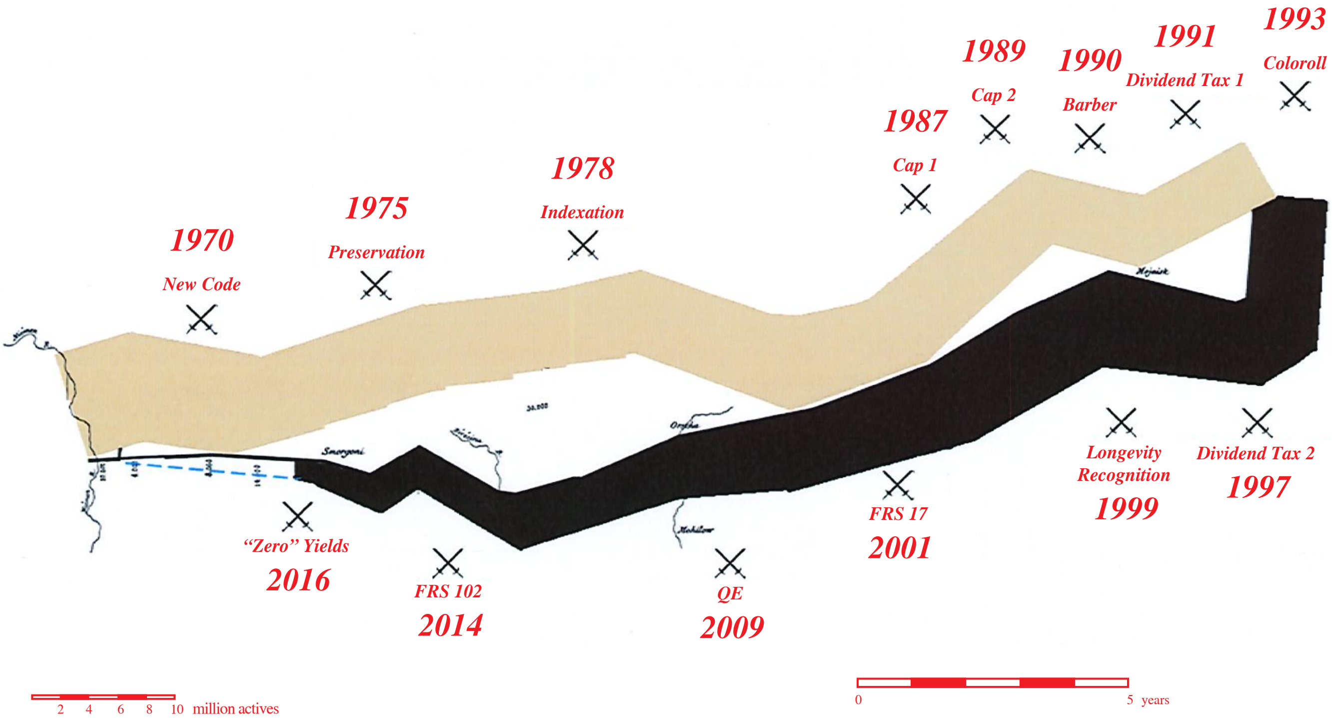
The decline of the UK Private Sector 'Final Salary' Pension Scheme

Keith Wallace FPAS, 2016, after Engineer Minard



Graphics: Patti Tihey and Matthew Furillo Print: GH Cityprint

The Decline and Fall of the UK Private Sector "Final Salary" Pension Scheme

How 13,000,000 actives shrunk to 500,000

My career has spanned the rise and fall of what was called the "Final Salary" pension scheme for the UK private sector. ("Final Salary" was later replaced by "DB" or Defined Benefit. Its counterpart, originally "Money Purchase", has become "DC" or Defined Contribution.)

In 1968 when I did my first legal job for a pension scheme, there was just one section[1] which constituted the sole legislative control. These conditions for "tax approval" were undemanding and the design of the benefits left to the employer's taste. Schemes had been set up by the large enterprises. The workforce was stable, jobs being seen as "for life" and a "good pension" was valued as a key recruiting attractant.

By the late 70's, these schemes owned one third of British industry. (A heavy bias towards domestic equities had emerged) and the value of a retiring worker's pension exceeded the price of his house. As industries were de-nationalized, the then workforce was, on transition, guaranteed that their existing "civil service" type benefits would be replicated and secured in a funded private scheme.

