaries currently is exactly what represents a "matched" investment strategy (i.e. assets corresponding as closely as possible to the pension plan liabilities). Some now say that bonds are a better match for the salary-related liabilities of DB plans (not what the textbook says!). After all, a matching strategy should be the starting point for trustees to judge an appropriate level of investment risk.

We are fortunate in the UK by having a relatively long market in both fixed-income and inflation-linked Government bonds (terms up to 30 years or so currently). The term of liabilities is generally still longer, although in theory modern finance techniques can be used to extrapolate the yield curve or "synthesize" longer bonds.

However, in the absence of a significant corporate bond market actuaries have always advised equity as a better long-term investment to maximise likely returns. It is argued that the volatility risks of equity are most significant over the short-term, so pension plans are not too exposed. However, attempts by actuaries to quantify the benefits of equity investment are sometimes criticised as simplistic or subjective, and modern finance theory questions the rewards of overplaying an equity-based strategy. I believe we can expect to see a gradual future shift from equities to bonds, starting with the less well funded DB plans and the DC plans covering members who are less financially sophisticated. At the same time I can envisage mounting pressure for a greater volume of long-term corporate debt to be issued (and indeed we are now starting to see growth in this market).

**Funding and valuation of DB plans**

The actuarial profession in the UK is currently reviewing DB plan valuation methods. Traditional historical methods have allowed for an equity risk premium through a discounted dividend model. However, the Government's tightening of tax treatment of dividends in the hands of pension plan trustees, and the resulting changes in corporate dividend policy, mean that the traditional actuarial models may not easily cope with current conditions.
There is now an increasing lobby calling for UK actuaries to use market-consistent methods, backed up by new international accounting standards. In particular, there is pressure for expected investment returns and discount rates to become more objective.

Until we have a substantial corporate bond market I can only currently envisage a valuation model of Government bonds working well. This will, at the same time, force consultants to think more carefully about their equity investment advice (do we really think equities will continue to outperform in future and, if so, what are the risks?). In fact the UK bond market (especially inflation-linked) is not currently large enough for all UK pension funds to be simultaneously "matched", but bonds do nevertheless seem to represent the best theoretical matched model.

The Minimum Funding Requirement (MFR) was brought in because the Government was concerned that actuarial judgement did not impose sufficient discipline on employers' funding to reassure DB plan members as to the financial security of benefits. In fact, the MFR test itself is based on subjective actuarial methodology. It is currently being reviewed and will probably need to fall in line with more objective techniques, together with sufficient flexibility to make the test manageable (i.e. it should include an explicit, albeit subjective, equity risk premium). Better still, the scope of MFR could perhaps now be scaled back so it applies only to minimum transfer values and winding-up benefits (where it is proving most useful in practice) rather than on-going contributions.

There is not a consensus of opinion within the actuarial profession in the UK as to what the most appropriate techniques are, and I wonder if there ever will be. On-going actuarial debate is healthy, because it means that techniques do not stand still. There will always be scope for individual professional judgement in relation to a particular plan.

**State pensions and opting-out**

Setting a low basic State pension has helped to encourage second pillar provision in the UK (although there are many other reasons why second pillar provision has been encouraged, such as tax incentives).
Opting-out from the additional State pension to an occupational pension plan is possible in the UK and has proved popular, partly due to historical financial incentives (a tax rebate is offered to opted-out employers and employees) but these are now less significant. It is also possible to opt-out from the State pension to a personal pension plan, and even to opt-out from an occupational pension plan in favour of a personal pension.

Opting-out may have encouraged some employers to set up occupational plans. However, overall it is hard to say that opting-out has significantly increased the volume of retirement saving in the UK. What is undoubted is that it has significantly increased the volume of the retirement rule-book. Furthermore, the facility for opting-out from occupational plans to personal plans has caused nothing but trouble (and led to poor financial advice or “mis-selling” valued at more than $3bn).

It is now proposed that opting-out rules are to be changed again. However, the new S2P formula has created further problems for opting-out low earners. The current unworkable proposals suggest (to me at least) that the concept of opting-out is not sustainable.

Unfortunately, the Government may not be easily persuaded. Currently we do not even have plans to make occupational plan membership compulsory. This would be the first step, with compulsion being subject only to a simple quality check on the occupational plan (eg a broad value-for-money check on member contributions). The Government is concerned that some people cannot afford to join their occupational plans. In practice virtually all occupational plans provide excellent value for members’ money. Many are even non-contributory for members. Allowing further for the tax-relief on member contributions means that, in my opinion, no-one can afford not to join their occupational plan. Whatever rules are imposed, and putting to one side the huge compliance costs, I can only envisage that more people will be disadvantaged than helped by maintaining opt-out facilities.