

Reviewing the Future of Occupational Pension Schemes in the UK

The once mighty defined benefit (DB) occupational pension funds in the UK have been hit by a series of hammer blows over the past 10 years. **Matthew Craig** reports



In the mid-nineties, DB pension schemes in the UK were still hailed as a great post-war welfare success story. But cracks soon started to appear; now, there are warnings that the entire £1 trillion edifice is starting to crumble. In the words of Adrian Waddingham, Senior Partner at Barnett Waddingham, "we have moved from being the pensions envy of Europe to the bottom of the Third Division North."

Other influential figures share this bleak assessment. Ros Altmann, an independent expert on pension policy, comments: "Final salary pensions do not really fit with twenty-first century capitalism". And

Professor David Blake, Director of the Pensions Institute at Cass Business School, adds: "We are clearly seeing the end of final salary schemes in the private sector in the UK."

Closed shop

The most recent survey of UK pension schemes by the National Association of Pension Funds (NAPF) found that only 28 per cent of UK private sector DB plans are open to new members, down from 31 per cent in 2007 and 33 per cent in 2006. Of the remaining open schemes, only 37 per cent said they expected to say open with no changes for new members. Poor investment returns in 2008 and



Adrian Waddingham,
Senior Partner, Barnett
Waddingham

the approach of the UK government's initiative to widen pension coverage from 2012, Personal Accounts, could prompt further scheme reviews and possibly the closure of DB schemes to any future accrual as employers seek to cap their pension liabilities.

What are the causes of this sudden decline? Waddingham lists five factors: improving longevity; lower interest rates; stock market volatility, which has been magnified by the use of marked to market accounting rules; a change to the tax regime for occupational pensions in 1997; and over-regulation.



Ros Altmann,
Independent expert on Pension
Policy

Most other experts would agree with this list. But not all would be as blunt as Waddingham in attributing much of the blame to the politicians and the regulators. "Regulation is a big part of the reasons for employer unwillingness to run DB pensions any longer and the government is still acting as if it is not a problem," Waddingham comments. In his eyes, and in those of many other practitioners who advise on pensions, the real problem has been over-regulation, as legislators have concentrated on scheme security, oblivious to the unintended consequences of their actions. As Waddingham says: "It is ironic. We will have the best protected pension schemes in the world, but there won't be any of them."

Paternalistic notions

Over-regulation is one issue, but poor investment returns and changes in corporate and employee attitudes to pensions are also seen as important factors in the decline of DB. Altmann says: "Having a final salary scheme has been a drag on companies for the past few years." She describes the main pressure points on DB pensions as being the arrival of funding deficits, falling confidence in pensions among staff who are more interested in spending anyway, as well as increased employee turnover. Altmann comments: "The old paternalistic notions of looking after lifelong loyal workers no longer really applies either, as the average job tenure is around five years".

Investment is an over-arching issue for both DB and the DC pensions which are replacing DB schemes. CREATE-Research Chief Executive Professor Amin Rajan has recently produced a report with Investment & Pensions Europe, *DB & DC plans: strengthening their delivery*, looking at the investment issues surrounding both DB and DC pension plans.

It is undoubtedly true that DB schemes have been swamped by a series of investment storms. Back in the nineties, most DB plans were overweight in equities as they chased returns which would enable them to take or extend contribution holidays, under rules which encouraged this approach. When markets fell at the end of the tech stock bubble, average funding levels dropped from 115 per cent to 67 per cent according to Rajan. This fall was compounded by the start of a move out of equities and into other assets. "When the next equity bull market came, from 2003 to 2007, it passed many DB schemes like a ship in the night", Rajan comments. Since then, of course, schemes have been hit by what he calls "the mother of all market crises".

(re)Learning from the past?

Consequently, Rajan predicts an acceleration in the closure rate for DB plans, a move to bulk buyouts of scheme liabilities with insurance companies and more pressure on fund managers to deliver value to their clients. Rajan warns bluntly: "Without decent returns, the pensions industry has no future; it's as simple as that".