By the mid 80's, one observed the more risk-averse employers (mostly in the financial services sector) introducing money purchase DC schemes and closing their final salary schemes to new joiners or for new accrual, often in a manner in which some ongoing salary link continued. This makes the statistics for "active" private sector members thereafter a bit suspect.

⚔ 1970 New Code

This tax approval code replaced that of 1952. Schemes opted for "discretionary" approval – this gave the SFO (Superannuation Funds Office) a wide discretion, eventually codified into PNs – Practice Notes. The alternative was mandatory approval which was seen as narrow and inflexible. All investment income (and later underwriting) was made exempt[2].

Hence, the climate was one to encourage new or more generous schemes.

⚔ 1975 Preservation

Benefit design had been left to employers, who saw pensions as an award at, and not before, retirement. In consequence, schemes weren't obliged to make any provision for those leaving service in mid-career. Agitation extending many years sought for some "preservation" of benefit for "early leavers". This was fiercely opposed by employers and, curiously enough, by the National Association of Pension Funds.

When ameliorating legislation was finally introduced in April 1975, a pension had to be "preserved" for any leaving employee of over 26 with at least five years' service.[3] Eleven years later, the age 26 rule was abolished. In 1988, the five years' service was reduced to two years.

In that inflationary era, the preserved benefit, pejoratively called a "frozen pension", was at risk of erosion. Hence, from 1985, that component accrued since 1 January 1985 had to be "revalued" – normally at 5% p.a. This guarded measure in theory insulated schemes from a sizable retrospective cost – but employers often "revalued" all past service: and in this way both the idea of "indexation" was recognized, and an actuarial hit suffered.

⚔ 1978 Indexation

This was different. After years of inter-party wrangling, SERPS[4] was brought in and schemes could "contract out" of this additional state component by providing a GMP[5] in their own scheme. 97% of schemes did so. The GMP was indexed in deferment and, later, in payment. In theory, the inflation risk could be costed in. In practice, there was no available instrument. A tiny issuance of index-linked gilts – initially for pension schemes only – started in 1981.

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[1] Section 379 Income Tax Act 1952 – "Approved Superannuation Funds"

[2] Sections 208 and 222 ICTA and ss19 and 20, FA 1970 s21(2) FA 1970: exempted income, 21(2)(A) later added, exempted underwriting.

[3] Over 26, 5 years' service – section 63 Social Security Act 1973.

[4] SERPS – state earnings related pension scheme.

[5] GMP "Guaranteed Minimum Pension" essentially what a "contracted-out" scheme had to provide was equivalent to, through normally better than, the SERPS it replaced.

Indexation is a "large" subject. To the "revaluation" of deferred benefits described above, was added the indexation in deferment and payment of the "GMP" component of "contracted-out" schemes – nearly all of them.
Finally, that component of the DB scheme in excess of the GMP, had, since 1997, to be indexed once in payment. Until April 2005, this rate was RPI with a maximum of 5%: it then reduced to RPI with a maximum of 2.5%.
Britain is the only European country whose private sector benefits had to be indexed in both deferment and payment. Ireland was the only other country to index in deferment, but did not insist on indexation in payment.

⚔ 1987 Cap 1

For post-1987 entrants, two caps were brought in. One's "final remuneration" was capped, for the purpose of cash commutation only, at £100,000 p.a. Under the standard formula a post-'87 joiner's cash was capped at £150,000. Additionally, rules to allow late joiners to accrue a final 40/60ths pension over a mere 10[6] years, were abrogated and the minimum term extended to 20 years for full tax-approved pension accrual.

⚔ 1989 Cap 2

Members' own contributions were in 1989 restricted to 15% of pay with a £60,000 pay limit for this purpose.
In theory, the 1987 and 1989 caps were cost neutral. But the "moral hazard" effect was that from this point onwards, senior management no longer looked to the company scheme as the prime source of worktime and retirement compensation.
As their emotional and financial association with the company scheme withered, its full funding ceased to be a high management priority, being replaced with a perception of it being a "dead cost".
The next main cap was imposed in 2004 by setting a "lifetime allowance", initially at £1.8m of formula-valued benefits, but since then slowly reduced. On promotion, payrise or assumption of overtime, members can receive a severe tax bill. The sheer administrative difficulty of working the system makes ongoing DB provision unpopular with HR and payroll.

