



DISCUSSION PAPER PI-0616

Overregulating your pension out of existence: The long term consequences of British pension policy over the last 30 years

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15 June 2005

ISSN 1367-580X

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Overregulating your pension out of existence:

The long term consequences of British pension policy over the last 30 years

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Presented at:

*Why Has It All Gone Wrong? The Past,
Present and Future of British Pensions*

British Academy Symposium

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Early 20th Century Pensions Acts

- Superannuation and Other Trust Funds Act 1927:
 - ◆ Establishes pension trust funds using trust deed and run by trustees
- Finance Act 1921:
 - ◆ Exempt approval status gives tax relief on contributions
- Trustee Investments Act 1961:
 - ◆ Limited range of qualifying investments
- That's about it
- Last 30 years has seen an explosion of 'protective' legislation

Then the problems began to emerge

- **The rights of early leavers**
- **Social Security Act 1973**
 - ◆ Provided deferred pensions for early leavers
 - ◆ Must be at least 26 with 5 years' service
 - ◆ But without inflation compensation
- **Social Security Acts 1985 and 1990**
 - ◆ Deferred pension after 2 years
 - ◆ Transfer values to new scheme
 - ◆ Limited price indexation (up to 5%pa)

Then the problems began to emerge

- **Inadequate labour market flexibility**
- **Social Security Act 1986**
 - ◆ Contracted out money purchase schemes (COMPS)
 - ◆ Personal pension schemes

Then the problems began to emerge

- **Continuity of pension rights when contract of employment changes**
- **TUPE - Transfer of Undertakings (Protection of Employment) Regulations 1981**
 - ◆ Protects acquired pension rights when a job is transferred from local authority to private sector

Then the problems began to emerge

- **Disclosure of information**
- Members needed more information about their pension scheme
- 1978 Employment Protection (Consolidation) Act
- 1985 and 1990 Social Security Acts
- 1986 Occupational Pension Schemes (Disclosure of Information) Regulations
- 1992 Occupational and Personal Pension Schemes (Miscellaneous Amendments) Regulations
- 1995 Pensions Act
- 2000 Child Protection, Pensions and Social Security Act.

Then the problems began to emerge

- **Equal treatment of men and women**
- **1980 Social Security Act:**
 - ◆ Amended 1975 Social Security Act to take account of Council of the European Communities' directive on *Equal Treatment for Men and Women in Social Security*
- **1986 Sex Discrimination Act:**
 - ◆ Same retirement date for men and women
- **1989 Social Security Act:**
 - ◆ Equal male and female contributions to DC plans
- **1999 Employment Relations Act**
 - ◆ Part-time workers included in the pension plan

Then the problems began to emerge

- **Disability discrimination**
- 1995 Disability Discrimination Act:
- From December 1996, act applied to occupational pension schemes by imposing a 'nondiscrimination rule'
- Although membership can be refused if cost of providing benefit is 'substantially greater than it would be for a comparable person without the disability'.

Then the problems began to emerge

- **Pension fund surpluses**
- Removed to below 5% by 1986 Finance Act:
 - ◆ suspension of contributions from employer
 - ◆ suspension of contributions from employees
 - ◆ increase in benefits to existing pensioners
 - ◆ repatriation of the surplus to parent company, taxed at 35%.

Then the problems began to emerge

- **Security of pension assets after Maxwell scandal 1991**
- **1995 Pensions Act:**
 - ◆ Occupational Pensions Regulatory Authority (OPRA) regulates trustees
 - ◆ Codifies responsibilities of trustees:
 - ☞ Issue annual reports and accounts
 - ☞ Appoint professional advisers
 - ☞ Make statement of investment principles (SIP)
 - ☞ Establish schedule of contributions
 - ◆ Minimum Funding Requirement (MFR)
 - ◆ Pensions Compensation Board in event of fraud & malpractice

Then the problems began to emerge

- **Tax breaks to pension schemes 'too generous'**
- 1997 Finance Act:
 - ◆ Tax credits on UK dividend income no longer reclaimable after July 1997
 - ◆ Worth £5bn a year

Then the problems began to emerge

- **Inadequate transparency in pension scheme accounting**
- FRS17, a new accounting standard, came into effect in June 2003:
 - ◆ Measures assets and liabilities at fair value
 - ◆ No smoothing in the P&L
- Replaced by IAS19 from June 2005

Then the problems began to emerge

- **Myners Report 2001 argues that trustees are inadequately trained**
- **2004 Pensions Act:**
 - ◆ Requires trustees to have knowledge and understanding of investments

