Pensioned Off?

Background

Defined Benefit company pension schemes are essentially 'contracts of employment for life'. The implications of these particular pensions are hitting home as the population begins to collect and as the impact of many years of increased life expectancy hits. In some instances, the companies with the debt no longer have employees who are working and who are active members of these schemes so the legacy is no longer about employee benefits but has become a significant financial burden with little added value for the current company or employees. The most common form of Defined Benefit pension scheme is also known as a final salary pension scheme. Under these schemes employees are entitled to a particular level of benefit depending on length of service and salary level when they retire.

When Otto von Bismarck introduced the first pension for German workers over the age of 70 in 1889, average life expectancy was 45 years (although this also included a very high infant mortality rate). When the US social security system was set up in 1935, the official retirement age was 65 - three years longer than the lifespan of the typical American.

The 'Old Age Pension' was introduced in the UK in January 1909 for workers over 70 when average life expectancy was 66.

State pensions are becoming an increasing burden due to lengthening life expectancy and lower fertility. In 1950, there were 7.2 people aged 20 to 64 for every one aged 65 or over in the OECD countries. By 2010 it was 4.1. It is projected to reach just 2.1 by 2050. The average ratio for the EU was 3.5 in 2010, and is projected to go down to 1.8 by 2050.

In the 1970's membership of final salary schemes (already the norm in the public sector) became prevalent in the private sector. Britain has historically had one of the best pension provisions in the world and, in 1997, the final salary membership rate in the private sector stood at 34%. This has plummeted to just 9% recorded in 2010. These schemes are also coming under increasing pressure as a result of government intervention and regulation, and lower than expected investment returns - with the associated impact on a company's balance sheet.

Increased Costs

People are now living longer, and with pensions generally payable at 65 there is a problem when average pensioner life expectancy is now in the late 80s (with a potential move into the early 90s). Is it possible to save enough in one's working life to pay for what is now a much extended retirement?

The Minimum Funding Requirement (MFR) was introduced on 6 April 1997. Its aim was to set a minimum amount of assets that a defined benefit pension scheme should hold in order to fund the promised benefits. If a scheme did not hold sufficient assets, the pension scheme was required to achieve the minimum level of funding within a given time scale. The financial climate at the time meant that the MFR allowed some businesses to adopt a rosy view of valuations. This had an impact on funding which was probably lower than was realistic. Some companies were able to take pension holidays, and this was also a period when benefits to members were enhanced.

Then in December 2005 The Pensions Act (2004) abolished the MFR and introduced a new scheme-specific funding requirement. This Act established The Pension Regulator (TPR) and the Pension Protection Fund (PPF).

The PPF is funded through a levy on all occupational defined benefit schemes. There is a risk-based element which takes into account the scheme's funding position and the likelihood of an insolvency event occurring in relation to the scheme. This levy has proved controversial as the most vulnerable schemes, with weak employer covenant and large deficits, have been faced with significant payments. The irony is that the levy is paid to the PPF, not the company's own scheme. There is one large pension scheme that is not paying the PPF Levy and is arguing that should the company fail the PPF would not be able to take on board a scheme of this size.

In 1997 the tax relief for non-tax payers was scrapped, which had an impact on pension funds that could no longer reclaim any of the money taxed as Advance Corporation Tax (ACT) from their dividend income. This lowered returns. In April 2007, under the Freedom of Information Act, The Times uncovered documents that showed that Gordon Brown (then Chancellor) had been advised that pension funds would suffer a loss of £67bn of the actuarial value of their assets as a net result of a combination of policies, including the ACT change.

Investment strategy is determined by the trustees, but the sponsor has to bear the impact of poor or incorrect investment decisions. However, one of the key drivers of the valuation of pension liabilities is the yield on long term gilts. Quantitative Easing (QE) is having a depressive effect on gilt yields, with some studies suggesting that this is between 20 and 125 basis points.

The employer now has to value the assets and liabilities of the pension scheme by reference to current market conditions (under FRS17). Assets are taken at market value and liabilities are valued using a discount rate based on the return on corporate bonds (AA rated). FRS17 requires all surpluses and deficits to be shown as an asset or liability on the company balance sheet and this can mean high volatility.

Due to increased complexity, both schemes and companies have also been faced with increased running costs, which have led to an additional burden on the employer. Most pension schemes that were established when there was no obligation on employers to provide a pension have had successive layers of cost added, including compulsory revaluation and pension increases. All of the above paints a pretty dismal picture for sponsors, providers and employees.

Options

There are ways of dealing with the costs and risks of company sponsored pension schemes. Some of these are highlighted below.

Business as usual
Schemes need a sensible governance structure to ensure that the company and the trustees engage collaboratively to manage the on-going finances. This includes reaching agreement on funding arrangements and on the optimal risk/return profile of the investments which balance the needs of both parties.

Buy-out
At one extreme the scheme liabilities can be secured with an insurance buy-out policy. This gives the highest degree of security to the scheme members and removes the financial risks for the sponsor. However the current cost of buying out in this way is out of reach for most companies.

Deficit reduction measures
Any reduction in benefits, such as closing the scheme to future benefit accruals will reduce or curtail the build-up of liabilities. For those liabilities already built up, a range of offers can be made to members to reshape or remove their liabilities, for example:

- Flexible early retirement options where the member draws an immediate pension outside of the scheme
- Pension increase exchange – swapping future increases to the pension for a higher pension now
- Enhanced transfer values – incentives to transfer the deferred pension to a personal pension plan

Longer recovery plans
Recovery plans have started to lengthen in recognition of affordability constraints or where the company can provide some other form of security to the trustees. In particular we have seen the emergence of asset backed contribution structures in which the company provides a security right over a company owned asset to the pension scheme. The income stream from this asset is then used to fund the deficit recovery for the scheme. As the pension fund would have first call over this asset in the event of the company's bankruptcy, the pension fund has greater security over its future funding, and as a result, pension trustees are usually willing to accept longer deficit recovery periods typically around 20 years. Over time an increasingly wide range of assets are being used including property, loan notes and brands.

Compromise routes
When the pension liability becomes a crippling burden on the sponsor, compromise or ring fencing options come into play. This may result in the pension scheme being separated and entering the PPF or the pension scheme remaining ongoing with an equity stake in the business, but with a crystallization of the liability to the company.

The Role of Government

With many Defined Benefit pension schemes closed, surely now is the time to consider 'transition' programs in order to help companies to manage the liability.

Whilst this will require legislation, and is therefore unlikely to happen this side of an election, are there some simple enabling steps which could begin to establish a path for greater flexibility?

This is a long-term problem and the solutions will also need to be long term, but maybe we could start sooner with co-operation from the companies, the banks and the government.

In 2010 the Government announced that private sector pensions should be able to use CPI as the measure of inflation for indexing pensions in payment and deferred benefits. The CPI inflation rate tends to be lower than the corresponding RPI rate and, although the differences are often small, if accumulated over time they can amount to significant sums of money. Although the Government's announcement should have reduced the cost of pension provision, many schemes have nevertheless found that their rules will not allow them to make this switch.

What Next

When all other strategies fail a compromise or ring fencing may offer a better outcome than insolvency for both the scheme and the company. Make sure you have sensible trustees and manage the relationship carefully.

Pension sponsors need to take decisive steps to address their liabilities, but low investment returns over several years have hit their balance sheets hard. In many cases the underlying business needs to recover before progress can be made.

Management need the will to address the challenges. Often external advisors are needed to be the catalysts for change.

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