⚔ 1990 Barber

On joining the Common Market (later EU) in 1973, Britain became committed to the "equal pay" terms of the Treaty of Rome. In 1976, Defrenne II[7] had established that pensions were "pay". Hence, sex unequal pensions had to be equalized. Since some Member countries had unequal state pensions, they chose to ignore the Treaty obligation. "Marshall"[8] and "Bilka-Kaufhaus"[9] both in 1986, reinforced this equalisation need, and were both ignored by Britain. In 1988, Mr Barber started his case for unequal pay in pensions. (As a male, he wanted the more benign, earlier female pension age.). On 17 May 1990, Barber[10] was vindicated in the European Court of Justice.
The UK Government sought to contain the retrospective damage this case might have caused by engineering a Treaty change.[11]

⚔ 1991 Dividend Tax 1

Standard tax recoverability was the full (prevailing) 25% applied to dividends. The Conservative Government restricted this to 20% rather than the full amount.

⚔ 1993 Coloroll

For the details of the remediation needed following Barber, the Coloroll and other cases[12] were decided together in September 1994 though the likely direction had been pointed by the Special Advocate General (Baron Van Gerven) the previous year. The consequential cost to schemes was severe.

⚔ Dividend Tax 1997

The incoming Blair/Brown regime, noting how easily the Tories had got away with "Dividend Tax I", withdrew tax exception or recovery on dividends

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[6] These rules were known as "uplifted sixtieths".
[7] Defrenne II 43/75.
[8] Marshall 152/84.
[9] Bilka-Kaufhaus C-170 '84.
[10] Barber C-262/88
[11] Maastricht Protocol
[12] Coloroll, Avdel, van den Ackker, Beune, Vroege and Fisscher were the cases decided together on 28-09-1994

altogether. It was dressed up as the "abolition" of advance corporation tax, but the effect was to deny any recovery of the (implied or effective) tax on dividends. Ministers were well-briefed on Budget Day to respond to any criticism from schemes by saying "Well, pensions schemes have fat surpluses."

⚔ 1999 Longevity Recognition

Annuitants live longer than non-annuitants. "White collar" workers live longer than "blue collar" ones. As workforces "white-collarised", and manual work became replaced by machines, the traditional mortality allowances became recognized from the early 1990s as hopelessly adrift. As a rule of thumb, the capital cost hit was 1% or more of liabilities per year, year after year, so that by 2010 the cost was 1/3 higher. And in this period, mechanization led to workforce reductions; thus the mortality hit was to be borne by a smaller contributing base.

⚔ 2001 FRS 17

The metrics of pension risk has played a part. Life offices writing pension business adopted tight valuation criteria. Actuaries considered that looser assumptions could be adopted, with two consequences First, it always looked "cheaper" for an employer to move from a fully-insured arrangement to one where the trustees invested directly. Second, "aggressive" assumptions meant that the pension liability reported to shareholders looked benign and unthreatening. A rearguard action was fought over many years to oppose accounting disclosure reform in this area, led by US businesses, terrified of disclosing the true cost of their promises of lifelong medical cover for employees.

The introduction of FRS 17 did not strain a scheme's finances, but it compelled management to disclose a more realistic number to the business owners, and, for themselves, to appreciate, more acutely, risks and volatility.

⚔ QE 2009 – "Quantitative Easing"

In consequence of the banking collapse of 2008, the Bank of England initially purchased £175 billion of, mostly, gilts. That figure quickly rose to £375 billion. With egregious self-restraint, the Bank committed to limiting itself to buying no more than 70% of any issue. (By 2020, QE purchases totalled £895 billion.)

This intentional lowering of long-term yields had a disastrous effect on the liability valuation of pension schemes.

