February 2011

PENSION CAPITAL STRATEGIES
Innovative Alternatives

THE PCS ALERT
The latest in DB Pensions

THE CON OF CONTRACTING OUT

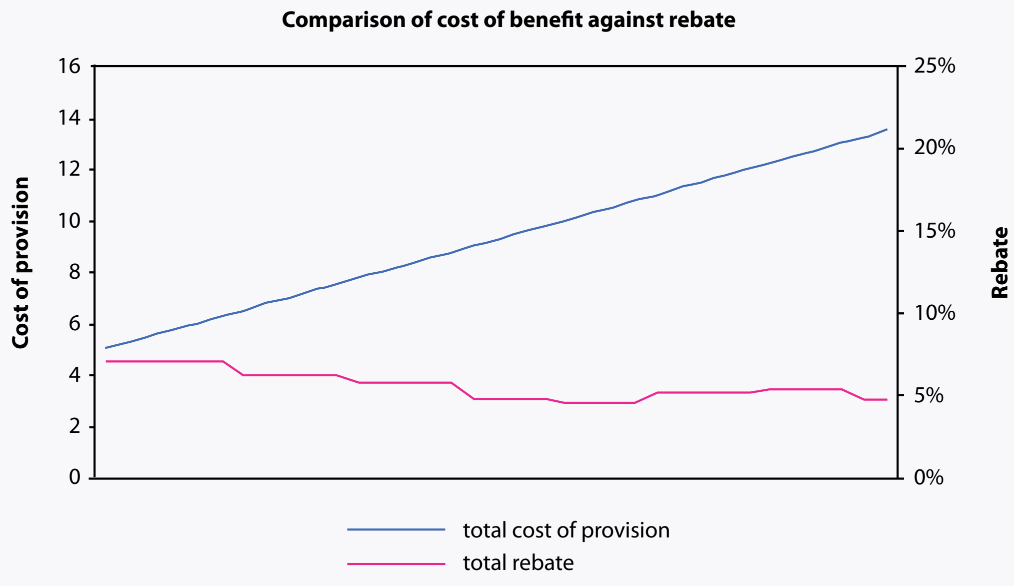
Dear Sid

Why do defined benefit schemes continue to contract out?

For years, the rebate provided by the Government has been paltry compared with the benefits that a pension scheme is expected to provide in exchange. For example, when contracting out commenced in 1978 the employee rebate was 2.5% and the employer rebate was 4.5%. The rebate last year was 1.6% for employees and 3.7% for employers.

Last week the Government announced that the rebate was to fall from 5.3% in total to 4.8% in total. Put aside the fact that the decrease in rebate is in effect a further tax on jobs that still manage to provide contracted out defined benefit pension. Note that the trade off between these defined benefits and the alternative State Second Pension widens even further.

Over the same period, from 1978 life expectancy at birth for males has increased from 70 years to over 77 years. That is, the expected length of time a man was expected to live after his state retirement age has increased from 5 years to 12 years - more than double. The increase is similar for women, although given the lower state retirement age and greater life expectancy, the proportional increase is not so dramatic.



The inequity of the increase in life expectancy alongside the decrease in the rebate has been repeatedly pointed out to the Government and the DWP yet the Government persists in offering such terms. As rebates stand, it makes no financial sense for a company to contract-out its defined benefit pension scheme.

In 2012 the Government will abolish money purchase contracting out. Clearly there is an opportunity to redress the inequity that exists with defined benefit contracting out either through higher rebates or by simply removing the option to contract out.

The Government plans to retain defined benefit contracting out, presumably because by retaining contracting out, the Government won't need to fund higher state benefits for individuals working for these companies.

Open defined benefit pension schemes are rare. We urge the new Coalition Government to look for ways to encourage defined benefit pension schemes - we ask that the new Government starts by removing this grossly unfair tax on the schemes.

Recently the Actuarial Profession has written to the DWP pointing out that a more appropriate level of benefit for contracting out would be approximately half the level that is currently in place. Not only are state benefits being reduced, the Government is changing the state retirement age for many individuals, this means that companies contracting out are providing an even more generous benefit relative to the state benefits that they contracted out from.

Looking at this a different way, the companies are required to honour a promise that the Government itself is failing to keep.

Companies should be looking to change their benefit provision, contracting back into the state pension scheme and reducing accrual. They'll get better value for money and avoid paying this increased job tax.Using this approach the same level of overall benefit for an employee can be provided at a lower cost, although employees are at risk of the Government unilaterally changing state benefits again (a luxury which isn't available to companies).

At PCS, we provide advice to companies relating to the cost and risk of defined benefit pension provision, seeking ways to mitigate risk and manage cost to provide our clients with the edge that they need to compete in an ever increasing competitive environment.

Our solutions look for ways to provide value for pension scheme spend as well as removing any unnecessary risk associated with the defined benefit pension scheme.

Yours sincerely,

John Breedon

John Breedon
Consultant
Pension Capital Strategies

Email: john_breedon@pensionstrategies.co.uk
Direct: 0161 253 1110
Mobile: 0776 700 4813

For more information on how PCS might help please contact Charles Cowling on 0161 242 5388 or Rob Dales on 0113 203 5883.