Defined Benefit pension schemes

Standard Note: SN/BT/1759
Last updated: 9 March 2009
Author: Lucinda Maer and Djuna Thurley
Business and Transport Section

A Defined Benefit (DB) pension scheme is one where the pension is related to the member's salary or some other value fixed in advance. For example, a person may accrue benefits equal to a proportion of final salary (say, 1/60th) for each year of service in the scheme.

During the second half of the twentieth century there was, broadly speaking, a growth in the membership of private sector DB schemes. The recent trends, however, have been for a decrease in coverage. This note sets out some data relating to the membership and operation of DB schemes in the private sector. It then discusses some of the factors which have been suggested as reasons for the shift away from provision of DB schemes. These factors include better than expected improvements in longevity, low investment returns, increased legislation and regulation and broader economic factors.

The Government set up a "Deregulatory Review of Private Pensions", with the aim of simplifying and reducing the burden of legislation. An independent report said it would not be appropriate to make changes which would affect rights already accrued but made some recommendations for change. The Government legislated in the *Pensions Act 2008* to reduce the cap applying to the revaluation of deferred pension rights, accrued from a future date, from 5% to 2.5%. A limited statutory override is to be introduced by regulations. Some have argued the need for further changes, particularly in the light of the economic downturn. For example, it has been argued that there should be a new tier of legislation to enable a degree of "risk-sharing" – for example, such that benefits would only be index-linked if scheme funding allowed. However, the Government has decided not to take this forward.

Schemes have take steps to contain future liabilities – closing to new members, for example. In recent years, the Pensions Regulator (TPR) has become concerned at the development of "non-insured buy-outs", in which the link with the employer is severed so that the scheme may be operated for profit but to the detriment of scheme members. To better enable TPR to protect the benefits of scheme members, the Government introduced changes to its powers in the *Pensions Act 2008.*

The note draws on expert comment and analysis, such as that of the Pensions Commission, the Pensions Regulator and the Pensions Policy Institute, as well as views of employers and discussion in the media.

The funding requirements on DB schemes and the implications of the recent difficulties in the financial markets are discussed in more detail in Library Standard Note: SN/BT/4877, "Pension Scheme Funding".

Standard Notes are compiled for the benefit of Members of Parliament and their personal staff. Authors are available to discuss the contents of these papers with Members and their staff but cannot advise others.

Contents

1 Background 3

1.1 What is a Defined Benefit pension scheme? 3

1.2 Numbers of members and schemes 3

1.3 Implications of the shift from DB to DC 6

2 Factors influencing trends in DB schemes 7

2.1 Overview 7

2.2 Demography 10

2.3 Accounting standards 12

2.4 Regulation 13

2.5 Advance Corporation Tax 15

2.6 Economic factors 17

Market risk 17

Interest rates and inflation 18

The labour market 19

2.7 Contribution holidays 20

3 Policy developments and proposals 21

3.1 Deregulatory Review of Private Pensions 21

Risk sharing 22

Circumstances triggering an employer debt 24

Treatment of surplus 25

Other proposals 27

4 Scheme responses 28

The Pensions Regulator's powers to protect scheme benefits 29

5 Further reading 30

1 Background

1.1 What is a Defined Benefit pension scheme?

A Defined Benefit (DB) pension scheme is one where the pension is related to the member's salary or some other value fixed in advance. The majority of DB pensions are related to "final salary" [1] i.e. each year of service earns a fixed fraction of the final salary, often at the rate of 1/60th of final salary per year worked. Some DB schemes work on a "career salary" basis, with pensions accrued on the basis of salary in each year of service.

The main alternative to a DB scheme is a Defined Contribution (DC) pension, where the individual receives a pension based on contributions made and the investment return they have produced. The proceeds of the pension fund are generally used to purchase an annuity, which then provides an income throughout retirement. DC schemes are also called money purchase schemes, and are the basis of personal pensions.

Occupational schemes are either DB or DC. However, it is possible to combine the two approaches in one scheme, in a "hybrid" structure. This is usually achieved by providing either a money purchase underpin to a DB scheme, or a DB underpin to a DC occupational pension scheme.[2] The Pensions Policy Institute (PPI) explains that the advantage of such schemes is that they "provide employers with some degree of cost and benefit predictability while at the same time providing members with a more reliable pension than may be available under a pure Defined Contribution plan."[3]

The status of an occupational pension scheme may be open, closed, frozen or winding up. As defined by the Office of National Statistics:

- an open scheme admits new members
- a closed scheme does not admit new members but may continue to receive contributions from, or on behalf of, existing members who continue to accrue pension rights
- in a frozen scheme, benefits continue to be payable to existing members but no new members are admitted, and no further benefits accrue to existing members. Members can make no more contributions but further employer contributions may be made
- a scheme that is winding up is in the process of termination, either by buying annuities for the beneficiaries or by transferring assets and liabilities to another scheme[4]

1.2 Numbers of members and schemes

During the second half of the twentieth century there was, broadly speaking, a growth in membership of private sector DB schemes. The recent trends, however, have been for a decrease in coverage of DB schemes.

---

1 National Association of Pension Funds (NAPF) Press Release PR 53/08, 6 October 2008, NAPF Annual Pensions Survey 2008. Stability now, but further change on horizon

2 IDS Pension Service, "Pension scheme design", para 2.37

3 PPI, "The changing landscape for private sector Defined Benefit pension schemes", October 2007, p6

The pensions landscape is complex. As schemes are of varying sizes and contrasting histories, and schemes related to different industries often have different characteristics. The most reliable long term evidence for membership of occupational pension schemes has been the Government Actuary's Department (GAD) survey of occupational pension schemes. This survey of public and private occupational pension schemes was been carried out every five years since 1953 until 2003 when they became annual. In 2005 it covered only private sector schemes. The surveys have been conducted by the Office for National Statistics since 2006, the latest published survey is for 2007 [5]

The changing balance between DB and DC schemes can be looked at in two ways: in terms of the number of schemes or the number of members in different types of scheme.

The number of **schemes** by type is set out in the table below.

UK private sector occupational pension schemes: by status and benefit type

Number

	Defined benefit			Defined contribution			Total		
	2000	2005	2007	2000	2005	2007	2000	2005	2007
Open	17,900	6,230	2,240	43,700	44,670	25,830	61,600	50,900	28,070
Closed	11,200	4,510	6,250	17,700	8,290	12,550	28,900	12,800	18,800
Frozen	5,600	1,290	na	1,200	480	na	6,800	1,770	4,310
Total	**34,700**	**12,030**	**8,490**	**62,600**	**53,450**	**38,380**	**97,300**	**65,470**	**51,180**

Excludes schemes that are winding up
Excludes hybrid or sectionalised schemes
Source: Occupational Pension Schemes Survey, GAD/ONS

There has been a continuation of the sharp decline in the number of open schemes in 2007. Notably, there was a decline in the number of DB and DC schemes, albeit at a faster rate for DB schemes (Schemes are categorised as "open" where new members are able to join)

The number of open DB private sector schemes declined from 17,900 in 2000 to 2,240 in 2007; while the number of DC schemes rose from 43,700 to 44,700 in 2005 but fell to 25,830 in 2007.

Additionally, part of the shift from DB to DC schemes has involved an increase in 'sectionalised' schemes, mainly through the closure of the DB section and the opening of a new DC section of a scheme. Sectionalised schemes are those that offer different benefits to different groups of members within the same scheme, or that segregate the rights of different groups of members so as to account better for the costs arising from each group. Because consistent data for sectionalised schemes is not available they are not included in the above table.

In terms of pension scheme **members,** between 1987 and 2007, membership of DB pension schemes among employees fell from 47 to 31 per cent, while membership of DC schemes increased from 1 to 4 per cent.

[4] Sarah Levy and David Miller, *Economic and Labour Market Review,* Vol 2, No 1, January 2008

[5] See Office for National Statistics, *Occupational Pension Schemes Annual Report,* No. 14 2006 edition

Active employee members of pension schemes by sector 1975-2007

millions of employees, UK

	Private	Of which:		Public	Both Sectors			Proportion of employees with:	
	Total	DB	DC	Total	DB	DC	Total	DB	DC
1975	6.0	5.8	0.2	5.4	11.2	0.2	11.4	48%	1%
1979	6.1	5.9	0.2	5.5	11.4	0.2	11.6	49%	1%
1983	5.8	5.4	0.4	5.3	10.7	0.4	11.1	51%	2%
1987	5.8	5.3	0.5	4.8	10.1	0.5	10.6	47%	2%
1991	6.5	5.6	0.9	4.2	9.8	0.9	10.7	44%	4%
1995	6.2	5.1	1.1	4.1	9.2	1.1	10.3	42%	5%
2000	5.7	4.6	1.0	4.4	9.0	1.0	10.0	38%	4%
2004	4.8	3.6	1.2	5.0	8.6	1.2	9.8	35%	5%
2005	4.7	3.7	1.0			1.0			
2006	4.0	3.0	1.0	5.1	8.1	1.0	9.2	32%	4%
2007	3.6	2.7	0.9	5.2	7.9	0.9	8.8	31%	4%

DB = Defined benefit
DC = Defined contributions
ONS *Occupational Pension Schemes Annual Report 2007 (& earlier equivalents)*
ONS Employee data series MGRN

In spite of the decline in the number of such schemes and in the number of members, the largest group of employees who are members of occupational pension schemes are those in DB pension schemes. Twenty years ago around half of employees were active members of these schemes. The latest figures show the current proportion to be just under one-third. Over the same period, the proportion of employees in DC schemes has risen from 1-2% to 4-5%.