Then the problems began to emerge

- **Increases in company insolvencies (eg ASW) leads to members losing 80-90% of pension after 40 years membership:**
 - ◆ for many the membership of the scheme was compulsory
- **2004 Pensions Act establishing Pension Protection Fund:**
 - ◆ To protect members of private sector defined benefit schemes whose firms become insolvent with insufficient funds in their pension scheme so they can be reassured they will still receive most of the benefits which they were expecting
 - ◆ Started in 2005

Then the problems began to emerge

- Levy:
 - ◆ Charged to all private sector DB and hybrid occupational pension schemes
 - ◆ Collected by Pensions Regulator
- Three-part levy:
- **Pension Protection Levy**
 - ◆ **Scheme factors element:**
 - ☞ Number of members
 - ☞ Balance between active and retired elements
 - ◆ **Risk factors element**
 - ☞ Linked to level of underfunding
 - ☞ Credit rating
 - ☞ Investment strategy
- **Administration Levy:**
- Covering set-up and ongoing costs of PPF
- **Fraud Compensation Levy**

Evidence from PBGC shows PPF faces a massive moral hazard problem

What have been the consequences?

- Falling occupational pension scheme membership
- Virtual end of private sector occupational final salary schemes and large deficits
- Switch to DC which has resulted in:
 - ◆ lower contributions
 - ◆ higher costs
 - ◆ transfer of risks to individuals

