{ PENSIONS }

JEREMY WARNER

Observers waiting for UK regulators to show their hand on how they will address pension deficits are likely to wait a long time

As legacy issues go, they don't come any more challenging than paying for the pensions promise made to past and present employees. A combination of greater longevity, absurdly oppressive accounting rules and declining rates of return have hugely increased these costs, making them virtually terminal for some companies.

The problem is particularly acute in the UK, where the main source of private pensions has historically been through funded 'defined benefit' schemes, where the employee is guaranteed a certain level of pension, sometimes related to final salary.

Other countries, whose private pension provision is based more on the pay-as-you-go principle, face an equally daunting, though different type, of challenge, but it is the UK model and the problems it has thrown up that I wish to focus on here.

There are approximately 6,000 defined benefit schemes in existence in Britain today, but the vast bulk of them – nine out of 10 – have long since closed their doors to new members.

This has largely succeeded in staunching the accumulation of new pension liabilities, but it can't do anything to address the ballooning liabilities of the past. At the last count, these had given rise to a combined accounting deficit of roughly a quarter of a trillion pounds, and much more on a so-called 'buyout' basis, which calculates the present-day costs of buying the same level of benefit from insurers.

Pensions regulators naturally insist that sponsors close these deficits as soon as possible by topping up their schemes accordingly, but it is a constant balancing act. If they ask for too much, it might put the sponsoring company out of business.

In such circumstances, the scheme falls back on the Pensions Protection Fund (PPF), which will continue to service the liabilities, albeit on a reduced basis. Two recent high-profile cases – BHS and Tata Steel UK – have served to highlight the problem.

Yet since the PPF is paid for via a levy on other defined benefit pension schemes, it scarcely looks an any more sustainable construct. If the solvent are forced to pay for the insolvent, it will eventually drag everyone down. And the UK taxpayer would presumably have to pick up the tab.

UK government policy must shoulder a large part of the blame. Over-regulation and the gradual removal of tax breaks has widened the gap between assets and liabilities, thereby all but destroying the incentives for providing employees with defined retirement benefits.

UK benefit schemes have closed their doors to new members

Ever tougher rules for accounting for pensions liabilities have further piled on the disincentives. Even though the liabilities stretch long into the future, accounting rules put companies are under pressure to ensure matching assets at all times.

The damage started in the 1980s, when most funds were still in rude health, with substantial surpluses. Concerned that this was costing the exchequer tax revenues, the government forced schemes into taking prolonged contribution holidays. At the same time, employees won substantial increases in benefits, growing the size of future liabilities at a time when funding was being reduced.

The other part of the problem is simply that of unconventional monetary policy. Very low rates have substantially increased the notional costs of funding future liabilities, such that it is reckoned that a rise of only one percentage point in market interest rates would be enough to eradicate many deficits.

There are, then, two possible solutions: either the pensions regulator could choose to look through the current level of deficits and treat them as a temporary aberration that will eventually go away with rising interest rates, or the Bank of England could recognise the collateral damage that low rates are causing and tighten policy accordingly. Unfortunately, it would be most unwise to count on either possibility.

Jeremy Warner is assistant editor of ***The Daily Telegraph*** and one of Britain's leading business and economics commentators