Commenting on the 2007 survey findings, ONS reported that:

> In 2007, the estimated total number of occupational pension schemes in the UK was 54,110, only 56 per cent of the total in 2004. Most schemes (53,800) were in the private sector, with only 310 in the public sector. The downward trend in the total number of open schemes continues: in 2007 there were estimated to be only 28,810 open schemes (28,680 in the private sector), compared with 54,260 in 2004.[6]

The report went on to state:

> There was a marked increase in the number of active members between 1953 and 1967, from 6.2 million to 12.2 million. This was followed by a steady decline. In 2007, there were an estimated 8.8 million active members of occupational pension schemes, of whom 3.6 million were in the private sector, compared with 6.5 million in 1991 and 8.1 million at the peak (in 1967). The decline in total numbers of active members in the private sector over the last 16 years reflects the fall in membership of private sector defined benefit schemes, from 5.6 million in 1991 to 2.7 million in 2007. On the other hand, active membership of public sector schemes rose from 4.2 million in 1991 to 5.2 million in 2007, despite the reclassification of some large public sector schemes to the private sector from 2000.

[6] ONS *Occupational Pension Schemes Annual Report* 2007 edition

1.3 Implications of the shift from DB to DC

In its First Report, published in October 2004, the Pensions Commission noted that in DB schemes the provider bears most of the risk of pension provision. In DC schemes, on the other hand, much of the risk falls on the individual:

> Pension provision and pension savings entail either the provider or the individual absorbing four different categories of risk: longevity risk, of which there are three subtypes, investment return risk, default/political risk and earnings progression risk. Different forms of pension provision allocate these risks differently. In state PAYG and in private DB schemes with price indexed benefits the provider bears almost all these risks and the individual none. In DC schemes invested directly in equities or bonds only longevity risk post retirement is absorbed by the providers of annuities; all the other risks are born by the individual.[7]

A key consequence of the shift from DB to DC in recent years has been a shift of investment risk to individuals, exposing them to "major uncertainty about the value of their future pension, given the volatility of rates of return over periods relevant to pension saving" and placing greater responsibility on them":

> As a result of this shift in risk bearing, individual's income in retirement will be increasingly influenced by the investment decisions they make. Individual pension savers are therefore increasingly faced with a choice between (i) accepting equity return risks which they are often ill-equipped to evaluate and which will introduce a random variation into the distribution of pensioner incomes; or (ii) moving to lower risk, bond-rich investment strategies which on average imply lower expected rates of return, which in turn implies that higher contributions will be required to deliver a given level of income.[8]

The Commission also said that the high equity returns of the 1980s and 1990s had allowed many schemes to ignore the rising costs of pension promises and to delay necessary adjustments. The manner of the delayed adjustment, when it happened, had exacerbated inequalities in pension provision:

> The exceptional equity returns in the 1980s and 1990s allowed many private sector DB schemes to ignore the rapid rise in the underlying cost of their pension promises. When the fool's paradise came to an end, companies adjusted rapidly, closing DB schemes to new members.
>
> A reduction in the generosity of the DB pension promises which existed by the mid 1990s was inevitable. That generosity had not resulted from a consciously planned employer approach to labour market competition, and would never have resulted from voluntary employer action well informed by foresight as to the eventual cost, or operating within rational expectations of equity market returns.
>
> But the suddenness of the delayed adjustment, its extremely unequal impact as between existing and new members, and the major shift of risk occurring as many people move from DB to DC provision, have severely exacerbated the gaps that have always existed in Britain's pension system.[9]

---

7 Pensions Commission, First Report, Chapter 3, p104

8 Ibid, p109-112

9 Ibid, p125

Chris Lewin and Ed Sweeney, in their independent report to DWP's Deregulatory Review of Private Pensions noted the advantages of DC from the employer's perspective:

> We believe that two important reasons for the flight from DB schemes in recent years have been the ever-increasing regulatory burden surrounding them and the fact that they often represent open-ended burden of risk for the sponsoring company, leaving it exposed to unlimited extra costs, for example, from poor investment performance or improved longevity. By contrast a DC scheme provides relative simplicity, leaving employers free to concentrate on their main business activities, and any long-term risks for the company and employees are often forgotten.[10]

In its 2006 report on *Pension Reform,* the House of Commons Work and Pensions Committee noted that there were differing views on the implications of the general trend from DB to DC:

> 151. When giving evidence to the Committee, Kay Carberry, from the TUC, expressed concern about this trend, suggesting that when DB schemes closed and were replaced by DC schemes "in most instances the employer contribution goes down". However, even if the contribution were maintained, she pointed out that DB schemes provided more certainty in retirement, as in DC schemes "the risk falls onto the shoulders of the employee".
>
> 52. On the other hand, it is argued that DC schemes are capable of producing high returns and also that it is possible to 'manage' investment risk through a lifestyle-smoothing' approach. The problem is that the shift to a Defined Contribution scheme is often accompanied by a reduction in the employer contribution.[11]

2 Factors influencing trends in DB schemes

2.1 Overview

The Pensions Policy Institute (PPI) said in a report published in 2007 that a number of factors had influenced the decline in DB schemes in the private sector:

> Better than expected improvements in longevity, low investment returns, increased legislation and regulation, and broader economic factors have all added to the costs and risks to sponsoring employers of providing a DB pension scheme.[12]

The Pensions Commission, established by the Government in 2002 to review the evolution of the UK's system of pension provision and to advise on whether the existing system of voluntary private pensions would deliver adequate results,[13] provided a useful analysis of the factors contributing to trends in DB provision. The Commission, chaired by Lord Turner of Ecchinswell, published three reports. Following the publication of its First Report, the Commission sought views on whether there was "broad agreement" with its description of trends in the UK pension system. In its Final Report, published in April 2006, it said that,

---

[10] Chris Lewin and Ed Sweeney, 'Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions', Foreword

[11] House of Commons Work and Pensions Committee, *Pension Reform,* 22 July 2006, HC 1068-I, 2005-06, paras 149-162

[12] PPI, The changing landscape for private sector Defined Benefit pension schemes, 2007, p3

[13] See Library Standard Note SN/BT/3829, Pensions Commission

"new trends in pension provision and pension saving, while inevitably limited, have tended to confirm the analysis of the First and Second Reports".[14]

A summary of the Pensions Commission's analysis was included in its Second Report.[15] This has been reproduced here.

The long-term trends
Both the First Report and Chapter 1 of this Report have described the rapid decline in private sector DB provision (primarily final salary in form) which has occurred in the last 10 years. In 1995 there were 5.2 million members of open private sector DB schemes; today there are fewer than 2 million with numbers falling fast. But it is important to understand that private sector DB provision has been in underlying decline for much longer. Adjusting for the distorting effect of utility privatisation, it is clear that the percentage of the private sector workforce covered by DB provision has been in decline since the 1970s.

This followed a period of explosive growth. In 1953 only 3.1 million people were members of private sector occupational schemes: by 1967, over 8 million, with 55% of them members of final salary schemes and another 15% members of average salary schemes.

Explaining the trends: the affordable rise
In part this growth reflected a society of growing prosperity and tight labour markets with employers competing for workers. But it also reflected specific features of the policy context and of economic conditions:
- High marginal income and corporation tax rates made pension provision highly tax efficient.
- Incomes policies constrained cash wages, but not non-cash pension benefits.
- And final salary schemes, initially opposed by trade unions as favouring senior managers, were subsequently welcomed as imperfect ways of ensuring price indexation, at least up to the point of retirement.

These pension promises however left many gaps: early leavers typically acquired minimal rights; spouse benefits were not assured; women did not enjoy equal access to pensions, for instance, if working part time. Most crucially, price indexation was usually at the discretion of trustees, with no regulatory requirement and in most cases no clear contractual commitment.

These gaps mean that it is wrong to think of the heyday of DB schemes as an unalloyed golden age. But it was precisely these gaps and the discretionary nature of the promise that made the pension promises affordable. Underlying contributions (employer and employee combined) required to support a typical DB promise, when the schemes were put in place, were usually estimated at about 10-14% of salary.

Explaining the trends: survival in the 1970s
From the start UK pension funds invested heavily in equities. Between October 1973 and September 1974 the value of the UK stock market fell by 50%, a far bigger stock fall than between 2000 and 2003. Inflation averaged over 10% for the next decade, and the stock market did not regain its 1973 real value until 1980.

But there was no wave of DB scheme closures for two reasons: first the schemes were far less mature than today, with a much higher ratio of workers to pensioners. Second and crucially, the absence of required price indexation meant that the impact of high inflation, and of negative real stock market returns, fell on pensioner incomes not on the viability of the fund.

