



A KPMG
Special Report:

The Great British Pensions Dilemma

The country's working population is getting older while the holes in company and state pension funds are getting deeper. To put it bluntly, pensions in the UK are in big trouble, a picture made immeasurably worse by the tumultuous economic events of the last two years.

The system is so out of balance that according to the annual KPMG Pensions Repayment Monitor for 2009, FTSE 100 companies are now paying more in pension payments for former employees than they are for existing ones.

All of which makes the job of company owners and directors even more difficult as they seek ways to reward their staff and help them build towards a retirement pot, but in a way that the company itself can afford.

In this special report, Linda Bell and her team from KPMG's Pensions Division, who advise companies on the options open to them and how to deal with legacy pension promises to ex-employees, reflect on some of the key issues.

What should the future hold?

Katie Sokolowski explores the reasons why changes are being made.

The decline of defined benefit (DB) schemes has been well documented in recent years. DB benefits are "guaranteed" by the employer and the costs of providing them have soared. In fact, most private sector DB schemes in the UK are now closed to new employees who are offered defined contribution (DC), also known as money purchase, pensions instead.

BT, Marks and Spencer, British Airways, Barclays, BBC, W.H. Smith, IBM are just a few of the high profile companies who have made changes to their DB schemes. Some have closed the schemes entirely, meaning no employees can continue to earn towards a DB pensions.

WHY ARE THEY DOING THIS?

Companies are facing large deficits in these unprecedented economic times and they have to find the cash to plug them. Most of the cost relates to paying the pensions for former employees but these "accrued" benefits cannot be touched, nor can they for current employees who are part of the DB scheme. So making changes to the future pensions of current employees is one way to try to reduce costs. It also stops adding to the scheme's liabilities and therefore prevents building up further problems.

But there are other complications in the system. Many firms are running two tier pension systems as an indirect consequence of closing their DB schemes to new entrants. Employees of the same age, doing the same job, earning the same wage can be receiving very different pension benefits if one is DB and one DC. Firstly the cost can be very different – average employer DB contributions are often 15-20% compared with average DC contributions which are closer to 7%. Even where company costs are similar a DC scheme offers greater flexibility and choice but at much greater risk to the individual.

Employers sometimes cite competitive pressures as a reason for making changes. Newer companies rarely operate a DB scheme which means they have a lower cost base; some companies can find themselves at a disadvantage if they are having to spend time and money on a DB scheme, potentially making them less profitable and less attractive to investors.

A further consideration: it is often the case that when a new senior team is brought in, one that does not enjoy the DB scheme themselves, they recognise that there is a large cross-subsidy from one group of employees to another and seek to limit the discrepancies that arise. Whilst DB members never want to lose their generous benefits, often the rest of the workforce are pleased to see a cap put in place on the liabilities they have to work to pay for.

SO HOW CAN AN INDIVIDUAL AFFECT THESE CHANGES?

Employers are required by legislation to consult with affected members for at least 60 days prior to any pension changes or the closure of a DB scheme. This is a consultation rather than a negotiation but the employer must provide sufficient information and give due consideration to responses received.

A question often asked by employees is: what is the point of the consultation period? They might feel they are being presented with a fait accompli and the employer will implement changes no matter what response they receive. However, in many of the recent examples substantial amendments have been made following consultation where employees or their representatives made a case for a variation.

Communication is key to running a successful consultation process. Some employers carry out extensive consultation via letters, presentations, one-to-one meetings, further letters. Where changes are complex in nature or rationale this is important so that employees can understand and respond if they wish. However the costs of a consultation must reflect the nature and complexity of the proposed changes, and some employers struggling for cash do not feel it appropriate to go too far to mollify what is often a small proportion of their workforce.

SHOULDN'T THE TRUSTEES OF THE DB SCHEME STOP EMPLOYERS CHANGING THE RULES?

The trustees' duties in a DB scheme are primarily to ensure benefits are paid correctly and to protect the security of the accrued benefits, i.e. the pensions accrued to date.

Having said that, many members will take their concerns directly to trustees in the first instance, so it makes sense to keep them, at the very least, fully briefed on the proposals. Some changes require an amendment to the trust documentation, which may require explicit trustee consent.

WHAT MIGHT A REPLACEMENT PENSION LOOK LIKE?

If the proposal is to close the pension scheme entirely, employers typically provide an alternative in the form of a DC scheme. Where new employees have been joining a DC for a period there can be a dilemma for employers, particularly those who want to harmonise benefits. Do they cap all contributions to the level of the existing DC rates, which can be a significant benefit cut for those in DB; do they enhance the rates for those whose membership of the DB scheme was ended - maintaining a 2-tier system - or enhance the rates a little for everyone?

SO FAR IT HAS BEEN FAIRLY MIXED AS TO WHICH ROUTE EMPLOYERS ARE TAKING.

