

Some FAQs on Pensions

Questions from workers regarding the relative benefits of defined benefit and accumulation schemes are common, but implementing agency managers should be aware that senior managers in the enterprise often have an interest in retaining a defined benefit scheme. The implementing agency may therefore need to become involved with a communications exercise on pensions directly to workers. This appendix provides answers to some Frequently Asked Questions (FAQs), particularly on accumulation (defined contribution) schemes versus defined benefit schemes.

Accumulation Schemes – Worker Questions and Answers

Public sector employees are often reluctant to move from defined benefit arrangements across to accumulation arrangements. This is because the existing arrangements are perceived as generous and because, unlike in a defined benefit scheme, the amount of their pension in an accumulation arrangement is subject to investment risk. Here are some potential answers to questions on a potential move away from defined benefits.

Question: Why should I change? Aren't defined benefit schemes always better for workers?

Answer: Not always, although they tend to be most beneficial for senior managers and those with long service. For example:

- Defined benefit schemes are particularly attractive for employees who have both long service and large wage escalations. If a worker starts say as a junior Grade 1 Administrator and works his or her way up to General Manager every year used in the pension calculation in a defined benefit scheme will be based on a salary close to his or her final General Manager's salary despite the fact that they may only have paid contributions based on the General Manager's salary for a short period of time.
- In contrast, for a worker who starts as a junior Grade 1 Administrator and retires as a mid-scale Grade 3 Administrator then it is possible that the real rate of return (see glossary) in an accumulation scheme will be greater than the wage escalation factor and the worker could be better off in an accumulation scheme.
- Workers with short lengths of service, or those who have moved in and out of the public service will also not benefit so much from a defined benefit scheme

Question: Will leaving a defined benefit scheme and moving to an accumulation scheme be bad for me?

Answer: Not always. This depends upon the vesting scale and the indexation treatment. In the most extreme case they will only get back what they contributed plus some interest. In the best case they will get a benefit based on the preserved benefit as if they had retired on the day they left, and with that preserved benefit being increased by inflation until the day they actually reach retirement age. In some cases, if inflation is high, the increase in deferred benefits may be less than inflation. For those employees an accumulation scheme may be better as in such a scheme the preserved benefit will be increased by the rate of investment return actually earned by the fund.

Question: Don't Defined Benefit schemes pay out more?

Answer: Usually true, but... This perception generally comes about because the rate of contributions to an accumulation scheme is usually much lower than for a defined benefit scheme. If the same rate of contribution were made to an accumulation scheme as to a defined benefit scheme, then a very significant part of the workforce is likely to be better off in an accumulation scheme.

Question: Is there is more security in a Government run scheme?

Answer: Not always. There are some significant risks with Government schemes in many developing countries:

- First, some schemes are actuarially bankrupt. Fundamental reform is needed sooner or later and either pensions will be reduced or contributions raised
- Second, schemes may be badly administered with a history of poor investment decisions and poor returns, made worse by excessive staffing and other management costs.

Source: Adam Smith Institute, personal communication