Explaining the trends: the growth of unplanned and unanticipated costs

[14] Pensions Commission, Final Report, April 2006, p2
[15] Pensions Commission, Second Report: A New Pension Settlement for the Twenty-First Century, November 2005

By the start of the 1970s, the private sector had voluntarily put in place affordable, but highly unequal and to a degree discretionary, promises. Over the next 30 years, the inequality and discretion were removed by regulation. A series of Social Security Acts from 1973 to 1997 created equal access to pension rights for women, protected early leavers' rights, defined spousal benefits, and limited discretion over price indexation.

In addition the external context changed in two important ways:
- Inflation fell to low single figures thus limiting the potential to degrade real pension incomes through non-indexation even where discretion still remained.
- And life expectancy increased. Between 1950 and 1980 estimated male life expectancy at 65 rose only very slowly from 11.9 to 13.9 years: between 1981 and 2004 it increased by 5 years to reach 18.9.

The combined effect of these changes in regulation and context was that the underlying cost of a typical final salary pension promise as a percentage of salary rose from 10-14% when most schemes were initially designed, to 22-26% today.

Explaining the trends: irrational exuberance delays necessary adjustments
Given this huge increase in underlying cost, what is surprising is not the decline of DB pensions in the 1980s and 1990s, but that this decline was initially very slow and that there was minimal change in scheme design. Faced with increasing cost we might have expected to see some mix of (i) reductions in headline generosity e.g. switches from 60th to 80th accruals; (ii) increases in retirement ages to offset rising life expectancy; and (iii) increases in both employer and employee contributions. On average few of these adjustments occurred.

In part this can be explained by the delayed appreciation of life expectancy increases: only in the late 1990s did estimates start to reflect the assumption that rapid mortality reductions might be maintained well into the future.

But the bigger explanation is the long equity bull market of the 1980s and 1990s. From 1974 to 2000 the average real return on UK equities was 13%, compared with a twentieth century average of about 5.5%. This made increasingly expensive pension provision appear easily affordable to both employers and to government. Employers took contribution holidays, and used pension fund "surpluses" to make early retirement packages look like costless alternatives to cash redundancy payments. And the government tightened the tax treatment of pension funds in 1986, 1993 and 1997. In retrospect the actions of both employers and government were based on irrationally exuberant assumptions about sustainable returns.

Conclusions and implications
The exceptional equity returns in the 1980s and 1990s allowed many private sector DB schemes to ignore the rapid rise in the underlying cost of their pension promises. When the fool's paradise came to an end, companies adjusted rapidly, closing DB schemes to new members. A reduction in the generosity of the DB pension promises which existed by the mid-1990s was inevitable. That generosity had not resulted from a consciously planned employer approach to labour market competition, and would never have resulted from voluntary employer action well informed by foresight as to the eventual cost, or operating within rational expectations of equity market returns.

But the suddenness of the delayed adjustment, and its extremely unequal impact between existing and new members, have severely exacerbated the gaps that always existed in the UK's pension system.[16]

The Pensions Commission predicted that the decreasing provision of DB schemes would continue:

[16] Pensions Commission, Second Report: A New Pension Settlement for the Twenty-First Century, November 2005, p 122-3

> Where employers do provide pensions, the shift away from Defined Benefit (DB) schemes has continued even more rapidly than we predicted in the First Report. There are now fewer than 2 million active members of open private sector DB schemes. In the First Report we suggested that the number would be unlikely to stabilise above 1.6 - 1.8 million: a much lower figure now looks likely. It is difficult to see private sector DB provision, certainly final salary in form, playing more than a minimal role in the future UK pension system.[17]

The future of final salary pensions was also considered by the Conservative Party's working group on economic competitiveness, chaired by John Redwood. In their view:

> …the need to put more into company pension schemes to tackle low bond yields, rising regulatory requirements, the absence of the dividend tax credit, and longer mortality has meant UK companies have had to spend a great deal of their free cash flow on this issue. This has diverted money from much needed investment in plant and equipment, new products and services, and research and development.[18]

A report for Policy Exchange, *Quelling the pensions storm,* found that:

> There are various factors behind the collapse in private sector defined benefit pension provision, but the most important is a big increase in costs arising from:
>
> - legislative changes which have increased members' benefits;
> - reductions in inflation and to average rates of return; and
> - increases in life expectancy…
>
> In addition to these changes, there have been other – sometimes less well-intentioned – sources of extra costs for defined benefit schemes. In particular:
>
> - the National Insurance rebates for contracted-out members no longer match the value of the state benefits foregone (see the Appendix);
> - punitive changes to corporation tax have cost pension schemes billions since 1997, both in direct costs and in lost investment returns;
> - the Pensions Regulator, the Pension Protection Fund and new accounting rules have increased administration costs and encouraged conservative investment decisions.[19]

A more detailed discussion of the influence of the different factors is set out below.

2.2 Demography

People are living longer than they have done in the past. Insofar as the age at which people can take their pension is not raised, the cost of final salary pension schemes has inevitably increased as life expectancy increased. In their report on the causes of the decline in DB

---

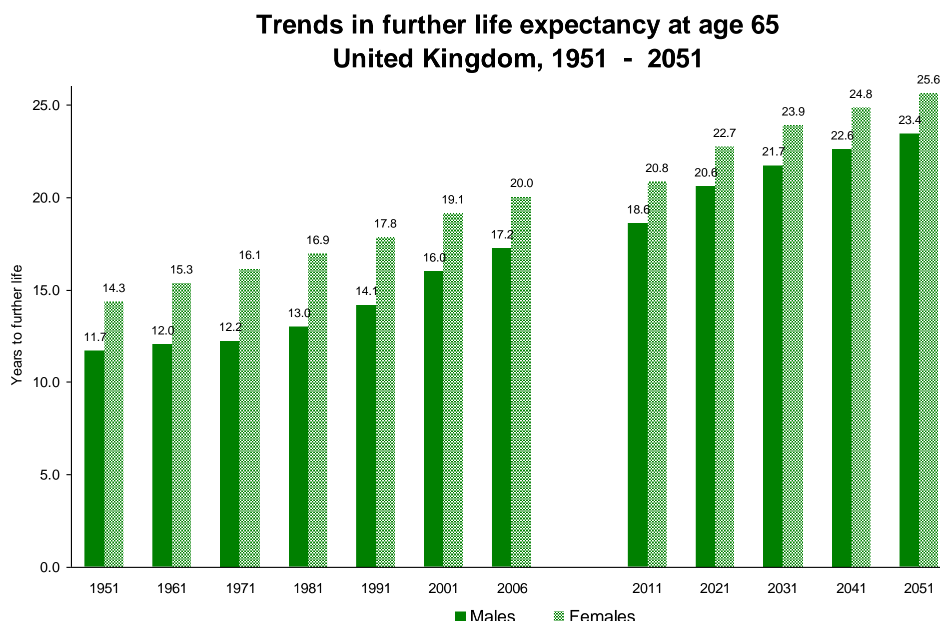
[17] Ibid, p48

[18] Economic Competitiveness Policy Group, Freeing Britain to Compete: Equipping the UK for Globalisation, August 2007, p5,

[19] Hillman N (2008), *Quelling the Pensions Storm – Lessons from the past,*

pension schemes, the PPI concluded that "larger than expected improvements in longevity has potentially placed the largest pressure on private sector DB schemes".[20]

The chart below shows how life expectancy has increased:[21]



Sources:
Government Actuaries Department, UK Interim Life Tables (1980-82 onwards)
English Life Table (England & Wales) ONS, Mortality Statistics (1999) DH1 No.32

The PPI said that schemes had tended to consistently underestimate longevity. Getting this wrong could lead to significant underestimates of pension liabilities:

> …in 1980, when many DB schemes had predominantly male members, the average male life expectancy at age 65 was estimated as being 12 years. Today it is 20 years. In addition, there are now more women participating in the labour market and, therefore, in DB schemes. Women, on average, live longer than men. The average life expectancy of a woman at age 65 today is 22 years.
>
> It is the responsibility of a scheme actuary to estimate future trends in longevity. However, longevity has tended to be consistently underestimated. Even today, when the problems associated with underestimating life expectancy are well documented, there are still examples of schemes making relatively optimistic life expectancy assumptions. For example, the majority of FTSE 100 companies have lower life expectancy assumptions than the estimates provided by the PA 92 tables with 'medium cohort' life expectancy.
>
> Although it is difficult to know without the benefit of hindsight whether optimistic assumptions mean that schemes are underestimating life expectancy, getting mortality rates wrong can lead to significant underestimates of pension liabilities. As such, wrong estimates can ultimately cost scheme sponsors who do not put enough money aside to meet their pension obligations.

[20] PPI, The changing landscape for private sector Defined Benefit pension schemes, 2007,p31

[21] The chart shows actual figures up to 2001. The figure for 2006 is the latest estimate. The figures beyond 2006 are projections.