If employees are being offered a choice, such as the option to increase their own contributions to maintain the DB scheme, it will be important to ensure that they fully understand the implications of this choice, particularly if it is a once and for all decision. Independent financial advice is expensive, and arguably excessive - employees typically just need information and someone with sufficient knowledge, such as a pensions manager or a consultant, to talk it through with.

SO WHERE ARE WE HEADING?

It is difficult to see a future in which any DB schemes can operate. In the private sector those companies who tried to avoid DB closure by reducing benefits a few years ago are now coming back to stop DB altogether. The public sector of course continues to provide them, as do some pseudo-public sector bodies such as universities or regulated companies but whether this is sustainable only time will tell.

The inescapable bottom line is that, under pressure to increase funding to protect the past-accrued benefits, employers must find ways to reduce their overall pensions bill. They have to look at future benefits.

Do you know what kind of pension you have and are you aware of some of the choices you could make about it?

Maddy Kaur explores some of the different ways to make your benefits work better for you

Retire at the age of 50. Take some of your pension as a tax free lump sum. Have enough money to pay off the mortgage, go on holiday and spoil the grandchildren. How many of you think that this is a realistic ambition?

Changes to pensions legislation, plus changes in the financial markets and the way companies choose to provide benefits for their employees will probably mean this is no longer realistic except for the lucky few.

For instance, did you realise that from 6 April 2010 most people will not have the option to retire from age 50 as the minimum retirement age is being increased from age 50 to 55? If you are under age 55 now, you might want to explore with your various pension providers whether you should retire and draw your pension before April next year. This does not mean you have to stop working, but it could give you some extra income now, or the flexibility to go part-time and wind down to retirement.

Many of us now have pension savings in defined contribution (DC) (money purchase) schemes. We pay in contributions, which we hope will grow with investment returns, and then we buy an annuity at retirement. However the combined effect of falling investment values and new rules that are going to apply to annuities means our expected retirement income has plummeted. *continued...*

The ability to retire before your normal retirement age and take some of your pension as a tax free lump sum is relatively well known. However, there are many other standard options available which most people don't know about, and options that the sponsors and trustees of your pension scheme may not have considered, that could help you make your benefit entitlements meet your needs more effectively.

CONSOLIDATION

As jobs mobility has increased over the years, people now tend to have pension arrangements with several employers rather than one or two, which was more common some years ago. Consolidating your benefits could make all of the schemes more manageable and may, depending on the type of arrangements, result in increased flexibility and control.

You are entitled to transfer the value of your benefits from one pension arrangement to another and if you have a trust-based scheme you are allowed to request one transfer value quotation from the trustees of your pension scheme every year.

In a DC or money purchase arrangement, the amount will usually be the value of the funds. In a DB scheme (for example a final salary scheme), an amount is calculated based on the current expected cost of providing your pension. These transfer values can make transferring unattractive but in the past few years some companies have offered an enhancement for a limited period of time to make it more attractive. The decision on whether or not to transfer should always be made with input from an Independent Financial Advisor who will consider a number of issues including how adventurous you are when it comes to investment, when you plan to retire and any other pension arrangements you have. If you are interested in transferring you can always approach your ex-employer to see if they would be interested in making an offer.

MAKE USE OF YOUR PENSION INCREASES

When you retire with a DB scheme, your pension will usually increase each year. These increases may be linked to inflation, perhaps with a maximum or minimum increase, or they could be fixed percentages. Legislation sets out the minimum level of increase that must be made.

If your pension scheme gives higher increases than the minimum, there may be an opportunity to give up some of these increases in return for an immediately higher pension. This is not a standard option usually available from pension schemes but it is an option that some companies and trustees are increasingly exploring.

This is a similar option to choosing your cash lump sum - would you prefer more pension now or later when you are older? Again this option needs careful consideration.

UNDERSTAND

Key to making your benefits work for you more efficiently is understanding them – where they are, how much they are and how secure they are.

If you were formerly employed by a company and were a member of their pension scheme you should have received a statement when you left, setting out your benefit entitlements and any options you had on leaving. In addition, as long as the trustees of the scheme have your current address, you should receive a 'Summary

Funding Statement' each year setting out, amongst other things, how well funded the scheme is and the contributions the company have agreed to pay.

You also have the right to request other scheme documentation such as the rules, the Trustees annual report and accounts and various other documents setting out how the company and trustees have agreed to fund the scheme and how the assets will be invested. These documents could help to give you a better understanding of your benefits and how secure they are.

If you think that you have some benefits in a scheme but have not been receiving information from them then you could contact the pension scheme administrators or trustees from any previous correspondence or alternatively make use of the Pension Tracing Service offered by The Pensions Regulator. Further information on this can be found on their website.