The report, which was based on interviews with over 200 pension funds and asset managers worldwide, makes it clear that pension schemes want more from fund managers. Product attributes such as transparency, liquidity, risk-return features, volatility, complexity and correlation are all seen as needing urgent attention. Rajan states: "Only a small number of asset managers see the world through the eyes of their clients".

Given the parlous state of the UK's private sector DB plans, the attention paid to both DC pensions and the run-off of DB liabilities looks likely to increase. For DC pensions, the recent extreme market volatility has shown the risks for members. Rajan comments: "Anyone who thinks DC plans are better than DB plans is living in a fool's paradise"; while Waddingham believes the inherent weakness of DC schemes will eventually lead to a return to a modified form of DB provision. "In the 1970s, employers spotted that DC plans would not deliver worthwhile benefits. Nothing has changed, it has just been forgotten and we will relearn that lesson. Whether it is in five years or 15, I am not sure", Waddingham comments. In his view, if benefit increases were made discretionary, for instance, career average schemes, with accrual rates of 1/100ths could be used by employers. "We have to recognise that the old approach, of two-thirds of final salary, is simply not affordable", he adds.

Longevity risk

Altmann believes that DC plans will have to replace DB provision, but, like Waddingham, she thinks that peoples' expectations need to change. "Pensions are meant to last five years, maybe 10. Expecting them to pay out large amount for 20 or 30 years is simply not financially realistic." The contribution rates and investment returns needed for this are not realistic and Altmann points out that the annuity market could cope with the demand: "This is a fundamentally important point that the government has not addressed. We cannot expect insurers to be able to shoulder the longevity risk of all these pensions."

However, there are signs that a market in longevity risk products is developing. The Pensions Institute recently produced a paper, *The Birth of the Life Market*, authored by Blake and two colleagues, Andrew Cairns and Kevin Dowd, which looks at the beginnings of a market in longevity-related financial instruments.

get a fraction of what they were promised and they will be very unhappy as a result."

But Blake adds that the capital markets are getting to grips with longevity risk and insurers and pension schemes will be able to pass on this risk through the capital markets to long-term investors seeking uncorrelated returns such as hedge funds, sovereign wealth funds, endowments and ILS (insurance-linked securities) investors. "The one part of the market that am I pretty confident will progress is the longevity risk transfer market" Blake comments.

International comparisons

Looking ahead, it could be said that the Netherlands and Australia are possible models for the future of UK pensions. In the Netherlands, strong occupational schemes still exist. Waddingham attributes this to more sympathetic regulations, for example, making pension increases conditional on funding being available, rather than compulsory.

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Blake agrees that DC contributions are currently too low and that this could lead to future problems with pension adequacy. He also points out that the pension buyout market, which could potentially reach £40-50 billion, does not have sufficient equity capacity to buy out all of the UK's £1 trillion in private sector DB liabilities.

Under current rules, which it seems might be revised, solvent employers cannot walk away from their DB liabilities. But if a recession bites, the results could be very grim under the current regulations. Blake says: "Many companies will go bust and their pension liabilities will end up in the Pension Protection Fund (PPF). The PPF must be very worried about the consequences of this; a lot of people in this country expecting to get a decent pension could find themselves depending on the PPF. If the PPF is underfunded, which is very possible, individuals may

In Australia, a compulsory DC pension system, Superannuation, has built up a large pool of assets. But Rajan points out that it has benefited from favourable market conditions and adds that, under the Australian system, there is nothing to stop retirees blowing their funds and then falling back on the state.

Occupational pensions in the UK face a series of challenges in the UK if they are to succeed in delivering adequate retirement benefits. Better regulations and more innovative investment approaches will be part of the solution, but it seems inevitable that people will have to lower their expectations as well. Before good occupational pension schemes were established in the UK, many workers would have feared retirement as a time of poverty. Unless things change, those days could be returning. ■



David Blake,
Director, Pensions Institute,
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