> The cost of providing for each 65 year old pensioner in a scheme would increase by 3% if mortality assumptions are off by just one year. This rises to 8% if the assumptions are off by three years and to 13% if they are off by five years. For FTSE 100 companies alone the cost could be significant. Each year of extra life expectancy adds around £12 billion to UK pension liabilities for the top 93 companies with a DB scheme.[22]

In February 2008, the Pensions Regulator (TPR) proposed that the adoption of unreasonable mortality assumptions should be a "trigger" factor encouraging it to look more closely at whether a scheme's funding plans were adequate:

> Over the past couple of years there have been significant developments in our knowledge of trends in mortality. It is the regulator's view that some projections that have been in common use can no longer be considered reasonable assumptions. We wish to bring these developments to the attention of trustees and outline how they should go about deciding on funding assumptions for defined benefit schemes.[23]

However, in September 2008 TPR announced that following feedback from the industry, mortality assumptions would only be scrutinised where a scheme was "flagged up by an existing trigger".[24]

Some pension schemes have responded to the financial pressures of pension schemes by attempting to increase the normal retirement age for the scheme. According to the PPI, around one in ten DB schemes have already done this, and another 11% are considering a rise.[25] However, the impact of the Government's agreement with the public sector unions to leave the retirement age at 60 for many existing employees (such as the Civil Service, teachers, and NHS staff) may have been to make it increasingly difficult for private sector schemes to raise normal retirement age.[26] The PPI reported that:

> Over 60% of senior executives felt they would experience some form of impact as a result of the Government's settlement on public sector pensions. Of those that expected to be affected, 63% believed it would make it difficult to negotiate with trade unions and employees.[27]

2.3 Accounting standards

FRS 17 (or its international equivalent IAS 19) has been mandatory for accounting periods beginning on or after 1 January 2005. UK listed companies are required to report their pension costs in accordance with IAS 19 (International Accounting Standard 19), while UK companies not listed on the stock market can choose whether to report their costs using IAS 19 or FRS17 (Financial Reporting Standard 17).[28]

---

[22] Ibid., p23

[23] The Pensions Regulator Press Release, 'Regulator sets out intentions on longevity'. 18 February 2008,

[24] The Pensions Regulator Press Release, 'Regulator publishes response to longevity consultation', 23 September 2008

[25] Ibid., p35

[26] For more information about the public sector pension age see Library Standard Note SN/BT/2209 Public service pension age

[27] PPI, The changing landscape for private sector Defined Benefit pension schemes, 2007, p26

[28] IDS Pension Service, 'Pension trustees and administration', para 9.12

Although the requirement to report pension costs in company accounts does not in itself create pension liabilities,[29] it does appear to have focused attention on the financial implications of pension arrangements. The Accounting Standards Board has said:

> The accounting framework has also changed. For example, many companies have adopted International Financial Reporting Standards ('IFRS'), including IAS 19 'Employer Benefits'. This standard requires deficits or surpluses in pension plans to be reflected in the employer's financial statements and provides a number of options for achieving this. This may have focused attention on the financial implications of pension arrangements, and thus have played a part in some of the developments referred to above. Some have criticised accounting standards for promoting changes which they see as undesirable; others whilst agreeing that recent developments in pensions accounting have improved financial reporting have suggested that it is possible to make further progress in reducing the number of options and enhancing the quality of the information provided.[30]

PPI found "although FRS 17 has added transparency to a company's accounts, it may have inadvertently made DB schemes less attractive to sponsoring employers and trustees."[31]

A 2003 research report for DWP, found that the FRS requirement could act as a prompt to employers to close a scheme:

> For example, a large care organisation was looking to obtain external funding and hence felt that there was a need to reduce costs to a level comparable with other care organisations so that they would look an attractive proposition to potential lenders. The costs of their defined benefit scheme added significantly to their staff costs. The FRS requirement would only have made their costs look even greater and hence was a further prompt to close the scheme. 'When the transitional period for FRS 17 is over, deficits in pension funds will wipe out a lot of organisations' balance sheets and this is a primary reason why defined schemes are closing around the country'. Similarly for a large food services company, the FRS requirement was the 'final straw'.[32]

There has recently been some controversy around the way in which pension scheme liabilities are measured under FRS17. This is discussed in more detail in Library Standard Note SN/BT 4877, Pension Scheme Funding.

2.4 Regulation

The Pensions Commission said that one of the key factors arising from its analysis of trends in DB schemes was that initially there had been a high degree of discretion in employer pension promises. However, over time legislation had removed this discretion:

> - Many of the reasons for growth of private sector occupational provision in the UK were specific to the economic and social policy context of the 1950s to 1970s.
>
> - These pension promises were also put in place in the period when longevity trends were not well understood, with decisions based on expectations of life expectancy which turned out to be far too low.

---

29 HC Deb, 10 March 2003, c84W

30 *Discussion Paper: The Financial Reporting of Pensions,* January 2008

31 PPI, The changing landscape for private sector Defined Benefit pension schemes, 2007, p28

32 Karen Bunt, Lorna Adams and Alistair Kuechel, Pension scheme changes and retirement politics: An employer and employee perspective, DWP Research Report No 194, 2003

> - The original promises were subject to a high degree of discretion, and were only affordable at the originally estimated cost precisely because of that discretion. In particular they treated early leavers badly and often increased pensions in payment less than in line with inflation. But this discretion was removed by legislation during the 1970s, 1980s and 1990s as government, slowly retreating from its role in pension provision, aimed to place more of the burden of adequate pension provision on the voluntary occupational system.[33]

The Pensions Commission concluded that taken together, changes in regulation and context had increased DB costs:

> The combined effect of these changes in regulation and context was that the underlying cost of a typical final salary pension promise as a percentage of salary rose from 10-14% when most schemes were initially designed, to 22-26% today.[34]

Chris Lewin and Ed Sweeney, who conducted an independent deregulatory review of private pension provision for DWP, concluded that the "ever-increasing regulatory burden" was one of two important reasons for the flight from DB schemes in recent years. They argued that an easing of the regulatory burden would create a more level playing field between DB and DC and therefore might encourage more employers once again to consider DB, or an element of DB.[35]

In its response, the Government said that although "each successive layer usually had the aim of protecting scheme members or simplifying the regulatory structure", there was "little doubt that the weight of regulation has contributed to a belief by some employers that the costs and risks of having their own pension schemes are becoming too great." [36]

The PPI argued that the impact of increased regulation was difficult to measure:

> There is a perception that increased regulation has resulted in higher costs for employers. In reality, it is difficult to measure what impact the new rules have had on the cost of running DB schemes. Scheme sponsors report concerns about increased regulation but it is difficult to prove that the regulations have directly influenced employer behaviour. And one must also consider what the counterfactual would be. Part of the policy rationale of the increase in regulation, and the added security it has brought, may have played a role in supporting consumer confidence in pensions. But once again this is difficult to measure.[37]

It concluded that there was no guarantee that allowing schemes extra flexibility[38] would "be sufficient to stem the flow away from DB." Some flexibility to change schemes already existed and despite this, "many sponsors have chosen to drop DB schemes altogether in favour of DC arrangements."[39]

---

[33] Pensions Commission, Second Report: A New Pension Settlement for the Twenty-First Century, November 2005, p124

[34] Ibid., p123

[35] Chris Lewin and Ed Sweeney, 'Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions', Foreword

[36] Deregulatory review – Government response, October 2007, p12

[37] PPI, The changing landscape for private sector Defined Benefit pension schemes, 2007, p25-7

[38] For example, by giving schemes discretion over the rate of pension increases before and/or after retirement or by making it easier for schemes to change their rules in relation to promises already made

[39] PPI, The changing landscape for private sector Defined Benefit pension schemes, 2007, p49

For further discussion of the policy proposals to decrease the pressure on DB schemes, see section 3.1. ("Deregulatory Review of Private Pensions") below.

2.5 Advance Corporation Tax

In his Budget speech on 2 July 1997 the then Chancellor of the Exchequer, Gordon Brown, announced to changes in the taxation of company profits and dividends: first, a cut in the main rate of corporation tax from 33% to 31% to apply from April 1997;[40] and second, the abolition of tax credits paid to pension funds and companies when they received dividend income net of advance corporation tax. The Chancellor also announced that tax credits would be withdrawn from other dividend recipients exempt from income tax – notably charities and non-taxpayers – although not until April 1999. In 1997-98 payments of tax credits before taking account of these changes would have been about £5.25 billion, of which credits to pension schemes and insurance companies were £3.5 billion.[41]

In July 1999, two years after the abolition of dividend tax credits, the then Paymaster General, Dawn Primarolo, was asked to estimate the impact of the change in ACT on pensions; her reply was:

> Our package of corporation tax reforms included not only the abolition of payable tax credits, but also a 2-3 per cent. reduction in the rate of corporation tax. The overall effect on pension funds of these changes will vary depending upon factors like the type of scheme and investment policy adopted. So it is not clear that steps are necessary to limit the impact on pension funds of the abolition of payable tax credits. But during 1997, when tax credits were available for only 6 months, the average British pension fund manager delivered an overall investment return of 16 per cent. and a real return of 12 per cent., which compared very favourably with an average return for the previous year of around 9 per cent.[42]

In answer to a similar parliamentary question in March 2002 the then Financial Secretary, Ruth Kelly, gave the following answer:

> The Government's package of corporation tax reforms included measures to boost corporate investment by removing tax distortions. The withdrawal of payable tax credits on dividends was just one part of these measures. Pension funds will share in the long-term benefits from these changes to corporation tax. The overall effects of these changes on pension funds and future pensions will depend on a variety of factors, including: the type of scheme paying the pension; the take-up of private pensions; the level of future pension contributions; pension schemes' asset allocation and investment policies; and investment returns generally.[43]

The Pensions Commission had reported that:

> …From 1974 to 2000 the average real return on UK equities was 13%, compared with a twentieth century average of about 5.5%. This made increasingly expensive pension provision appear easily affordable to both employers and to government. Employers took contribution holidays, and used pension fund "surpluses" to make early retirement

---

[40] In his March 1998 Budget the Chancellor announced a further 1 percentage point cut in the main rate of corporation tax to 30% from April 1999.