Figure 3.24 Active Members of Occupational Pension Schemes, millions

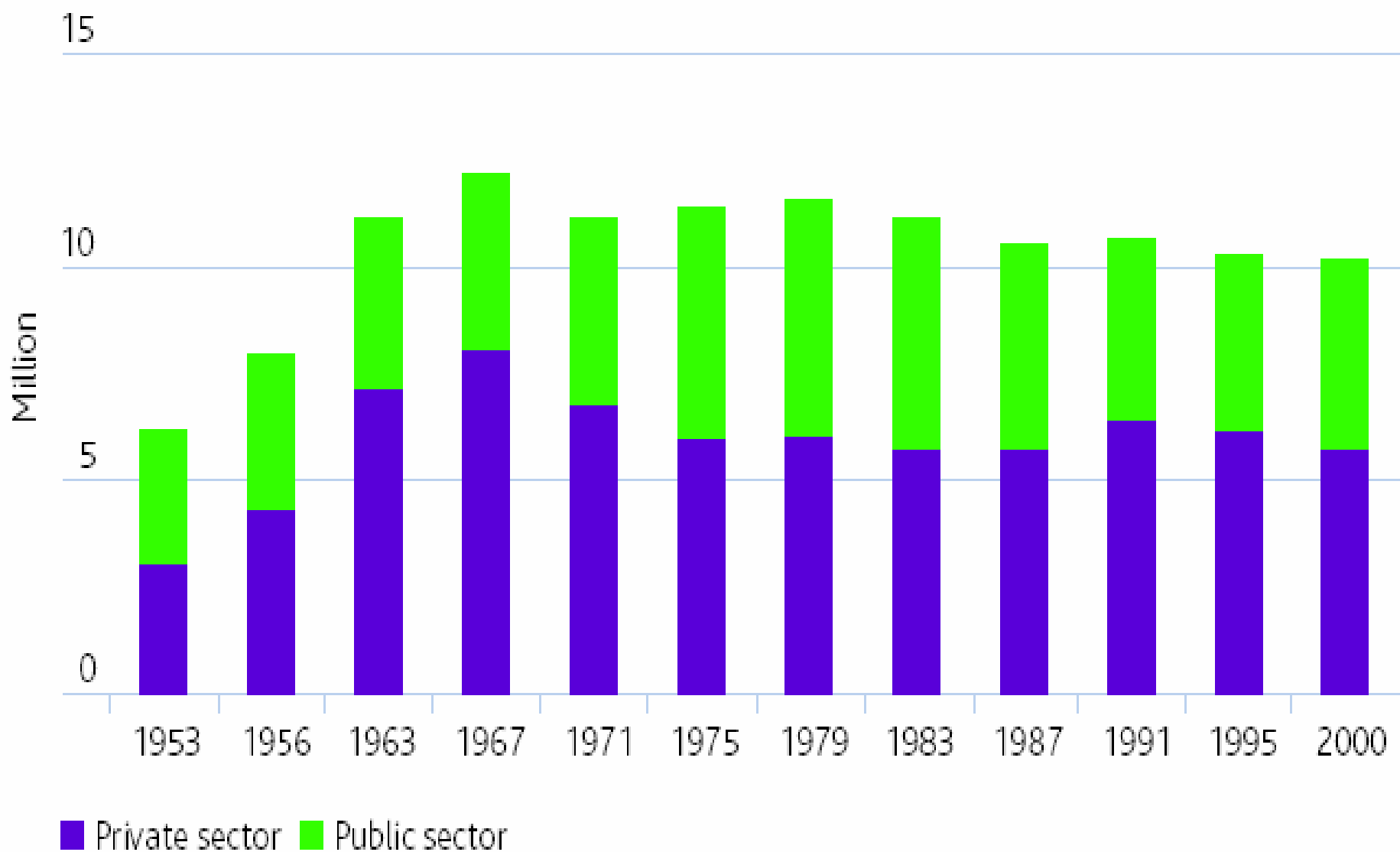
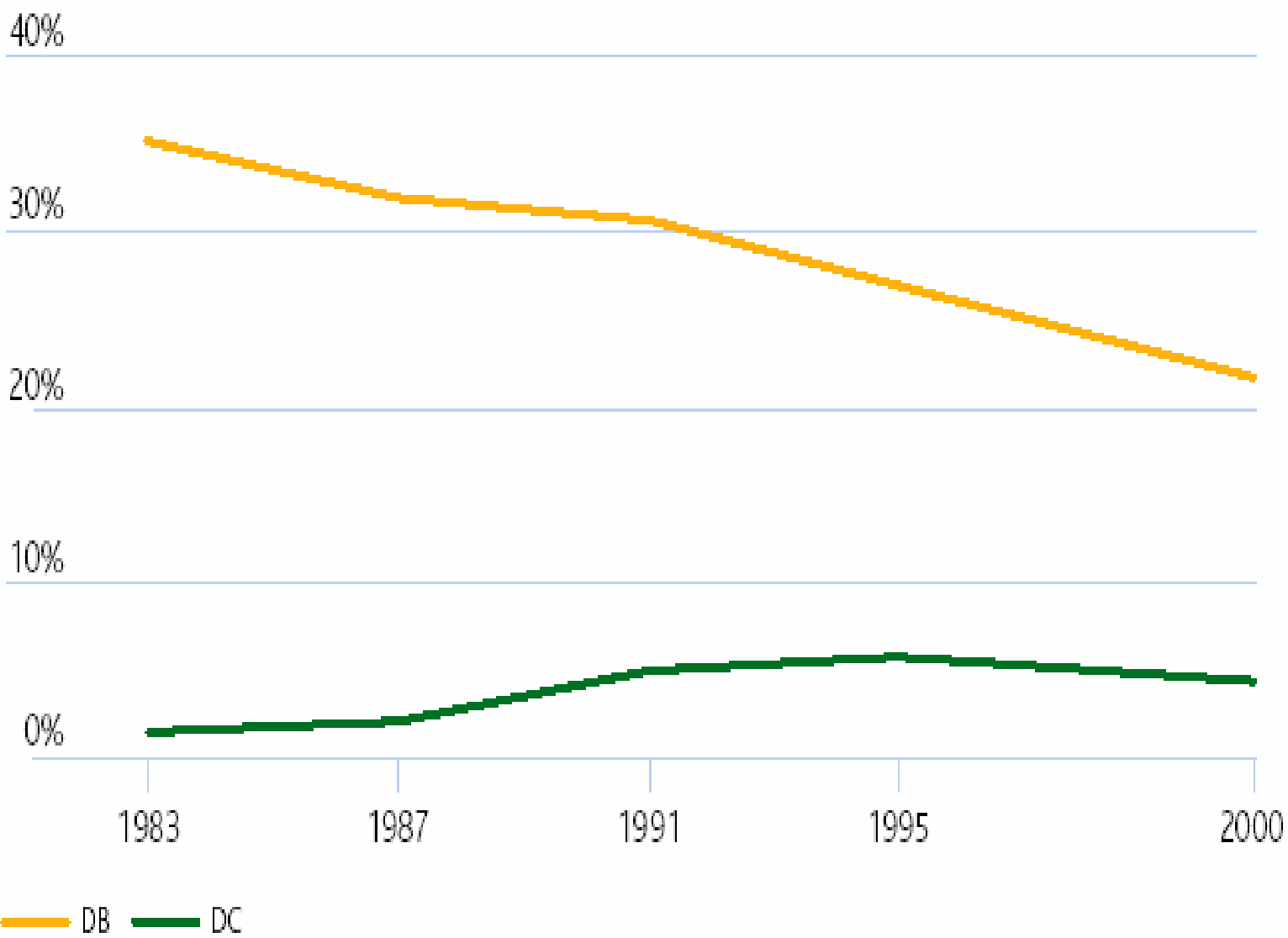


Figure 3.26 Estimated Percentage of Private Sector Employees Participating in Occupational Pension Schemes



What have been the consequences?

