DEFINED BENEFITS: A WAY OUT?

WITH THE UK FACING A PENSIONS CRISIS, CHAIRMAN OF THE ACT **DAVID CREED** AND KEY SPEAKERS AT THE 2003 ACT PENSIONS CONFERENCE, INCLUDING MPs **PETER LILLEY** AND **FRANK FIELD**, SPEAK OUT.

As David Creed, Chairman of the recent 2003 Association of Corporate Treasurers (ACT) Pensions Conference pointed out, the signs of the problems ahead were already apparent at last year's conference. Low interest rates and higher wages were driving up the net present value of future pension liabilities. People are living longer, and some companies had made their position worse by taking pensions holidays. The problems highlighted in last year's conference had become a full-blown crisis in 2003.

Creed told delegates that the combination of economic, demographic and technical accounting factors had created problems in the industry that were difficult to address. Every week there are new reports of defined benefit schemes closing to new members, or closing completely. Members of defined contribution schemes, as a contrast, were facing all of the investment risk and, in order to mitigate that risk, were afraid they would have to work longer.

AN ISSUE FOR ALL. The difficulties were largely seen as a political problem and have undoubtedly been exacerbated by what the keynote speaker, Peter Lilley MP, called the "political ping-pong" played by successive governments. But, he added, taking politics out of the equation would not necessarily make a difference. A number of speakers at the conference, drawn from politicians, actuaries, accountants, employers and trustees, certainly seemed to back that view.

Lilley, Conservative MP for Hitchen and Harpenden, began by detailing the scale of the crisis. The question of how to fund pensions, he began, had become the biggest single domestic issue for every economy. The UK did once hold the enviable position of being better placed than anywhere else in Europe, as it had built up more than £1bn of funds.

However, by today, the UK's funding gap has exploded. He estimated that 60% of defined benefit schemes were closed to members (later speakers put that estimate even higher) and according to the Pensions Tsar, Adair Turner, there will be no defined benefit schemes in the private sector within 20 years.

In Lilley's view, there were five key questions that had to be faced if the crisis was to be resolved: compulsion, funding, protection, pension age and costs. Personally, he said, he was not in favour of compulsion, although it already exists in some form through the National Insurance and tax system. The answer, he said, was to compel people to pay enough into a pension only in order to avoid dependence on means-tested benefits. To do this, he favoured replacing the unfunded Second State Pension by an equivalent Mandatory Funded Pension, but added that if everyone were required to pay in a minimum amount to a defined contribution scheme, the state must promise to top it up by flat rate tax rebates to a guaranteed minimum level.

If the government would not take the step of requiring everyone to save for a second pension, the only alternative was to raise the retirement age, according to Lilley. He told the conference that his decision, while Secretary of State for Social Security, to raise the retirement age for women to 65 from 2010, would be the biggest single saving in public funds achieved by any minister. But, he added, governments should not be in the business of telling people when to retire. The population should be allowed to draw their pension at the point when their fund is sufficient to avoid the need for other state benefits. Finally, he proposed that the state should bear the cost of 'super longevity' by funding in full the second pension from the age of 85. The improvement in the annuity rate for a defined end date, at age

'THERE'S A LARGE TRAIN CRASH COMING A FEW YEARS DOWN THE TRACK AND NO-ONE WANTS TO PICK THIS UP'
DAVID JONES, HEAD OF BUYING SERVICES, WAITROSE


RT HON FRANK FIELD, MP

85, would be much greater for the individual than the cost to the state because the market was currently over-pricing the cost of super-longevity.

Another politician was to present a very different proposal later in the conference. Frank Field, Labour MP for Birkenhead and Chairman of the Pensions Reform Group, told the conference that the means-tested scheme devised by the government was not sustainable. "It simply won't hold up in the long run," he said. The government's plans to reverse the 40/60 private capital/taxpayer funding mix for pensions to 60/40, he added, was also unattainable. In some counties in the UK, it was already the case that 40% of the police budget goes towards pension payments, and that will become the norm rather than the exception.

Any pension policy reform, said Field, should be based around ensuring a minimum pension (he suggested one of between 25% and 30% of average earnings, funded by the National Insurance surplus) for everyone. "How and how much they save on top of that is no one's business, least of all the government's," he said.

In response to a question from a delegate, though, he rejected the idea that a rise in the retirement age could solve many of the problems. "You have to be realistic. We can't persuade many people to work at 45, let alone 65," he said. "We're going to have trouble raising the retirement age unless we first address the gap between the death rates of the poorest and wealthiest sections of the community."

CLOSING DB SCHEMES. While the politicians attempted to tackle the long-term view, a number of speakers addressed the more immediate problem of companies that have defined benefit schemes and are looking for a way ahead, or an alternative scheme. David Jones, a partner with Lane Clark & Peacock, warned the conference that the closure of a defined benefit scheme was not the only solution, and not necessarily the best solution. "Closing your scheme to new entrants will not solve your problems overnight," he said. Another Lane Clark & Peacock partner, Tony Cunningham, echoed that message: "The day you close your defined benefit scheme to new members, you change the nature of the thing you are managing. Don't wait 10 years to adjust." Closing a defined benefit scheme presented a company with significant future liabilities, he warned, such as the winding-up costs of the scheme in 15 years' time. The decision to close a scheme must be

'WE WERE RANKED ALONGSIDE THE MAN WHO SHOT BAMBI'S MOTHER'
ALLAN COOK, TECHNICAL DIRECTOR, ACCOUNTING STANDARDS BOARD, ON THE INTRODUCTION OF FRS 17

made for the right reasons – there was a danger today, he warned, that it had become the "fashion" to close defined benefit schemes.

The Lane Clark & Peacock partners suggested some alternatives for companies which were considering closing their defined benefit schemes. Legislation prevents the reduction of past service benefits, but it was possible to reduce future benefit promises, for example from 1/60ths to 1/80ths, which could save 25%.

Hybrid pensions schemes are emerging as a real alternative to defined contribution and defined benefit schemes. Jones described a few options, such as a cash balance plan, an "investing half-way house" that provides a lump sum on retirement (for example, 15% of pay for each year of service) that can be used to secure a pension. Or a scheme where the company offered a defined contribution scheme up to a certain age (or salary level), then a defined benefit scheme. Hybrid schemes can protect lower-paid workers, while encouraging higher-paid workers to take more risks, he said, but added that it was important to look at the consequences of scheme design. "The take-up for a particular scheme may be greater that for the one it replaces, which would push the costs up," he said.

Mark Ashworth of the Law Debenture Pension Trust Corporation emphasised the need to communicate effectively with pension scheme members. Legally, the responsibility for good communication lay with the trustees, but morally, he added, it was a joint responsibility for trustees and employers.

Treasurers, concluded David Creed, need to be closely involved in pension funds, as a trustee if possible. "We need someone between the fund and the technicians who is independent and capable," he said, "and no one is better placed for that than the treasurer."

The ACT Pensions Conference, sponsored by Lane, Clark & Peacock, took place on 23 October 2003.

DAVID SWANN, BAT (LEFT) AND DAVID JONES, WAITROSE

ALAN COOK, ACCOUNTING STANDARDS BOARD (LEFT) AND DAVID CREED, THE HOUSING FINANCE CORPORATION AND CONFERENCE CHAIRMAN