[41] Detailed information on the history of the Advance Corporation Tax and its impact is available in the Library Standard Note SN/BT/581, Advance corporation tax (ACT) and pension funds

[42] HC Deb 13 July 1999 c 184W

[43] HC Deb 4 March 2002 cc110-111W

> packages look like costless alternatives to cash redundancy payments. And the government tightened the tax treatment of pension funds in 1986, 1993 and 1997. In retrospect the actions of both employers and government were based on irrationally exuberant assumptions about sustainable returns.[44]

The PPI said:

> The overall impact on pension funds depends on their chosen asset mix. The cost could be less if pension schemes invested less in UK shares and more in other types of assets, such as bonds, which remain tax free.
>
> These uncertainties mean that it is difficult to determine the cost to pension funds today of removing ACT relief. But it is clear that when the reforms were introduced in 1997 they cost pension funds significantly less than £5 billion per year. It also seems likely that this cost will have reduced over time.[45]

In March 2007, following a finding of the Information Tribunal, the Treasury published five papers prepared in May and June 1997. In a covering note the Department drew attention to the other factors which it argued had had a much greater impact on pension funds.[46]

One of the papers released had been submitted by the Inland Revenue's Financial Institutions Division. The authors argued, "the pensions industry will react to the loss of tax credits with clamour and public consternation. After talking to the Government Actuary's Department, we think that the likely outcome is that pension schemes should be able to cope with the change. But this is a judgment, and there are risks." On the financial impact, the authors estimated the cost to pension providers of "about £4bn a year, growing over time with future dividends. But with companies continuing to distribute the same proportion of pre-tax profits, the cut in CT rate to 30% would reduce this loss to £3.3 billion a year." They went on to note "pension funds generally have significant surpluses on existing assets", although "there are no reliable figures for surpluses available and there will be a wide variation between schemes."[47] A second paper the division issued a few days later stated, "further work continues to suggest that the pensions industry should generally be able to cope", although the lack of information on pension fund surpluses meant that there remained, "a very big uncertainty over the extent to which pension schemes could absorb [the impact]."[48]

A paper from the department's Savings and Investment Division concluded, "the general message is that the big employer pension schemes will be able to cope at some cost to employers. But members of money purchase schemes would all be potential losers."[49] A second paper drew on further work done by the Government Actuary Department on the size of pension fund surpluses that suggested that "total actuarial surpluses could be as much as £60 billion [so that] the immediate impact on employer costs would be substantially cushioned." However these estimates had been based on information the Department had on certain very big schemes: "much of the data is quite old and GAD have had to use some

---

[44] Pensions Commission, Second Report: A New Pension Settlement for the Twenty-First Century, November 2005, pp122-123

[45] Pensions Policy Institute, Is £5 billion being taken every year from pension funds?, PPI Briefing Note Number 22, June 2005

[46] *Payable tax credits – statement to accompany the release of documents,* March 2007, pp3-4

[47] Inland Revenue, *Assessment of impact on pension schemes and insurers,* 15 May 1997, p2, para11, 19

[48] Inland Revenue, *Consideration of options,* 22 May 1997, para 7

[49] Inland Revenue, *Assessment of impact on pension providers and friendly societies,* 21 May 1997, p2

rough and ready assumptions to update it. Also we do not know whether the performance of the very big schemes is typical of those at the smaller end of the range."[50]

The publication was widely reported as showing the Government had "defied repeated warnings" about the likely impact the withdrawal of credits.[51] In an editorial the *Financial Times* acknowledged the other factors undermining DB schemes, but went on to argue that scrapping dividend tax credits was "both a policy and a political error":

> It was a policy error for three reasons: first, it was a destabilising shock to the part of the tax system that most needs stability, namely, that for savings; second, it was not part of a coherent reworking of company taxation, but an attempt to reintroduce an unjustified bias towards retained earnings; and, third, it is quite reasonable for pension funds to accumulate income tax free, as they do on interest receipts. The decision was also a political error: it was a perfect example of the "stealth taxes" that have rightly damaged the chancellor's reputation; furthermore, it gave scheme sponsors and advisers a perfect excuse. They now blame Mr Brown for all their blunders.[52]

Notably, in a subsequent editorial, the paper challenged the notion that the publication of the papers showed the Government had ignored officials' advice.

> The papers are impressive - exactly what one might hope for from the elite of Britain's civil servants. They set out the arguments. The analysis evolves as more information becomes available. The uncertainties are spelt out. And there is debate within the papers and between them - that the measure would create "a big hole" in pension surpluses; that the less well off were the likeliest losers; and that pension funds "should be able to cope", but that "this is a judgment and there are risks", some of which, including a big stock market fall, did not in fact materialise. The chancellor decided to go ahead. That is the way government works. Civil servants advise, ministers decide - and then live with the consequences politically.
>
> As for the argument that the chancellor should have stayed his hand because there were risks: that is outlandish. Ministers have never taken a decision worth the name that did not involve risks, from Aneurin Bevan's nationalisation of the hospitals to Margaret Thatcher's decision to take on the miners or privatise British Gas.[53]

2.6 Economic factors

Market risk

Pension funds invest in a wide range of financial assets, such as equities and bonds, to other assets, such as land and property. The investment return on these assets varies as markets fluctuate. If the returns on the funds are insufficient, the company sponsoring the scheme may have to increase its contributions to make up for the deficiency. This places any additional cost or burden caused by lower than expected investment returns onto the company.

---

50 Inland Revenue, *Consideration of pension fund surpluses and pensioner incomes,* 27 May 1997, paras2, 5

51 For example, "Pension time bomb – Brown defied advice", *Times,* 31 March 2007; "The great pensions heist", *Sunday Times,* 1 April 2007; "Leading Article – Abject Nonsense: Gordon Brown cannot claim not to have been told of the risks to pensions", *Times,* 2 April 2007; "The £100bn stealth tax he hoped we'd never notice", *Times,* 3 April 2007.

52 "Editorial: Brown's pension raid has left a bitter legacy – the chancellor was wrong to ignore the Treasury's warnings", *Financial Times,* 2 April 2007.

53 "Editorial: A fledgling needs the chance to fly", *Financial Times,* 9 April 2007

The Pensions Commission said that high equity returns in the 1980s and 1990s allowed many schemes to ignore the rising underlying costs of pension promises. When returns fell, rapid adjustments were made:

> The exceptional equity returns in the 1980s and 1990s allowed many private sector DB schemes to ignore the rapid rise in the underlying cost of their pension promises. When the fool's paradise came to an end, companies adjusted rapidly, closing DB schemes to new members.[54]

The PPI said that investment return risk for DB schemes could be a particular problem for DB scheme sponsors as "they have an obligation to provide their members with a certain level of pension, regardless of the performance of the stock market or bond yields."[55]

On 24 October, the Pensions Regulator (TPR) issued a "statement to trustees about current financial pressures". This said that TPR's contacts with larger schemes suggested "a relatively limited direct exposure to so called 'toxic' assets and limited involvement in derivative trades with counterparties that are in difficulty." Instead:

> The main issues faced by pension schemes are likely to be firstly the more general fall in asset values, and secondly the emerging pressures on company covenants and ultimately solvency.

Schemes with a deficit are required to have a "recovery plan" in place, indicating the period of time over which the scheme plans to meet its funding objective. Current recovery plans had been drawn up in "relatively benign economic circumstances." TPR anticipated that because of current economic difficulties, those drawn up in 2009 might show larger deficits and "weaker covenants" (i.e. a weakening of the employer's financial position and willingness to continue funding scheme benefits[56]). The expected implications of this were "higher technical provisions" (the "technical provisions" are an estimate of the assets needed to make provision for accrued scheme benefits[57]) and "longer recovery periods being proposed, recognising the emerging pressures on company cash flows and thus affordability".[58]

This issue is discussed in more detail in Library Standard Note SN/BT/4877, Pension scheme funding.

Interest rates and inflation

The nature of pension provision by companies is also dependent on wider and changing economic factors. The PPI has pointed to the volatility of long-term interest rates as "perhaps the primary source of uncertainty when it comes to forecasting the evolution of company pension liabilities".[59] Inflation is also a factor, as this effects both interest rates and on wages. The PPI analysis of final salary pension schemes explained that:

---

[54] Ibid, p125

[55] PPI, The changing landscape for private sector Defined Benefit pension schemes, 2007, p23

[56] The "employer covenant" refers to the strength of the employer's financial position and its willingness to continue funding scheme benefits (ref: TPR's Code of Practice 03 – Funding Defined Benefits, para 57)

[57] TPR's Code of Practice 03 – Funding Defined Benefits, para 22

[58] The Pensions Regulator, 'Statement to trustees about current financial pressures', October 2008; See also TPR Press Release, PN08-26, 'Statement issued to trustees on current market conditions', 24 October 2008.

[59] Ibid., p24

- If inflation falls, as it has been doing for the last ten years, investors will demand less compensation to take on the risk of investment returns being eroded. This means lower nominal interest rates, which in turn means lower discount rates.