CHANGES IN 2009

Finally, the recent Finance Act now means people earning over £150k will no longer receive the full tax relief on pension savings as they have in the past. Whilst £150k may sound like a lot it is affecting a surprising number of people as it includes income from all sources - employment, property, investments, etc. Those caught may find it difficult to build up benefits in a UK registered pension scheme without incurring a very penal tax rate. If you are affected you might incur additional tax liabilities on contributions you or your company make, or in the case of a DB scheme, the additional benefits you build up over the year - you should be asking your employer now!

Pensions – how would you do it differently?

Charlotte Gibson explores why pensions are such a financial burden on companies and how it could all be so different...

The concept of a defined benefit (DB) pension is a good one: company rewards loyal employee for years of continuous service with a guaranteed income stream in retirement; employee has means to live the last few years of his life in comfort, when he is no longer able to work, with few financial worries.

For the company it is a great way to retain and motivate their staff. When these schemes were set up, most were broadly structured so an employee would work for 40 years, retire at 60 or 65 and draw a pension for an expected 10 or maybe 15 years.

Herein lies a key problem and the reason why a lot of DB pension schemes are under threat of closure, with many having closed already. Individuals are now living longer, a lot longer. Someone retiring at 60 is now expected to live 25 or maybe 30 years. So the pension is being paid out for more than twice as long as was usual when the schemes were first set up. Plus it is now compulsory to provide inflation linking (up to a cap), so someone living for 25 years could be drawing double the pension they first received at retirement.

Some companies are also finding themselves with individuals looking to retire at 50 or 55, so there are cases where their pension promise can mean almost 50 years of inflation-linked monthly

payments. The ultimate cost of these payments is uncertain and companies are now required to hold prudent, i.e. large, reserves of assets to cover these promised pensions.

Legislation prevents pension schemes from making retrospective changes to benefits but we wonder how things could have been done differently. What fundamental design points could have been included on set-up to prevent the huge rises in costs we are seeing today which are leading to the demise of many well intentioned schemes? With the benefit of hindsight we explore two ideas.

Spouse's Pensions – An Old Fashioned Concept?

Most DB schemes provide a pension to a spouse or civil partner on the death of the member at any age, often 50% or two-thirds of the member's pension. This concept reflects the era when these schemes were set up: men worked, many women didn't, or at least not in jobs where they would earn a material pension of their own.

However, nowadays a high proportion of women work in comparable jobs to men and are building up their own pension provision. They do not need their spouse to provide for them and whilst this might be a nice additional income it is unlikely to be hugely valuable when they are old and on their own.

This is not to suggest there should be no spouse's or civil partner's pension. If a member dies whilst he or she is still working their partner may need to stop working to look after children, or a couple may have decided to invest only in one pension scheme to support them both. However it could be optional - where members value it they keep it, where they do not it is removed as a benefit. The cost of providing spouse's pensions adds around 10% to typical pension liabilities. By making the provision of a spouse's pension perhaps optional after retirement the benefits would be far more affordable to provide.

Nothing Lasts Forever

One pensioner lives until 110 and their pension is paid until this time. His ex-colleague dies at 75 and his pension ceases at this time. Both have provided the same service to the company and paid contributions into their company pension scheme for the same amount of time and at the same rate. This is the nature of pensions, it is a type of insurance against living forever, or at least a lot longer than you expect.

This poses enormous problems for a company setting aside assets now to pay these pensions. They can estimate (with the help of their actuary) how long the promised payments will be made for but they can't predict with any certainty. The potential variation is significant and as a result a company in this position will have to hold an expected excess for every person - a costly thing to do. Although this excess funding could eventually be returned to the company, that might not be for 50 years or more.

So how about if the pension payment was structured so that if someone did live longer than expected the benefit was reduced so it was less onerous on the scheme to keep paying it? This also reflects the fact that as someone is older they are less likely to be out and about and may not need such a high income.

The pension could start at 100%, but fall to say 25% if someone lived longer than 30 years after retirement at age 60.

Alternatively, it could taper down, e.g. 100% for the first 10 years, 75% for the next 10 years, 50% for years 20 to 30, and 25% after that.

Members would need to consider their post-retirement budgeting, and the regulated life companies, who are far better placed to provide "insurance" than UK corporates, could provide some form of protection to shield members against their own longevity.

DB schemes are unlikely to be around for much longer. While legislation has served to improve and protect many DB schemes it has also choked them by making costs unpalatable for the companies providing them. This has been exacerbated by increasing life expectancies and the recent unprecedented economic conditions which have demonstrated just how volatile and onerous these pension promises are.

Yet even if it's difficult to see why any business would want to provide DB schemes ever again, if we could come up with a design that made them a little more flexible, and spread the risk a bit more, might not employers think twice?

If you are interested in discussing these, or any other, pension issues, please get in touch with Linda Bell or Charlotte Gibson:

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