No more clocking off?

In part one of our major new series, Jane Pickard explains why the old pensions model collapsed, and explores how employers are trying to make the sums add up again

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Recessions come and go and some, like this one, are worse than others. But the losses incurred by individuals and companies in their pension schemes over the past year have been completely unprecedented. So, exactly what has been going on?

The problem

Between January 2008 and March this year, more than £105 billion was wiped off the value of UK companies' final-salary pension schemes, according to calculations by consultants Aon. This represented between one-sixth and one-fifth of pension fund assets. As Marcus Hurd, head of corporate solutions at Aon UK, says: "It's the biggest drop in pension values we have ever seen."

So it's not surprising these big defined benefit (DB) schemes are declaring huge deficits because of the crash in value of the shares and bonds in which they invest. They review and report on the state of their funding every three years, but nowadays they have to "mark to market", declaring the value on a particular day, which means the 25 per cent or so of schemes coming up for their triennial valuation this spring were somewhat unlucky. The Pension Protection Fund (PPF) index of 7,400 companies shows that total deficits reached £253 billion at the end of March, compared with £81 billion a year earlier. Among the largest are BT's and Royal Mail's. The latter headed the top 10 biggest deficits published last year by consultancy Lane Clark and Peacock. According to the report in December on Royal Mail by Richard Hooper, chair of the government's postal services sector review panel, its pension scheme had a deficit of £3.4 billion in 2006 with the most recent estimate putting it at £5.9 billion (a figure confirmed as £6.8 billion as PM went to press). He observed that this was "six times larger than the cash generated annually by its business operations" and contributed significantly to its financial pressures.

Such deficits have caused an acceleration in the flight of companies out of final salary pensions into other types of pension, particularly defined contribution (DC) schemes, where employees take the risk.

However, a disaster of even greater proportions has scythed through individual pension pots held in corporate DC schemes, where members have lost on average 29 per cent of their fund value in the past 18 months, according to Aon's calculations. For those retiring in the next two to five years, it estimates 40 per cent has been wiped off their pensions. They will have a choice between working another seven years or so, or facing a poverty-stricken old age. But for everyone, it's money they invested which could have been spent and now has gone.

The situation was summed up by Pensions Management Institute (PMI) president Steve Delo at the institute's spring conference in March: "The nation needs to be aware that widespread retirement in one's early sixties
is no longer going to be feasible and to prepare for a combination of longer working and less consumption."

The causes
But why are things so bad? After all, previous recessions haven't led to such a crisis. This is partly because company pensions are relatively recent. Go back to the 1930s depression and, with a few exceptions, they didn't exist. Company pensions came in after the second world war and all were final salary schemes. They took off through the 1950s, 1960s and 1970s until most employees of large companies could expect to retire at 60 or 65 on around a half or two-thirds of their final salary with contributions paid by the employer into a scheme which was compulsory.

However, this was all at the discretion of the employer. If the company ran into serious financial problems, it could stop paying. If it went bust, there was no protection. And when inflation started to roar away in the 1970s, it became clear that if you had left a job 10 years earlier, the then final salary which would determine your pension would not prove to be worth very much. In the late 1980s, the government decreed that these pension pots should be increased in value in line with price increases (that is, indexed to inflation).

From then on, in the wake of various pension scandals such as Robert Maxwell's misappropriation of Mirror Group pension funds, which came to light in the early 1990s, governments brought in a series of protective laws which many experts believe has had the perverse effect of weakening schemes.

Mike Sullivan, vice president of the PMI and head of employee benefits at service provider Veolia, describes regulation as the straw that broke the camel's back, in particular the 1987 law which meant a company could no longer compel people to join their scheme. He also points out that deficits weren't even stated on company balance sheets until the FRS17 accounting standard was introduced in 2003.

Joanne Segars, chief executive of the National Association of Pension Funds (NAPF), puts the volume of regulation at the top of her list of problems, with FRS17 second, followed by the impact of falling markets and longevity. She says that since 1995 there have been more than 700 sets of regulations, four acts of Parliament and the creation of the Financial Services Authority, the Pensions Regulator and the Pensions Protection Fund. Regulations

NAPF cites as unhelpful include the indexation of pension payments in 1997, and inflexibility over changing the age at which pension is paid. One other feature of the 1980s, which seems crazy in retrospect, was the tendency of many companies to take pensions "holidays", suspending contributions to their schemes. This was because the big stock market gains of the time meant schemes built up surpluses and governments did not want employers hiding away taxable assets in their pension funds. So surpluses were capped and the potential for companies to save money for the rainy day we are now experiencing was lost.

