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Department for Work and Pensions

Research Report 271

Hybrid pension plans: UK and international experience

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A report of research carried out by Hewitt Bacon & Woodrow on behalf of the Department for Work and Pensions

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Summary

Introduction

This research report is one of three projects commissioned by the Department for Work & Pensions (DWP) into hybrid or risk sharing pension plans. The main objective of the research is *"to increase the knowledge of risk sharing and hybrid pension plans compared to traditional final salary and pure defined contribution plans; and to promote discussion and better understanding of these within Government and the wider pensions world".*

Definition

In this report we define hybrids as *"private pension schemes which are neither pure Defined Benefit (DB) nor Defined Contribution (DC) arrangements, where pure DB arrangements are taken to mean final salary pension schemes"*. The following types are included as hybrid plans:

- Career average and CARE (Career Average Revalued Earnings) plans.
- Sequential hybrids, where a member may e.g. join a DB scheme after a period of DC membership.
- Combination hybrids, where a member is accruing both DB and DC benefits.
- Final salary lump sum plans.
- Self-annuitising plans, where a DC plan offers an in-house annuity option (rather than an open market option).
- Underpin arrangements, where the benefit is calculated as the better of e.g. a DB or a DC benefit.
- Cash balance or retirement balance plans.

Cash balance plans

Cash balance plans are an emerging type of hybrid plan in the UK and are rather different from many of the hybrids considered above. There is a single scale of benefits incorporating risk sharing between sponsor and member. These plans may be referred to as shared risk plans, cash balance plans or retirement balance plans. The member's benefit is typically an entitlement to a capital sum at retirement which is converted into an annuity in a similar fashion to DC plans. However unlike DC plans, the amount in the member's account is not directly related to the returns achieved on the underlying assets, but it may be guaranteed or smoothed or subject to some form of underwriting by the sponsor.

Risk attribution and pensions

All pension arrangements are premised on the payment of income at a future date. The effect of unknown future events, between the date the promise is given and the date it is delivered, means that all pension promises are affected by these future events. One way of characterising different pension plans is by looking at who bears the consequences of that unknown future experience – be it good or bad. This risk allocation is illustrated in Diagram A and Table A below: both are simplified versions with full details in the body of the report.

Diagram A: Risk Spectrum for Scheme Design

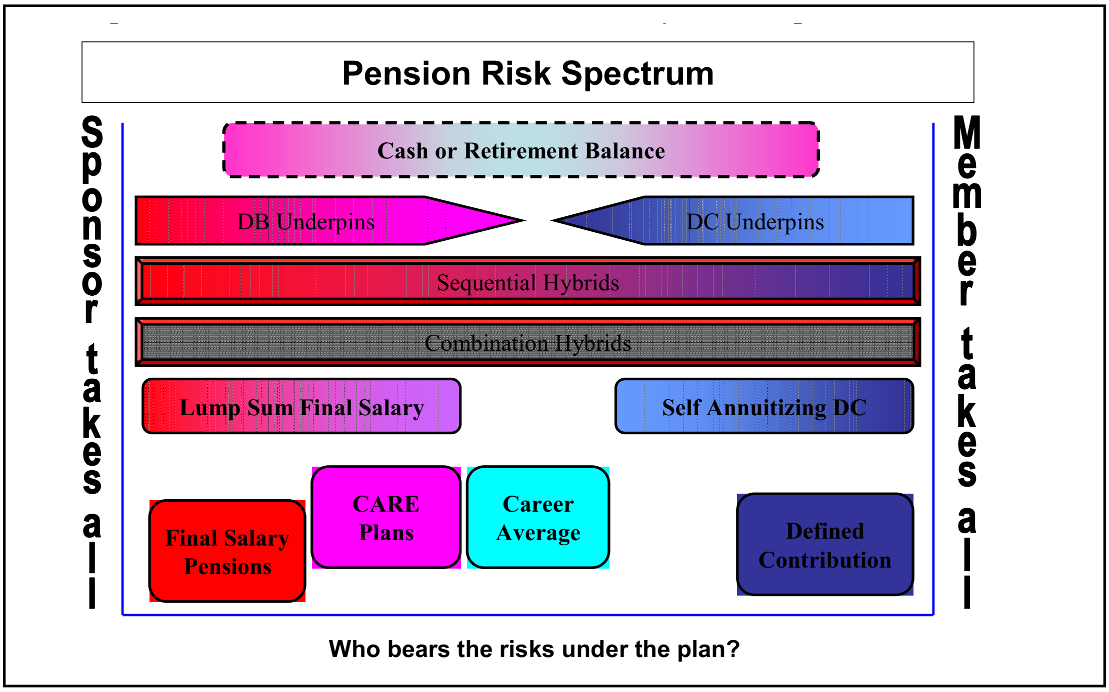

Table A: Risk Attribution in Pension Plans

Risk Feature	Investment	Annuity Conversion	Salary Inflation
Final Salary Pension	Sponsor	Sponsor	Sponsor
Final Salary Lump Sum	Sponsor	Member	Sponsor
Career Average/CARE	Sponsor	Sponsor	Member
Sequential Hybrid	Both	Both	Both
Combination Hybrid	Both	Both	Both
Final Salary Underpin	Sponsor	Sponsor	Sponsor
DC Underpin	Member	Member	Member
Cash Balance	Sponsor	Member	Member
Self annuitising DC	Member	Sponsor	Member
Defined Contribution	Member	Member	Member

Drivers of change for UK plans

The popularity of cash balance plans in the UK may increase as a result of dissatisfaction from employers with the polarised designs of final salary and DC plans. Final salary plans have suffered from significant cost pressures, as a result of:

- Lower interest rates and lower (or negative) investment returns.
- The impact of improved longevity.
- Tax changes.
- The conversion of discretions into guarantees and progressive improvements in benefits.

