# Are defined benefit ("DB") pensions really golden? Maybe there is an alternative...

## *Why we think defined contribution ("DC") is better than DB.*

***Dean Wetton digs beyond the obvious***

The case for defined benefit (DB) pensions is well aired.

> *"Ask people what they want from a pension plan and they all say adequate replacement income, certainty of outcome and someone else worrying about delivery",* says Lindsay Tomlinson, Chairman of the National Association of Pension Funds (NAPF).

Traditionally this has been what a DB plan offers but how much certainty is there really?

The NAPF has announced:

> *"Radical reforms have been proposed for two high-profile schemes run by publicly funded employers. The Universities Superannuation Scheme (USS), which is the largest scheme for university and college staff, is proposing to move from final salary to career average benefits, with employee contributions increasing from 6.35% to 7.5%. The pension age will also be increased to 65, and benefits will be indexed to the CPI (Consumer Price Index) rather than RPI (Retail Price Index)."*

The NAPF also reports that the Parliamentary fund is considering changing from final salary to career average and while RPI will be retained it will be capped at 2.5%. We are seeing an erosion of benefits all the time, and the Government's announcement of the change from CPI to RPI as a measure of inflation is a broader example which may affect all DB plans. So the adequacy of retirement income in DB schemes is under attack.

Certainty of outcome is also dependent on the backing of the employer well into the future. Bankruptcy is unusual and difficult to predict. Who would have predicted 20 years ago that the following names would not be around now?

**Well known recent bankruptcies**

These are just the high profile examples, not all of them. In the UK the Pension Protection Fund (PPF) was started in 2005 in response to public concern that when employers sponsoring defined benefit pension schemes became insolvent, scheme members could lose some or all of their pension if the scheme was underfunded. To date the fund has taken responsibility for some 160 schemes covering some 50,000 members. It has paid out £170m compensation until June 2010. The Average yearly payment per person is £3,700 but it is not clear how this compares to the expected benefit.

At present the real benefit of DB is that someone else takes the longevity risk? Members' life expectancy increased by six months in 2009 according to Mercers' survey. How long can employers sponsoring DB schemes continue to absorb these increases? They will increasingly take the same action as the BBC is proposing and close the DB plan because they can't afford it. The UK is only now reaching this view. Estelle James, a consultant to the World Bank, reports on this view globally in her study of pensions in 30 countries.

**Defined Benefit versus Defined Contribution Plans.** (www.estellejames.com)

Employers around the world have found that in globally competitive labor and product markets they are unable to credibly insure against longevity and investment risk, which is the goal of defined benefit plans. If investment returns are lower than expected, or if workers live longer than expected, employers (facing competition from other firms without these pension burdens) will be unable to come up with the extra money needed to keep their promises in the long run. And if employers try to avoid these risks by conservative funding policies, their costs will be higher than those of competitors who accept higher risk, in the short run. Regulations have placed increasing financial burdens on defined benefit plans to make their promises credible. Additionally, defined benefit pensions are difficult for workers to carry from one job to another. In contrast, defined contribution plans are typically more portable and help employers avoid longevity and investment risk. As a result, even though some employer sponsored defined benefit plans remain, they are gradually being phased out.

How do we quantify the cost of longevity risk? If we look at the Office of National Statistics data we learn the following about average employer contribution rates in 2008:

**DB: 16.6% of salary**
**DC: 6.1% of salary**

According to a recent Lane Clark and Peacock survey the DB contributions of FTSE 100 companies went up 50% in 2009. It is not clear though whether this funding is for the whole scheme as a percentage of current employees in which case it will be skewed by companies where the current workforce is much smaller than in the past. But we could we think about this another way and say to employees, “would you take on your own longevity risk if we gave you 20% of your salary to put in your pension pot?” Now we don’t know whether 20% is the right number; longevity is a movable, and increasing, target; but it has to be higher than current DC contributions of 6% and employers will value consistency, that is, not having to face 50% increases, especially at times of financial stress.

**How much more will/can you pay me to take my own longevity risk?**

So, let’s revisit Lindsay Tomlinson’s original premise; someone else worrying about the problem? We are not so sure. Leaving it to someone else has meant that they have focused on their own interests. In contrast if we take the Australian example, as Australians have been forced to invest at least 9% for over 10 years they now have sizeable pots and are taking an interest in ensuring that they are managed properly.

So let’s look again at DC:

> **Security** – As members assets are ringfenced, irresponsible employers can’t lose assets by going bankrupt or being the victims of fraud.
>
> **Control** - Members can either control the amount of investment risk they would like to take, or they can let someone else do it. In many cases members do not want control, but at least with DC, they have the choice, with DB they get what the employer decides. They can also control the rate at which they contribute or draw down and make it fit around major life events such as births or redundancy. This strength can be a weakness if members do not want control, therefore we at DWA believe this control should be delegated to independent professional trustees, not employers, unions or insurers. A good DC plan should allow choice for those who want it and makes appropriate investment choices for those who don’t.

**A good DC plan should allow choice for those who want it and makes appropriate investment choices for those who don’t.**

> **Portability** and **Simplicity** - Members can easily transfer their pension pots from one scheme to the next, rather than accumulating benefits with several DB plans or insurers. DC affords members simplicity, they have accumulated whatever is in the pot, and no one can adjust this retrospectively.

This is the real battle that people should be focusing on when trying to protect their pensions. It’s the contribution rate that matters more than the underlying benefit structure. How much more will/can you pay me to take my own longevity risk?

DC, with good governance, is a better structure, so take the switch to DC but make sure you keep a decent employer contribution rate!

## About Dean Wetton Advisory

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Dean Wetton Advisory believes in the manufacturing concept of "Mass Customisation" which is the use of flexible computer-aided manufacturing systems to produce custom output. Those systems combine the low unit costs of mass production processes with the flexibility of individual customisation. In the same way, Dean Wetton Advisory looks to provide advice to smaller institutions, finding ways to allow organisations access to high quality professional and services at low costs. With an innovative approach to costs, Dean Wetton Advisory is able to provide a competitive offering.

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