The final blow to pensions emerged in the last decade with the realisation that people were living longer, while stock markets became more volatile and delivered lower returns. Longevity has become an increasing and controversial issue, with actuaries tending to predict the average age of mortality being around 88 or 90 in 30 years' time. The idea that people will continue to live longer is challenged by some. Mike Sullivan says: "My personal view is that the life expectancy issue will get to a peak soon. Extreme levels of obesity, alcohol and substance abuse by the young and others will start to affect it… Statistics only tell you what's happened in the past."

The solutions

Given that the causes of the crisis are many and complex, what can be done about it?

Experts frustrated with regulation are lobbying the government. NAPF has issued a six-point action plan calling on ministers to, among other things, provide flexibility in scheme rules on retirement ages and indexation. However, for most companies, the immediate cost and riskiness of DB schemes are the problem and the simple solution is therefore to switch new members and/or existing members to DC or at least away from final salary. BT, for example, has switched from a final salary to a career average basis, raising the retirement age from 60 to 65. It has also improved the company's defined contribution scheme, upping the contributions and turning it into a corporate self-invested personal pension plan (CSIPP).

More than two-thirds of DB schemes had closed to new members by the end of last year, usually putting new recruits into a DC scheme. But that was before the worst of the financial crisis. A survey by NAPF reported in January that 52 per cent of DB schemes which remain open to new members expect to close this option - equivalent, says NAPF, to the closure of 1,000 UK private sector schemes. Moreover, 27 per cent of DB schemes which are already closed to new members and 24 per cent of those which remain open intend to switch existing members to some form of DC or hybrid/career average scheme.

The first company to do this, in 2006, was Rentokil. Debra Hayes, its pensions manager, says that the company had already closed the scheme to new recruits. Unfortunately, after a restructuring in 2005, new recruits included most of the senior management team. So the disparity between those enjoying the superior benefits of the final salary scheme and the new people on the DC scheme "was becoming a bit of an issue," she says. In addition, there was a £350 million pensions deficit. Hayes says the company put a substantial sum into the fund to meet the shortfall and decided to close the scheme to its 3,000 members to remove the risk posed by future salary increases.

Reports at the time also cited the pressure on companies by the Pensions Regulator to get rid of their deficits in 10 years. A third motive was the lack of staff mobility caused by the scheme: "DB had become almost a golden handcuff because people were with the company for the pension scheme rather than anything else," says Hayes. Rentokil is now one of the few companies with a scheme that is in surplus.

When a company takes such action, the employees' existing pension rights remain protected, but future savings are in the new scheme.

However, switching people to DC schemes means employees shoulder the risk and, when the switch occurs, most companies cut their contributions. Government statistics show that in 2007, the average employer contribution rate for private-sector DB schemes was 15.6 per cent of salary compared with 6.5 per cent for DC schemes (although Rentokil pays 6 per cent, 8 per cent or 10 per cent depending on employee contributions). Employees also paid in less: 2.7 per cent rather than 4.9 per cent in DB schemes.

Steve Rumbles, head of DC at investment manager BlackRock, says that if you are 20 years old and save for 40 years in DC scheme, you need a combined contribution of 14 per cent to get the two-thirds pension people used to expect from a final salary scheme. If you and your employer saved 14 per cent for 15 to 20 years, your pension would be more than halved. And if you are in that position and retiring this year, you could be looking at a pension of five or 10 per cent. “So the 9 per cent currently going in to most DC schemes is too low,” he says.

Contributions could get lower still. In 2012, pensions legislation comes into force which many predict will tempt companies to drop their contributions to 3 per cent – the minimum required under the new law. This is because all employees will be automatically enrolled into a pension scheme to which employers must contribute. Staff who don’t want to be in the scheme will have to opt out. With 47 per cent of adult employees not in a pension scheme in 2005-06, sheer inertia makes it likely that pension schemes will expand, making it more costly.

But the flight to DC is not the only option for a company. Like BT, it can save money by increasing the retirement age, or switching to a career average basis for calculating pension rather than final salary. It can also reduce the accrual rate. There are various hybrid schemes which combine elements of DB and DC, for instance offering a DC scheme to employees up to the age of 40 and a final salary scheme after that.

Many companies are capping pensionable pay rises. Marks and Spencer announced in January that, from October this year, only pay increases up to 1 per cent – or less if inflation was lower – would be counted towards the salary used to calculate pension. It had already closed its scheme to new members. The company says the DB scheme cost £300 million over three years which was half the company’s annual profits. Its scheme will be cheaper as a result, but does not put employees at the mercy of stock markets.

