The Pensions Nightmare – ways to wake up?

By Malcolm Small - June 2006

Right now, 16% of the UK population is retired according to ONS figures. This number is predicted to rise to at least 25% in 40 years' time.

And yet, public faith in pension provision of any description has never been lower.

The fall-out from the effective failure of Equitable Life has been immense, as has the effect of the personal pension 'mis-selling' scandal. This latter had been based upon the assumption that remaining in a Defined Benefit pension scheme run by your employer was 'safe', whereas transferring to a personal pension plan was 'risky'. For sure, doing so whilst in employment with the sponsoring company was likely to lose you peripheral benefits such as life insurance as well as the employer contribution to your pension.

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But for the 85,000 workers now facing the loss of all, or a large part of, the Defined Benefit pension they believed they had been 'promised', hindsight might be a wonderful thing. As their employers have hit the economic wall the pensions 'promise' has often been found to be an empty one and we now see employers going into administration specifically to offload what to them has become an economic ball and chain.

How on earth did we get into this mess?

The UK private pension system has long been recognised as one of the best in Europe, if not the world, with more money invested per capita than any other country. Now, the wheels seem to be coming off, big time. Not only are prospective pensioners seeing their pensions evaporate, but corporate activity such as takeovers and mergers, which would normally be broadly beneficial, is being prevented by perceived or actual pension fund deficits and the re-funding requirements of the Pensions regulators.

As usual, there is no single answer to how we got here, but the story trails back to the 1980s and 1990s, when many schemes were in 'surplus'. This was perceived, for whatever reason, as a bad thing. It's true that companies took payment 'holidays' or tried to extract the surplus by a range of doubtful methods, but the situation was not helped in 1997 when the relief on payment of Advanced Corporation Tax schemes had previously enjoyed was removed. At the time, the future implications of this were little understood even by pension tax experts, but it soon became clear that, at a stroke, this had opened up an immediate requirement to increase funding radically to cover a shortfall estimated at £5bn per annum.

On top of this, with timing presumably devised by some malign force, came the stock market 'correction' of 2000/2001. Let's remember that we are still, six years later, more than 10% adrift of the FTSE 100 peak of 6700 seen at that time, and that many schemes were heavily invested in the market.

To make matters worse, a series of accounting rule changes have forced companies to declare their pension shortfalls on their balance sheets, and to calculate those shortfalls (and their remedies for them) using Bond yields. This has had the effect of making companies move rapidly from Equities to Bonds, often taking losses on the former to do so, and putting immense pressure on the market for Bonds, whether government or corporate. One scheme, Boots, famously migrated from Equities to a complete holding in Bonds in a brilliantly planned series of trades. This means that there is a furious market for any new government debt, depressing the very yields that are supposed to match future liabilities, forcing the purchase of more Bonds to cover the increased funding gap thus opened up.

And so on, in a downward spiral.

Now, with the arrival of the Turner Report, there seems to be a new determination on the part of government to find better ways of running UK Pensions plc in the shape of a 'money purchase' National Pension Savings Scheme (NPSS). 'Money purchase' schemes simply accrue money in a ring-fenced fund, which is then used to buy a pension at retirement. There is no 'promise' related to final salary but then, as we have seen, that promise is not what people thought it was.

Unfortunately, all this is unlikely to deal boldly with the malaise pervading existing Defined Benefit schemes.

However, the emergence of a new market sector for 'bulk buy-outs' may well offer a 'solution' for companies anxious to be freed of what they now perceive as a ball and chain. In this circumstance, the deficit is topped up to an agreed level, the scheme is closed to new members, and the liability for payment of existing and future benefits transferred. Once this liability has been transferred to one of the new breed of insurance companies, or other vehicles, the company and its employees will be free to join NPSS, or, for their more senior people, to set up a Group Personal Pension offering more investment choice.

So, the market seems likely to provide its own solutions.

There can be no doubt that we are unlikely ever again to see new Defined Benefit pension schemes established. The future is money purchase.

What next?

The real issue is the amount that will need to be set aside from income into these new arrangements to stand a fighting chance of providing a decent retirement fund.

Right now, the average contribution, from both employer and employee, into a pension is 6.5%, before tax relief. The NPSS proposal is for a base line of 8%, including tax relief.

The expert consensus is that a figure of 15% of salary including tax relief is the bare minimum needed by way of a contribution throughout an individual's working life to accumulate a fund likely to provide a pension of around 50% of final salary. This figure is hard to predict because of uncertainties around future annuity rates and investment returns, but anecdotally, it feels about right.

There is clearly a major education job to do in the UK to get people to engage with long term saving on a realistic basis.

The jury is out as to whether the 'soft compulsion' of the NPSS will be enough to raise the figure of 58% of the working population who are members of ANY pension scheme.

The concept that over four out of 10 people are not even attempting to provide for their old age certainly scares me.