- But it is not just investors that take note of inflation. Employees will base their wage demands on expected rises in prices. It is this uncertainty about wage levels that adds an extra layer of uncertainty when calculating future pension obligations, which for DB schemes depend on future salaries.[60]

The labour market

The changing patterns of the labour market also have an effect on the nature of pension provision. The PPI has explained that:

> …a DB scheme may not be the most appropriate pensions saving vehicle for all employees. For example, for employees who frequently switch jobs a portable Defined Contribution scheme may be more suitable. Or, for some workers whose earnings diminish as they approach retirement a career average scheme would be more appropriate than a final salary scheme.
>
> Working patterns are changing. When DB schemes were first established the workforce was mainly male and jobs tended to be for life. This is no longer the case. The employment rate for women has risen from around 56% in 1971 to around 70% in 2005 but women are still more likely to be working part-time than men. Also women are more likely to be economically inactive than men, taking career breaks to care for children or the disabled. So employers could see advantages in providing a flexible DC scheme to cater for a more flexible workforce.

DB provision also depends on the longevity of companies themselves. The PPI concluded that “the primary threat to DB schemes is insolvency of the sponsoring employer”.[61] DB schemes have long been associated with the manufacturing sector. As this sector declines in the UK, the share of companies offering DB schemes decreases further; the 2008 Purple Book showed that:

> Schemes sponsored by firms in the manufacturing sector continue to dominate the Purple sample, constituting more than 35 per cent of schemes and s179 liabilities compared with the sector’s 13 per cent share of economic output.[62]

Lastly, one of the reasons for companies to offer DB schemes is their attractiveness to potential employees as part of a benefits package. Once some firms stop offering DB schemes, the incentive for their rivals to continue to offer such schemes decreases. Furthermore, if employees do not value pensions employers can not use them as a recruitment and retention tool. The PPI said that factors influencing the perceived value of pension provision could include:

> *Unclear interaction between private saving and state benefits.* Due to the complex interaction between private pensions and means-tested benefits, some employers are unsure as to whether it is always in the best interests of some employees to save in an occupational scheme, especially low earners.

---

[60] Ibid., 2007, p24

[61] Ibid., p30

[62] Pensions Regulator and Pension Protection Fund, Purple Book 2008 - Executive Summary, December 2008, p13

Lack of confidence in the financial services industry. This could create a barrier for employers and employees to increasing private saving. 20% of people say that one reason why they have not joined a pension is that they do not trust providers while 18% say that they are worried about poor returns from saving.[63]

2.7 Contribution holidays

A number of schemes took "contribution holidays" in the late 1980s and early 1990s. According to the Pensions Law Review Committee's 1993 report, two main factors contributed to this. Firstly, a huge growth in the real value of income-producing investments during the 1980s, coupled with a substantial reduction in the work force, led to schemes building up substantial surpluses." Secondly, the Government became concerned at the loss of tax resulting from "overfunding" and introduced provisions in the *Finance Act 1986* imposing a tax on income from excess surplus not eliminated within a five year period and a new charge to tax on payments to the employer.[64]

The Pensions Commission's account was as follows:

> But the bigger explanation is the impact of the long equity bull market of the 1980s and 1990s, which in retrospect appears as a period of irrational and unsustainable exuberance. From 1974-2000 the average annual real return on UK equities was 13%. The very long-term historic average is 5.5%. With UK DB pension schemes heavily invested in equities, this made increasingly expensive pension promises appear not only affordable without increased contributions, but even with decreased contributions. Contribution rates had increased during the 1970s to help repair the damage to scheme finances caused by the equities slump of 1974, but as the equity market recovery gathered pace they fell rapidly.
>
> Indeed not only did they fall but they were required to fall by deliberate government policy. HM Treasury had by the early 1980s become concerned that companies were using large pension fund contributions as a means of managing down corporate tax liability in years of high profit. The Finance Act of 1986 therefore required pension funds to identify whether (on certain actuarial assumptions), they had a surplus of 5% or more, and to take action to remove the surplus within five years, or else lose some part of their tax exempt status. The deep dip in contributions seen in the period 1988-91 in Figure 3A.6 almost certainly reflects the impact of this policy.
>
> Even with much lower contributions, however, the impact of high equity market returns was so positive that large surpluses were in many cases still left. These were therefore also used to pay for large early retirement packages in the corporate downsizings of the 1990-92 recession, as an apparently costless alternative to cash redundancy payments. (The latter were charged to the profit and loss account; early retirement packages were not.)[65]

The Commission concluded that the introduction in 1986 of the requirement for large surpluses to be reduced (like the later abolition of tax credits paid to pension funds and companies when they received dividend income net of advance corporation tax) was

---

63 PPI, The changing landscape for private sector Defined Benefit pension schemes, 2007, p31

64 See also, "Pension Law Reform, The Report of the Pension Law Review Committee", CM 2342-I, September 1993, p214

65 Pensions Commission, Pensions: Challenges and Choices: The First Report of the Pensions Commission, October 2004, p124

"predicated on assumptions about the sustainability of long term returns which were over optimistic."[66]

The PPI explains that these contribution holidays became problematic in early 2000 when pension funds entered a period of relatively low investment returns:

> Contribution holidays became problematic when the stock market hit a downturn in early 2000 and pension funds entered a period of low equity returns and relatively low global investment rates. Large pension fund deficits occurred when the net present value of the pension promises became greater than the market value of the assets of the pension fund. These market trends also had the effect of deterring some trustees from investing in equities, instead opting for lower-risk bonds, which are likely to produce lower investment returns than equities.[67]

3 Policy developments and proposals

3.1 Deregulatory Review of Private Pensions

A number of policy measures to reduce the pressures on DB schemes have been proposed. The May 2006 Pensions White Paper announced a "rolling deregulatory review of pensions regulation."[68] This would have the aim of simplifying and reducing the burden of legislation governing private pensions.[69]

Chris Lewin and Ed Sweeney produced an independent report on the issue for DWP in July 2007. They argued that if the regulatory burden and the extent of risk in a DB scheme was reduced, employers would find it easier to consider providing DB or an element of DB provision. The emphasis in their recommendations was on: the introduction of risk-sharing; removing or easing regulatory obstacles in DB schemes which prevented sensible courses of action by companies and moving towards simple out-come related principles in some areas of regulation.[70]

The Government's response to the review emphasised that this is a complex area, in which it is "difficult to strike the right balance between removing legislative burdens and protecting members." It did not believe that there was "a single measure or even a series of measures which would guarantee that employers would continue to provide and even strengthen their existing pension provision." Decisions on some key issues were announced:

- The Government agreed with the reviewers that "it would not be appropriate to make changes which would affect rights which have already accrued."
- It decided not to remove the statutory requirement to increase pensions in payment (Limited Price Indexation).[71] This was an issue on which the reviewers had been unable to agree.[72]

---

66 Ibid
67 PPI, The changing landscape for private sector Defined Benefit pension schemes, 2007, p24
68 DWP, Security in retirement: towards a new pensions system, Cm 6841, May 2006, para 2.42
69 Chris Lewin and Ed Sweeney, Deregulatory Review of Private Pensions. A Consultation Paper. March 2007
70 Chris Lewin and Ed Sweeney, 'Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions', Foreword
71 Ibid, p 4-6

The Government sought views on a number of proposals.[73] In December 2007, the Government said it had decided to legislate on three in particular.[74] Two measures were included in the *Pensions Act 2008:*

- a reduction in the cap applying to the revaluation of deferred pension rights from 5% to 2.5% (intended to apply to further rights, accrued from January 2009); and
- repealing the rules on "safeguarded rights" which currently apply when a pension is shared on divorce or dissolution of a civil partnership.[75]

The Government would introduce regulations to enable a "statutory override" in limited circumstances. It is also continuing work on other issues.[76]

Risk sharing

One of the proposals made to the Deregulatory Review was that there should be a new regulatory framework designed to allow a third type of scheme, which was neither traditional final salary nor defined contribution:

> The type of scheme envisaged would be one where members would accrue benefits on a career average basis, and the age at which the benefits became payable (normal pension age) could move by reference to a longevity index calculated by the actuary. Increases to pensions in payment and revaluation of pensions would be targeted, rather than guaranteed, and would only be paid where scheme funding allowed - in effect, this would remove the requirement to provide LPI and revaluation for these schemes.[77]

Advantages of this sort of "conditionally indexed pension scheme" were said to include the prospect of higher investment returns over the long term and, therefore, lower costs.[78] The Government consulted on the issue, but in December 2007 said it remained to be convinced.[79]

In December 2008, the Government announced that it would look further at a number of reforms that could be made under the current legislative framework. It had decided not to legislate for conditional indexation:

> The opposing views expressed by respondents to this consultation reinforce the need to be vigilant in striking the "balance between member protection and encouraging employer provision of pensions."
>
> The consultation responses included a wide range of suggestions in response to questions about the range of options under **the current framework** and what could be

[72] Chris Lewin and Ed Sweeney, 'Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions', Executive Summary, p1
[73] Ibid, p2
[74] DWP, 'Deregulatory review – Response to consultation', 5 December 2007
[75] Sections 100 to 101, *Pensions Act 2008;* For more information see the Library Standard Note SN/BT/4515, Deregulatory Review of Private Pensions; House of Commons Library Research Paper 07/94, *Pensions Bill [Bill 25 of 2007-08]*
[76] DWP, Deregulatory Review – Response to the consultation, December 2007
[77] Deregulatory review – Government response, October 2007, p12
[78] Ibid
[79] DWP, 'Deregulatory review – Response to consultation', 5 December 2007

done to make risk sharing easier to achieve. On the basis of these suggestions the Government will take forward the following areas of work:

- Consider, with the Pensions Regulator (TPR), what could be done to share information on current risk sharing practices more widely still.
- Work with practitioners and pension lawyers to develop proposals for regulations that will ensure schemes have more scope to introduce flexibility in the way pensions accrue for future service to reflect changing longevity with the aim of consulting by spring 2009 at the latest.
- Gather further evidence on whether the requirement to index pensions in payment is appropriate for cash balance schemes and subsequently consider the practical consequences of abolishing this requirement.
- Institute a general review of the burdens imposed by the arrangements for contracting out.
- Take forward other wider deregulatory review initiatives such as on employer debt.