Marcus Hurd, of Aon, dismisses some of these ideas as “tinkering”, believing instead that “schemes should look into deferring contributions and making alternative forms of contribution to cash”. A lot of companies Aon advises are providing property or a bank guarantee in place of cash to help pay off their deficits, says Hurd, adding that some employers are looking to suspend contributions for two or three years. Aon itself recently announced it was cutting contributions to its own DC pension scheme from 12 per cent to 6 per cent, although it will pay more for members who make higher contributions.

A more liberal approach than cutting employer contributions is to raise employee contributions. A survey by Hewitt Associates in January showed increasing contributions was the most popular alternative in the recent past. It was what PepsiCo opted for a few years ago although it raised the employer contribution as well (this was before the credit crunch). Jackie Orme, chief executive of the CIPD, was then chief personnel officer and vice president, HR, for PepsiCo's UK and Ireland business and persuaded the board to retain its final salary pension when alternatives were being discussed. Her defence of it shows how senior HR professionals can influence business strategy on pensions in the interests of employees as well as the company.

Orme says PepsiCo was market-driven on compensation and saw its role as a good employer as an important aspect of its contribution to the community. "So it was important to provide long term security," she says. PepsiCo still offers its final salary scheme. But in today's harsh economic climate, it is clear that many companies will be driven to DC schemes by the extra cost and risk involved in staying with DB.

Orme believes this need not be the end of good pension provision, pointing out that an employer could make generous contributions to a DC scheme. "A few years ago, an HR professional may have thought the business needed to look at a move to a career average scheme. Now they might be thinking about making a DC scheme attractive enough to attract talent and engage staff without damaging the business," she says.

Another motive for the switch to DC is the development of total reward. Companies often view DC schemes as fitting more easily than a final salary pension into a flexible benefits package. Charles Cotton, CIPD adviser, reward, says pensions are increasingly being seen as a part of the total reward package.

For those who want to support continued investment in good quality pensions, there is little hard evidence about whether they provide a business benefit. The CIPD has teamed up with BlackRock to commission research into this. What surveys there are indicate that pensions are rated highly by employees and could therefore be assumed to help attraction, retention and motivation.

For Sean Wheeler, people development director at the hotel chain Malmaison, introducing a new, improved DC pension scheme was a critical part of his recruitment and retention strategy. Faced with a rapidly growing company a few years ago, he really needed to attract people: "Before that, we had a stakeholder pension and no-one did anything with it; we didn't contribute and no-one joined it." Staff turnover is now about one-third of the industry average, says Wheeler.

Orme believes people need to recognise pensions as a tool in the competition for talent and as a creator of real employee engagement while understanding the cost and risk to the business which they pose. "There's an important strategic role for HR people to play on pensions and that's about holding these four issues – talent, engagement, cost and risk - in balance," she says.

"It requires HR to be great employee advocates as well as business people," she adds. "If you only understand it numerically you might as well go and join the finance function and if you only understand the employee relations aspects, you won't succeed.

“But these four things don’t stay static and the trick for HR is to handle the changing environment. For instance, you might say ‘This is a low cost DC scheme, so it’s good from a finance point of view, but it doesn’t score on engagement and talent.’”

If HR can grasp this balance and make its influence felt, there could perhaps be some future for good quality company pension schemes.

Pensions: know the lingo

DB Defined benefit: a scheme where the pension is fixed by a formula – usually one-sixtieth or one-eightieth of final salary multiplied by years of service. The risk of a funding deficit is borne by the employer. More than 8.5 million people are in DB schemes, says the Pensions Regulator.

DC Defined contribution: a scheme where the amount contributed is known but the pension relies on the performance of the fund, passing the risk to the employee. About 5.5 million people belong to registered occupational DC schemes.

CSIPP Corporate self-invested personal pension: similar to a GPP but allowing a wider range of investments including share options.

Deficit The amount by which a pension scheme’s liabilities exceed its assets.

FRS17 An accounting standard for the presentation of DB schemes in company accounts, introduced in 2003. Requires deficits and surpluses to be stated using current market conditions, meaning pension costs cannot be averaged out over years.

GPP Group personal pension: a type of DC scheme. Individuals have their own pension funds but they are grouped as part of company schemes, usually with employer contributions.

Hybrid scheme A scheme combining aspects of DB and DC. Some put career average schemes in this category.

Rate of accrual The element of the formula for calculating final salary pensions (for example, the “one-sixtieth”).

Trustees People responsible for ensuring the company (sponsor) offering a pension scheme fulfils its promise (covenant) to pay pensions accrued to date. They do not have powers to determine the future benefit structure of the scheme. GPPs and CSIPPs do not need trustees.