Many employers have closed their final salary schemes to new entrants and offer DC schemes instead. However a number of issues have emerged which point to potential problems ahead:

- Low contribution levels and low member take up rates.
- Vulnerability of members' retirement plans to stock market conditions, which may hinder employers' workforce management.
- Lack of ability or willingness of members to take suitable DC investment decisions.

Cash balance solutions

Whilst cash balance plans require a sponsor to take on greater risks than pure DC plans, UK employers may be prepared to take on this additional risk:

- The investment risk is less onerous than in a defined benefit plan. The timescale for investment is shorter, and matching investments may be available.

- Employers may seek to regain discretion in funding; there may be an intended level of benefits, but the legal obligation may be for something less. The discretion may provide the ability to weather adverse market conditions.

- Employers do not have to take on pension liabilities that are affected by future improvements in longevity. They may subsidise annuity conversion terms in ways that more closely suit the business needs.

- A uniform cash balance scale may help reduce the HR and potential legal issues involved in operating a generous closed final salary scheme and a low cost open DC plan for different sections of the same workforce.

Global context

In addition to the UK, we have looked in depth at four selected countries which illustrate particular themes about hybrid plans. A key learning point is that design is heavily influenced by local legislation, and if any of the following scheme design features are prevalent, they usually arise from local legislation:

- The level of flexibility in features such as contribution rates and investment options – how much individual choice is allowed?
- A minimum guaranteed investment return.
- The form of the benefit payable, i.e. lump sum or pension.
- The retirement age, and perhaps the early retirement options, particularly in countries where the State pension is significant.

US hybrids

Cash balance plans (the most common form of US hybrids) have been introduced since the 1980s, because they are perceived as being better understood and appreciated by employees (a "pot of money") than a traditional final salary scheme. About a quarter of major US employers now offer such a design.

Swiss hybrids

Plan design in Switzerland is in practice less varied than in the UK or US. Virtually all plans are effectively hybrid plans because of legislation: DC plans are required to offer a guaranteed minimum annual investment return, and DB plans are subject to a DC "underpin" on a certain slice of salary.

The guaranteed investment return in a DB plan may be underwritten by an insurance company if the plan is insured, which means the plan is hybrid for the employee, even though from the employer's (accounting) perspective it can be regarded as a DC plan.

Dutch hybrids

50% of Dutch employees were members of final salary plans in 2003 but this declined to 10% in 2004. Employees are increasingly being given revalued career average benefits, or "combination" hybrids offering revalued career average benefits up to a salary limit and DC on salary over the limit. In many schemes "conditional indexation" of pensions takes place, under which indexation is only given if financial conditions permit.

Belgian hybrids

Legislation in Belgium has led to the majority of plans being hybrid plans. From 2004, all DC plans have to offer a guaranteed minimum annual investment return. Also, most DB plans now define their benefit in lump sum terms (similar to US pension equity plans), thus transferring the post-retirement mortality risk to the employees.

The growth of other hybrids in the UK

Some of the key drivers for the growth of cash balance plans were described earlier. Brief summaries of the factors affecting growth of other types of hybrids are as follows:

- Career average plans – where companies still want to offer defined benefit plans, but at a lower cost (for the same accrual) than final salary. May include greater elements of discretionary benefit. Likely to be found amongst the larger private sector employers and the public sector.
- Final salary cash plans - growth prospects are muted.
- Sequential hybrids - will decline if more DB plans are closed to new entrants.
- Combination hybrids - probably companies who are reluctant to abandon DB provision but who need to reduce their overall risk profile. Hence combinations of reduced accrual DB topped up by DC contributions.
- Underpin plans - the main attraction of these plans will continue to arise from the financial options surrounding contracting out of the State Second Pension (S2P).
- Self-annuitising DC plans – no major growth prospects, if concerns about increasing longevity continue.

Legislation

Legislation can be a driver that either stimulates or discourages the development of hybrid plans. Current issues that are of concern in the UK at the time of drafting include:

- Statutory indexation of pensions in payment.
- Employment protection and discrimination issues.
- The treatment of discretionary benefits in relation to funding and disclosure to members.

The future?

The growth of hybrid plans in the UK is unlikely to be as dramatic as the growth in DC plans, because of the different drivers. The move to DC was part of a global trend, driven largely by financial considerations, as sponsors sought to take control of both the volatility and the overall cost of their defined benefit plans. Sponsors may be reluctant to move back to a position of taking on corporate risk in relation to employees' pension promises. However many of the factors that may lead to a greater prevalence of hybrid plans stem from the very uncertain outcomes inherent in DC plans and the volatility of members' accounts (where they follow equity-orientated strategies designed to maximise their future pensions):

- Some sponsors will be reluctant to pass on the investment risk to employees and so will offer career average, cash balance or combination plans instead. This could lead to a more balanced sharing of risk between sponsor and employee.
- Concerns about the susceptibility of members' retirement dates to market conditions, may persuade DC sponsors to take on limited amounts of pension risk.
- Government may wish to consider whether the variability of DC plans is acting as a disincentive and that individuals are being discouraged from saving sufficiently for their own retirement.
- Members themselves, and their trade unions may reject DC benefits; labour market pressures may lead to some more controlled outcomes through hybrid plans.

The growth of hybrids may come from a variety of directions, with global precedents for each of the main forces of change. The moves away from the polarised scheme designs of pure final salary and pure DC look set to continue.