Removing mandatory indexation would be a simple and radical deregulation, and although the Government rejected this proposal when it was raised by Chris Lewin in his report with Ed Sweeney, it has now seriously examined the case for reversing that decision in the light of responses to this consultation. However, in the absence of compelling evidence that such a move would reinvigorate DB provision, the Government still believes that the removal of this important protection for members would not strike the right balance between employer concerns and member protection.

The Government has carefully considered the arguments for and against conditional indexation. Significant additional regulation would be required to provide an appropriate framework for such an approach and the complexity would inevitably hamper member understanding and potentially undermine member confidence. The Government is also unconvinced that there is sufficient demand from employers to justify taking such measures. Finally, the consultation has demonstrated that there is, at present, no workable consensus on this proposal.

The Government's view is that the consultation has not provided the weight of evidence that this proposal is likely to make the significant impact on the level of DB provision that would have justified overriding the concerns of member representatives. It has therefore decided not to pursue conditional indexation at this time.[80]

The Government is to undertake further work on the detail of how "collective DC schemes" might operate in the UK.[81] In the Netherlands, such schemes work in a similar way to conditional indexation schemes, with expected benefit levels still calculated according to average salaries:

> 4.16 The key difference is that such schemes set a fixed employer contribution, meaning that nominal benefits are not guaranteed in the same way as under a conditional indexation scheme. The conditional indexation element and cuts to accrued benefits bring no direct financial benefit to the sponsor who always pays a fixed contribution. On this basis, these schemes are classed as DC rather than DB.

---

[80] DWP, 'Risk sharing consultation: Government response', December 2008

[81] Ibid, p2

> The introduction of this type of scheme is a recent development and it therefore remains to be seen whether an employer would, in practice, bail out a collective DC scheme if it was significantly underfunded.[82]

The decision not to pursue conditional indexation was met with some disappointment. The chair of the Association of Consulting Actuaries said that:

> Without a new 'middle way' option that better allows employers to cap DB costs for the future, the vast majority of private sector employees will be moved into defined contribution. The absence of choice under the current legislation leaves few other realistic options – but the absence of choice certainly won't halt defined benefit scheme closures.[83]

Joanne Segars, Chief Executive of the National Association of Pensions Funds said:

> A clear opportunity to ease the pressure on employers who support defined benefit pension schemes has been missed. In the current economic climate, a bold approach is needed to secure defined benefit provision in the same way a bold approach has been taken for other parts of the financial sector.

However, Hamish Wilson said a move towards "collective DC could solve the problems of public sector pensions."[84]

Circumstances triggering an employer debt

When an employer exits a multi-employer scheme, this may trigger an "employer debt". The purpose of the rule is to prevent employers from walking away from their pension promises:

> At present, where an employer exits a multi-employer pension scheme, whether due to a sale, due to an internal reorganisation or because it no longer employs an active member, a "cessation event" is triggered and a debt arises unless the scheme is funded to a buyout level. The debt that the departing employer must pay is its "share of the difference" between the funding level of the scheme and the projected buyout level. The employer's share is calculated (or at any rate supposed to be calculated) based on the past pensionable service of employees employed by that employer; so-called "orphan" debt arising from unattributed liabilities to members is then allocated based on the proportion of the ceding employer's attributed debt.[85]

Chris Lewin and Ed Sweeney, who produced an independent report for DWP as part of the Deregulatory Review, were told that these rules created "unacceptable difficulties".[86] They recommended a twelve month period of grace before a "cessation event" was triggered in order to alleviate many of the problems experienced by small employers with only a few staff. The Government has accepted this and consulted on draft regulations.[87]

The reviewers set out their general thinking on employer debt in the context of group reorganisation:

---

[82] DWP, 'Risk sharing consultation', June 2008

[83] Jemma Towler, 'Rejection of indexation spells death knell of DB', Professional Pensions, 18 December 2008

[84] Ibid

[85] Chris Lewin and Ed Sweeney, 'Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions', p36

[86] Ibid

[87] DWP, 'Deregulatory review – Government response', October 2007

> Where there is a group reconstruction of employers in a multi employer scheme, the principle should be established that the debt should not be triggered where the original covenant was strong, and if the remaining employers' covenant remains as strong, following the reconstruction, as the original covenant. The judgement as to whether the covenant remains intact should be the responsibility of the trustees, after taking appropriate professional advice. However, one of us (Chris Lewin) recommends that, where the original covenant is potentially weak, provided it remains unchanged after the reconstruction, the debt should still not be triggered.[88]

In its response, the Government said the purpose of the legislation on employer debt (Section 75 of the *Pensions Act 1995*) is to "ensure that an employer cannot 'walk away' from their pension obligations without ensuring that they are properly funded."[89] It accepted that the provisions could create difficulty for employers wishing to undertake a reorganisation and would continue to look at the issue:

> The Government also accepts that the current provisions may create difficulties for employers who wish to undertake a reorganisation and believes that, in principle, there is much to be said for distinguishing between reorganisations and complete severance of an employer from a scheme. However, this is a difficult area and it may not be easy to find a way to address this without creating loopholes within legislation. In addition to the changes already outlined in draft amending regulations, the Government intends to work with the industry over the coming months to seek a practical solution to the difficulties created by the current provisions which does not undermine the principle that employers should fully meet their pension obligations.[90]

In December 2007 the Government said it might not be easy to address this area without creating loopholes:

> the Government intends to work with the industry over the coming months to seek a practical solution to the difficulties created by the current provisions which does not undermine the principle that employers should fully meet their pension obligations. It will be necessary to scope the work and involve interested stakeholders. The Government will start to take this work forward in the New Year.[91]

In November 2008, it said an informal consultation on the issue was under way.[92] *Professional Pensions* reported on 9 March 2009 that DWP expected to launch a formal consultation in the spring, with a view to introducing changes later in 2009, should it "find a practical solution without creating loopholes."[93]

Treatment of surplus

In March 2001, in a review of institutional investment for the Treasury, Paul Myners commented that although employers were "rightly responsible in full for any deficit on the fund (at least up to the limit prescribed by the Minimum Funding Requirement (MFR))", they had "uncertain and partial right to any surplus".[94] The context was disputes over surpluses

---

[88] Chris Lewin and Ed Sweeney, 'Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions', para 148

[89] DWP, 'Deregulatory review – Government response', October 2007

[90] Ibid, p15

[91] DWP, Deregulatory review – Response to consultation, December 2007, p14

[92] HL Deb, 19 November 2008, c1160

[93] "DWP to relax s75 employer debt regulations", *Professional Pensions,* 10 March 2009

[94] Myners P, Institutional investment in the United Kingdom: a review, 6 March 2001; p 108

which had been the subject of a number of court cases in recent years.[95] Myners criticised the existing arrangements and argued that they had three adverse effects. First, they encouraged pension funds to be excessively risk averse because there would be limited gain from increased performance in a fund. Second, the uncertainty over access to surpluses would discourage employers from offering DB occupational pension schemes. Third, sponsoring companies would have less incentive to take an interest in the management of scheme assets because they had little to gain from any higher than expected growth. He concluded that that pension policy since Maxwell had paid insufficient attention to these arguments and "viewed the sponsor's involvement in a trust's affairs as likely to be against the interests of beneficiaries and therefore to be prevented as far as possible".[96]

In a reply to a Parliamentary Question in June 2002, Ian McCartney, the then Pensions Minister, said that the Government had no plans to change the law on pension surpluses, despite concerns that the rules encouraged employers to take a contributions holiday.[97]

The Pensions White Paper, published in June 2003 announced the Government's intention of legislating to restrict the right of solvent employers to take money out of a scheme unless it can meet its pension promise in full:

> 13. The Government believes that a solvent employer who chooses to wind up a scheme should ensure that there are sufficient funds in the scheme to meet the full costs of the rights accrued by scheme members unless doing so would put the company itself at risk, in which case the trustees, exercising their fiduciary duties, can agree a lower amount. We will introduce a full buy-out provision through regulations which we are consulting on as set out in the timetable in Chapter 5. Trustees may utilise these regulations so that they apply to schemes that are winding up on, or that start to wind up after, the date on which the draft regulations are issued.
>
> 14. In line with the full buy-out proposal we will restrict the ability of companies to take money out of a scheme which is in surplus on its own funding basis, unless the scheme can meet its pension promise in full – that is, it is funded to a level sufficient to allow full buy-out. Levels of contributions would continue to be subject to agreement between trustees and employers as at present.[98]

This was legislated for in section 250, *Pensions Act 2004.*

In their report to DWP as part of the *Deregulatory Review of Private Pensions,* Lewin and Sweeney reported concerns that the requirements for return of any surplus might be too onerous:

> 96. From 6 April 2006, legislation has allowed trustees to authorise payment to the employer from the funds of an ongoing defined benefit pension scheme, provided the scheme is funded to a "full buy-out" level and the trustees are satisfied that such a payment is in their members' interest.