⚔ FRS 102 2014

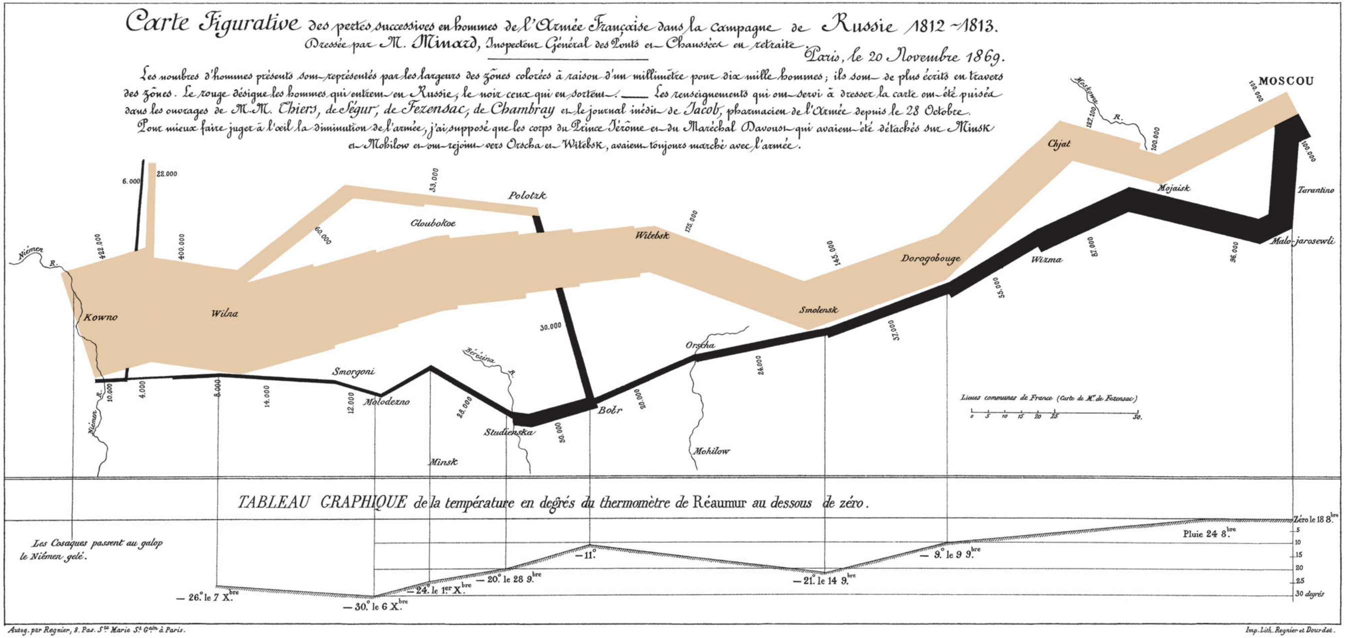
This accounting standard replaced and strengthened its predecessor FRS 17. The impact on management's perception of "final salary" pension risks was heightened. By now, the QE effect, lower yields and ongoing longevity recognition had resulted in the public disclosure of very sizeable deficits.

⚔ 2016 Zero Yields

A stampede to the lifeboats followed. Gilts, particularly index-linked gilts, were seen as the natural and only counter to the inflation risks to which schemes had been exposed by the politician-imposed elements of revaluation and indexation. The supply of gilts was constrained by QE and panic-buying by schemes. As yields were forced towards zero, further purchases were something of a self-garrotting.

Any Survivors in 2021?

The Office of National Statistics now uses a "DBH" category for the private sector. The "H" means hybrid, referring both to pure DB and also the desperate attempt by schemes and employers to dilute their DB risk by introducing hybrid modifiers. At Q4 2019, the ONS records 12 million private sector "DBH" members, of which 8% are called "active" – a total of 960,000. Since this latter figure contains "hybrids" one suspects that pure DB actives were then well under 500,000.



Minard – the Original – Pensioned Off

My graphic is based on the original by Engineer Minard (1781-1876). Now hailed as a triumph of design, it conveys six things in one: The route taken by Napoleon's armies to Moscow and back in 1812, the number of soldiers at any point, the distance travelled, latitude and longitude and, for the retreat, the falling temperature. An invading army of 450,000 was reduced to 10,000, though contrary to the implication of inclusion of the temperature table, much of the death toll was from starvation even before the Russian Winter set in.

Minard became a distinguished civilian engineer, superintending roads, harbours, canals and the emerging French railway system. His compulsory retirement age from state service was 70. Pensioned off, he continued lecturing and publishing until his death.

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