- Death of private sector occupational final salary schemes:
 - ◆ Two-thirds of UK employers operating final salary schemes have closed them to new entrants
 - ◆ Towers Perrin (2004) found that 24% of UK's largest companies considering abandoning occupational pensions altogether and offering employees cash instead.

What have been the consequences?

- Deficits in DB schemes due to:
- Employers using surpluses in 1980s and 1990s to fund major restructuring:
 - ◆ eg early retirement pensions and redundancies
- Equity bear market of 2000-2002, which eliminated most scheme surpluses
- Continuation of a low-inflation, low-return environment:
 - ◆ companies can't rely on rise in stockmarket values to lift funds out of deficit
 - ◆ nor will high inflation reduce impact of promised annual increases to pensions in payment.

What have been the consequences?

- Warnings about impact of DB deficits on employer profits have been coming thick and fast in 2005:
- **January:**
- Consultant Watson Wyatt said:
- “The burden of pension debt is starting to weigh heavily on the corporate world.
- It is affecting credit ratings and analysts’ forecasts.
- It will make takeovers, refinancings and capital-raising more problematic.”

What have been the consequences?

- **February:**
- Consultant Mercer Human Resources said:
- “Pension scheme deficits were not falling significantly despite rising stockmarkets.
- This was because the rise in asset prices was broadly matched by an increase in scheme liabilities, in turn driven by interest rate and longevity trends”.

What have been the consequences?

- **March:**
- Asset manager SEI Investments reported that:
- “Pension scheme deficits were already having a negative effect on 52 per cent of the companies it surveyed.
- One-third of companies said that their pension liabilities had caused a reduction in both the share price and dividend payouts”.

What have been the consequences?

- **March:**
- Credit rating agency Standard & Poor's said:
- “UK pension scheme trustees routinely fail to take account of the risk of default by their sponsoring employer when they set the employer contribution schedule and the investment policy for the fund”.

What have been the consequences?

- **April:**
- The new Pensions Regulator introduced a clearance procedure for prospective corporate activity to prevent employers reneging on pension scheme obligations.
- Consultant PricewaterhouseCoopers said that over half of the FTSE 350 companies are worried about the impact of their DB deficits in this area.

What have been the consequences?

- **April:**
- Society of Pension Consultants warned that:
- “The stockmarket values of many companies with DB deficits could be hit when these shortfalls appear directly on the balance sheet under new international accounting rules (IAS 19) introduced for companies whose financial year begins on or after January 1 2005”.

What have been the consequences?

- Lane Clark & Peacock's "Accounting for Pensions" 2004 survey shows the following deficits:
- British Airways - 112% of stock market cap
- BT - 66%
- BAE Systems - 60%
- Rolls-Royce Group - 49%
- GKN - 46%
- Cable & Wireless -35%
- ICI - 33%
- J Sainsbury - 28%
- Royal & SunAlliance - 27%
- Whitbread - 27%

What have been the consequences?

- Contributions:
 - ◆ Only 6% in DC, cf 15-18% for DB
 - ◆ Pension reduced from 100% of DB pension to 40%
- Costs/ charges:
 - ◆ State scheme: 10bp
 - ◆ Company scheme: 40bp
 - ◆ Personal pension schemes: 100-150bp

What have been the consequences?

- **During accumulation phase**, DC pensions subject to:
 - Contribution risk to contribution inflows arising from:
 - ◆ unemployment, ill-health, disability or death-in-service
- Investment risk to accumulating pension fund arising from uncertainties attached to asset returns

What have been the consequences?

- **During decumulation phase**, DC pensions subject to:
 - Interest rate risk at time of annuity purchase
 - Longevity risk after annuity purchased:
 - ◆ In 1981 the Government Actuary's Dept (GAD) projected that by 2004 male life expectancy at 65 would be 14.8 years, whereas in reality it was 19 years – a 28% error.

What have been the consequences?

- These risks are either expensive or impossible to hedge using private insurance markets
- Individuals unable to transfer risks efficiently to life companies operating in these markets.

Conclusion

- Piecemeal nature of the reforms and inadequate regulatory impact assessments have resulted in:
 - ◆ Individuals having much weaker pension promises than they did 30 years ago
 - ◆ Companies facing very serious solvency problems arising from their legacy DB schemes

Wise et al 'Pensions and economics: The way ahead' Staple Inn paper January 2004

- P7 “Final salary pensions used to be very flexible for employers. Employers had wide discretion in determining the level of benefits, such as early retirement terms, pension increases, commutation rates, as well as determining the level of wages. In addition, employers had wide discretion in determining the level of funding of schemes and could effectively use the scheme as a source of easy finance and a tax haven. Over time, these sources of discretion have been gradually removed and final salary schemes are now a burden.”