# Government faces a bloody pensions battle with employers – millions of employees will lose out

The government may win its battle with employers to ensure they pay employees the defined benefit (DB) pensions they have promised to date but it will be a Pyrrhic victory, warns the Pensions Institute at Cass Business School.

Employers will pay up – and then leave the battlefield, turning their backs on trust-based occupational pension provision. The biggest casualties will be the foot soldiers of British business – the employees – most of whom face an uncertain future in less generous, defined contribution (DC) schemes.

'Pyrrhic Victory? The unintended consequences of the Pensions Act 2004' is the first independent study of its kind on the early impact and unintended consequences of the Pensions Act 2004. It states that employers are angry about the level of regulatory interference in the way they run their business and the confrontational approach taken by trustees – both of which appear to be direct consequences of the Act.

Employers plan to get out of DB provision as soon as they can in order to eliminate a business risk over which they feel they have no control and the nature of which has changed fundamentally under new legislation. They will replace DB schemes with DC arrangements, which transfer the investment and longevity risk from the employer to the members.

The legislation urges trustees to behave like bank lenders and to set short 'recovery' periods to bring schemes up to the new Statutory Funding Objective (SFO) – a level of funding that in many cases will require substantial additional contributions from employers. It is the timing of the payments – not the amount – that employers dispute.

Debbie Harrison, Senior Visiting Fellow of the Pensions Institute and a co-author of the report, says, "If trustees try to achieve the SFO funding level within five years – as many are expected to do – this will prevent companies with significant deficits from paying dividends to their shareholders, raising finance for the business, and engaging in corporate activity."

She continues, "The Pensions Act 2004 and the June 2003 ruling* have alienated corporate pension sponsors. The legislation has turned a voluntary pension promise into a legal guarantee and is forcing financially strong companies to subsidise the weak via the Pension Protection Fund (PPF) levy. Importantly, it appears that this cross-subsidy relates to jobs as well as pensions."

The report found that many employers are now looking to distance themselves from trust-based schemes and to remove their DB liabilities from the company balance sheet as quickly as possible. Several respondents in legal and accounting firms said they were working on ways to help corporate clients do this.

‘Pyrrhic Victory?’ is the first fully independent piece of research on the new legislation that takes account of the views of all parties concerned: sponsoring employers, trustees, members, and the wide range of advisers who work in this sector, including consultants, accountants, lawyers, asset managers and investment banks.

Alistair Byrne, a Fellow of the Pensions Institute and co-author of the report, says, ‘We found that as a result of perceived conflicts of interest, company directors increasingly will feel obliged to withdraw as members of the trustee board. The resulting disconnection between scheme and sponsor will leave trustee boards rudderless unless new governance structures are implemented to maintain the two-way flow of information. The Act provides no guidance on this governance issue but our report reveals how sponsors and trustees are dealing with it in practice.’

Employers and their advisers are also concerned about the Pensions Regulator’s clearance procedures for corporate activity. Clearance is designed to ensure actions do not weaken the security of the pension scheme, which is an unsecured creditor to the company. Respondents said that there was evidence clearance was being used as a bargaining tool to push through immediate additional company contributions. Moreover, the report suggests that clearance is unlikely to provide a genuine *quid pro quo* for the employer in return for cooperation – that is, a guarantee that the cleared corporate activity would go unquestioned in future.

The Act has significant implications for practitioners. Actuarial and investment consultants have built their business on a model that assumes they will advise both the trustees and the company. The report states that the Act makes this increasingly untenable. Moreover, as trustees seek to engage with more complex asset allocation decisions they are talking directly to asset managers, thus undermining the consultant’s near-monopoly over investment strategy and asset manager appointments. The report also finds that consultants view investment banks as newly emerging direct competitors and that the banks are rapidly establishing their own actuarial expertise.

David Blake, Director of the Pensions Institute, says, ‘In compiling this report, the research team used an investigatory methodology within a strong academic research framework. Interviews with a wide and representative range of organisations were conducted on the understanding that information provided and opinions expressed would be quoted on a non-attributable basis. This methodology enables us to “tell it how it is” and express the personal opinions of senior figures in the industry, rather than the organisations they represent.’

**For more information or to obtain a pre-publication copy of the report contact:**

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The report will be available on the Pensions Institute website on Thursday 6 October: www.pensions-institute.org.

*** Notes to editors**

- Following a spate of scandals in which workers lost pension rights when their company wound up underfunded schemes, on 11 June 2003 the government announced that it would introduce legislation that prevented a solvent employer from walking away from its pensions promises. From this date companies that want to wind up a pension scheme must 'buy out' the liabilities in full through the purchase of current annuities for pensioners and deferred annuities for active and deferred members. The buy-out cost is prohibitively expensive for most companies at present.

- Many important features of the Pensions Act 2004 came into effect in April 2005, including the Pensions Regulator, the Pension Protection Fund (PPF) – a compensation scheme for members of DB schemes that are underfunded when their employer becomes insolvent – and a raft of new requirements for trustees. The new solvency requirement – the Statutory Funding Objective (SFO) – comes into force following the first actuarial valuation of the scheme from October 2005. From this point trustees must determine how they will get the scheme up to the solvency level and over what time period. They must take into account the financial strength of the employer in this process.

- Figures vary considerably on the extent of company pension scheme deficits and the picture is far from homogenous. Some companies have a modest deficit while others have deficits that are very significant relative to market capitalisation. According to the Lane Clark & Peacock 'Accounting for Pensions Annual Survey 2005 – UK and Europe' the combined accounting standard FRS17 deficit for the UK pension schemes of FTSE 100 companies was £37bn as of July 2005.

**About the Pensions Institute**

The Pensions Institute at Cass Business School was founded by Professor David Blake in 1996. As the first and only UK academic research centre focused entirely on pensions, the Institute brings together a broad range of disciplines from economics, finance, insurance, and actuarial science through to accounting, corporate governance, law, and regulation.

The objectives of the Pensions Institute are to undertake high quality research in all fields related to pensions, to communicate the results of that research to the academic and practitioner community, and to employers and trustees.