---

[95] For example, *Edge vs Pensions Ombudsman*, July 1999 and *National Grid vs Laws,* May 1999

[96] Myners P, Institutional investment in the United Kingdom: a review, 6 March 2001; p 108

[97] HC Deb 11 June 2002, cc 1141-2W

[98] Department for Work and Pensions, Simplicity, security and choice: working and saving for retirement: action on occupational pensions, June 2003, Cm 5835.

> 97. Some concerns have been expressed that these requirements for return of surplus may be too onerous, and that they may be leading some employers to resist agreeing to appropriately strong funding objectives. While excess funding levels (or "surpluses") have not been an issue for most schemes recently, there are those who believe that scheme funding levels will significantly improve in the near future.[99]

They recommended that a return of surplus should be allowed where the scheme has reached the scheme funding targets and trustees agree:

> The current provisions in section 37 of the Pensions Act 1995 should be amended to allow return of surplus to employers once the scheme has reached the scheme specific funding target and the trustees agree at that time that such a payment should be made. The existing explicit statutory requirement that the trustees must be satisfied that any surplus return is in the members' interests before giving their agreement should be repealed, on the grounds that it encourages overly conservative behaviour by trustees, who already have their fiduciary duties to observe.[100]

The Government did not agree with this recommendation, on the grounds that it had potential "significantly to jeopardise the current level of protection for scheme members." However, it undertook to explore the scope for addressing employer concerns further.[101] Organisations such as CBI have argued that there should be a change in the rules:

> Many CBI members perceive the regulations guiding the return of surplus to employers as unduly restrictive. Members believe more flexibility may be necessary in the future if surpluses start to arise. The CBI therefore believes that this issue should be kept under active review.[102]

Other proposals

The National Association of Pension Funds (NAPF) recently called for "exceptional measures" to help pension schemes in the economic downturn:

> These exceptional times call for exceptional measures and new thinking that goes to the heart of maintaining strong workplace pension provision in the UK. We have seen the Government take bold action in relation to the banking sector and to underwrite loans to small businesses, to both support the viability of these companies and to revitalise liquidity in the credit markets, for examples. Similar action is now needed for the UK's pension scheme.[103]

Its proposed action plan included:

- Improving scheme efficiencies by "facilitating and encouraging scheme consolidation where appropriate". DB scheme members would "gain if investment risks were reduced, returns are increased and/or scheme administration costs are reduced as schemes benefit from scale economies."
- Ease pressure on scheme sponsors through the greater issuance by Government of long-dated gilts which will ease the pressure on scheme sponsor balance sheets

---

[99] Chris Lewin and Ed Sweeney, 'Deregulatory Review of Private Pensions, An independent report to the Department for Work and Pensions', Foreword

[100] Ibid., p3

[101] DWP, 'Deregulatory review – Government response', October 2007, p15

[102] CBI official response to Sweeney/Lewin Deregulatory Review of Private Pensions, 30 April 2007

[103] NAPF, Pension Provision and the Economic Crisis, January 2009

and, beneficially, provide Government with access to funding at low rates of interest.[104]

Nicholas Hillman, in a report for Policy Exchange made a number of proposals, including allowing schemes more flexibility to respond to increasing longevity:

> The Government have said categorically that there can be no changes to the value of pensions that have already accrued. Yet there has been insufficient debate on this issue to date. Given the increase in life expectancy that has occoured, much of which was unexpected, there are strong arguments in favour of allowing schemes to look again at the age at which full benefits can be received for past as well as future service. This would replicate what Governments of both hues have done to the State Pension age, which is to rise for past and future accrual alike.[105]

He also proposed that there should be closer alignment of the benefits available from public sector and private sector schemes:

> There is little rationale for public sector pension schemes having more generous rules on issues such as indexation of pensions in payment and revaluation of deferred pensions, which – in contrast to the private sector – are uncapped and therefore more costly. Aligning the benefit rules in these areas would go some way to tackling the justifiable sense of unfairness that exists among those working outside of the public sector. There is also a case for raising the normal pension age from 60 to 65 for all staff, and not only new recruits as the Government have proposed.[106]

4 Scheme responses

There are a number of steps schemes can take to contain their future pension costs. The PPI found that scheme sponsors had been changing DB provision in a number of different ways:

- **Reducing deficits.** Scheme sponsors have taken measures to increase scheme assets and/or to reduce liabilities.
- **Changing investment strategy.** Pension schemes have been attempting to reduce the size of the deficit or to help stop deficits growing by changing their investment strategy.
- **Reducing the risk and / or level of pension provision.** Many DB schemes have been closed to new members and the replacement schemes are predominantly DC schemes, which can be less generous, place greater risk on the employee and have lower take-up rates. However, some employers have adopted hybrid or risk-sharing schemes, which spread the costs and risks of the pension scheme between employers and employees.
- **Winding up or selling on pension provision.** Although still relatively uncommon, buy-outs are becoming a viable option for some employers. A buy-out is when a

[104] NAPF Press Release, 23 January 2009, 'Economic crisis leads to need for radical action to help UK pension schemes'
[105] Nicholas Hillman N, Quelling the Pensions Storm – Lessons from the past, 2008, p19
[106] Ibid, p21

company sells a closed but fully funded pension scheme to a third party, usually an insurance company.[107]

The National Association of Pension Funds (NAPF) recently conducted a survey of its members in January 2009 to assess the impact of the economic downturn on pension schemes. It found that the likelihood that employers would make changes to their scheme had increased significantly:

> 52% of defined benefit (salary-related) pension schemes currently open to new members could close as a result of the current economic crisis. This is equivalent to 1,000 pension schemes.[108]

The Pensions Regulator's powers to protect scheme benefits

As explained above, one option is for a DB scheme to transfer its liabilities to an insurance company that is authorised and regulated by the Financial Services Authority (FSA) and wind up the scheme. This allows the scheme a clean break from any residual pension liabilities. This is called "full buy-out". Partial buy-out - where part of a scheme's liabilities is transferred to an insurer – is also an option.[109]

Recently, DWP and the Pensions Regulator have become concerned at the development of new business models, which have been described as "non-insured buy-out models" or "alternatives to buy out". These may look to "sever the link between the employer and the pension scheme, in order to operate well-funded occupational pension schemes for profit but to the possible detriment of scheme members."[110]

Following consultation, therefore, it introduced amendments to tPR's powers through section 126 of the *Pensions Act 2008.* TPR is now able to issue a notice that a contribution must be made to a scheme where it is of the opinion that "an act or failure to act has detrimentally affected in a material way the likelihood of the accrued scheme benefits being received." Previously, the test was that the "main purpose" of the act or failure to act had been to avoid the employer's debt to the scheme. The Government considered that this test of intent might "frustrate the use of the regulator's powers even in circumstances where intervention may be appropriate."[111] The Government also removed an "evidential hurdle" requiring tPR to "prove that a person's intent was to avoid a debt and to prove that the act was undertaken in bad faith."[112]

This is discussed in more detail in Library Standard Note SN/BT/4368, Pensions Regulator – Anti-avoidance powers.

---

[107] PPI, The changing landscape for private sector Defined Benefit pension schemes, 2007
[108] NAPF, Pension Provision and the Economic Crisis, January 2009; NAPF Press Release, 23 January 2009, 'Economic crisis leads to need for radical action to help UK pension schemes'
[109] See, for example, Lane Clark and Peacock, Pension Buyouts 2008
[110] DWP, Consultation on the powers of the pensions regulator, 25 April 2008
[111] HL Deb, 27 October 2008, c1430; *Pensions Act 2008 – Explanatory Notes*, para 369
[112] HL Deb, 27 October 2008, c1433

5 Further reading

Economic Competitiveness Policy Group, Freeing Britain to Compete: Equipping the UK for Globalisation, August 2007

Nicholas Hillman N, Quelling the Pensions Storm – Lessons from the past, 2008

National Association of Pension Funds, Pension Provision and the Economic Crisis, January 2009

National Association of Pension Funds, Annual Survey 2008, October 2008

Pensions Policy Institute, The changing landscape for private sector Defined Benefit pension schemes, October 2007

Pensions Commission, Pensions: Challenges and Choices: The First Report of the Pensions Commission, October 2004

Pensions Commission, A New Pension Settlement for the Twenty-First Century: The Second Report of the Pensions Commission, November 2005

The final report of the Pensions Commission, April 2006

The Pensions Regulator and the Pensions Protection Fund, The Purple Book. DB Pensions Universe Risk Profile 2008