

Defined Contribution Pension Schemes and their relative inadequacies – Briefing Paper prepared by UNISON’s Pension Unit, 20 July 2010

What is a Defined Contribution (DC) scheme?

It’s basically a scheme where contributions from both the individual member and hopefully an employer are paid into a fund which is converted into a pension on retirement by the purchase of a contract to provide a specified level of income for life on prescribed terms (commonly known as an “annuity”).

How many people are in these?

The 2008 Occupational Pension Schemes Survey estimated active membership of private sector defined contribution schemes to be 1 million in 2008 compared with 0.9 million in 2007.

Office for National Statistics Data estimates there to have been around 6.9 million contributing members of personal pensions in 2006/2007, so the total active membership of defined contribution schemes can be estimated to be around 8 million.

In comparison, Office for National Statistics Data estimated there to be around 7.9 million active members of occupational defined benefit (DB) pension schemes in 2007, with around two thirds of this figure coming from public sector pension scheme memberships.

It’s now very apparent that there are now more members actively contributing to defined contribution pension schemes than defined benefit pension schemes and that this trend is only going to increase.

At a glance main risks with such schemes.....

- There’s investment risk in that funds can go up and down depending on investment performance
- Annuity rates vary in line with mortality assumptions and interest rates and are generally going steadily down and it’s difficult to see this trend reversing. Indeed the likelihood is that annuity rates will only get worse.
- Contributions are generally significantly lower than those to defined benefit schemes
- Charges (for example an Admin charge) apply and are taken from the fund.
- Individuals often have to select a fund, sometimes from a vast array, and often have no idea what fund to select

- Most providers stipulate a minimum fund value for purchasing a pension meaning that in some cases individuals will be “stuck” as they don’t have big enough fund values
- Members will often be responsible for selecting their own annuity come retirement and may not know which provider offers the best rates or what type of annuity to get (for example, will they need spouses cover, will they need it to increase in value each year – the danger being that the more “add ons” the greater the initial cost)

The sad realities of DC schemes.....

FACT - Members almost certainly will get less pension on retirement than they would in a defined benefits pension scheme!!

Evidence

Prudential (who themselves provide annuities) claimed in a report published 24 June 2009 that workers with DC pension schemes will only receive a quarter of the retirement income they would otherwise get from a final salary scheme.

Prudential quoted that a 25 year old worker who joins a DC scheme this year, into which they pay 2.7% of their salary and with their employer paying 6.5% could expect to receive an annual pension of £16,023 if they retired at 65 in 40 years time. **But this income is just 28% of the pension of £57,714 a year that a 25 year old who joined a final salary scheme could expect to receive in 40 years time, according to Prudential.**

The figures are based on what the members projected earnings over the next 40 years would be. If we apply this to what would be the case if 40 years ago the Local Government Pension Scheme had provided an average DC scheme instead of a final salary scheme **then the average current pension in payment of approximately £4000 per annum would be about £1000 per annum and the current average for women of approximately £2000 per annum would be around £500 per annum!!!** Based on the current minimum income level of the Pensions Credit (i.e. approx £130 per week) nearly all the members would be dependent on the State!

Why do DC schemes provider inferior pension benefits to DB schemes?

Reason 1 – Overall contributions are significantly less

Evidence - Data from the Association of Consulting Actuaries 2009 Pension Trend Survey shows the average DC contributions to an open scheme to be

4.3% member and 6.7% employer respectively compared to 6.3% member and 23.2% employer in DB schemes – **Less money tends to be invested in DC schemes!**

Reason 2 – Poor investment returns where risk is all on the individual member

Evidence – Most fund holders are likely to have equity exposure in some form or another and yet UK equities returned **minus** 23.66% in the 12 months ending May 2009 (source: Hewitt Associates) – **DC members are therefore directly at the mercy of markets with often limited understanding of investment principles.**

Reason 3 – The rates at which funds are converted into long-term pensions are unattractive

Evidence - For example, a male aged 65 wanting a non-increasing annuity would need a fund value of £100,000 simply to purchase a best quoted pension with Canada Life of £6833 a year (Source: Annuity Bureau, June 2010).

Those most at danger.....

Are of course the young and particularly those entering the workforce as very few employers currently offer defined benefit pension provision to new employees. Indeed, we understand that there are only a handful of FTSE 100 companies that currently do so.

Increased reliance on the State to provide

Clearly there will be a greater reliance on the State to provide financial assistance to those with inadequate pension provision and hence a significant reason why the Government should be encouraging good quality pension provision so as to help save long-term costs.

It should also perhaps be noted that the Organisation for Economic Co-operation and Development (OECD) recently claimed the UK to be **bottom** of its league table with regard to state pension provision so state reliance is hardly likely to be financially appealing to the majority.

Clearly if we accept the route of continuing expanding DC provision we are accepting a significant deterioration in the state of individuals future prosperity and hence why it's vital that we continue to campaign against the inadequacies of such provision.

Is any level of DC contribution sufficient to provide broadly equivalent benefits to a DB scheme?

We have taken independent actuarial advice on this and the advice we have received is as follows:

To see the extent of this the table below shows estimates of the total contribution levels which would need to be paid (by the employee and employer combined) for each year of service (as % of salary) to target typical final salary benefits in a defined contribution scheme. The table shows total level contribution rates for employees between the ages of 25 and 55 on entry with benefits of 1/60th accrual over their working lifetimes and retiring at age 65.

| Starting Age | Defined Contribution (% of Salary) |
|--------------|---------------------------------------|
| 25 | 20.6 |
| 30 | 22.7 |
| 35 | 24.9 |
| 40 | 27.2 |
| 45 | 29.7 |
| 50 | 32.3 |
| 55 | 35.0 |

Table 1: Contributions required each year from Starting Age to target a 1/60th pension

What should UNISON and UNISON members do?

- Raise awareness of the issues with your colleagues
- Look to improve the terms of any relatively poor pension provision you or colleagues are offered
- Check the UNISON Pension website
- Contact your local politicians and candidates to state clearly that DC pension provision, unless significantly improved, is unlikely to provide retirees with sufficient income in retirement
- Counter misinformation against good quality DB provision wherever you hear it and be vigilant for attacks on DB schemes in the media

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