Pensions Policy Institute

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Executive Summary

The changing landscape of pension schemes in the private sector in the UK

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Executive Summary

Private sector pension provision in the UK has been changing over the last forty years. Defined Benefit pension schemes have been in decline since the late 1960s. By contrast, Defined Contribution pension schemes have experienced growth, both in terms of membership and assets under management, particularly since the late 1980s.

This report brings together the latest data on the state of private pensions in the UK. The report examines the main factors that have played a role in shaping recent trends in private sector pension provision. It also highlights how employers are responding to the challenges of providing workplace pensions and considers the future of pensions in the private sector in the UK.

The current pension landscape in the private sector
Private sector pension provision in the UK includes all non-state provided pension benefits. These pensions can take the form of Defined Benefit, Defined Contribution or hybrid schemes:

- In Defined Benefit (DB) pension schemes the pension benefits paid out are often linked either to the scheme member's final salary or to their average salary during the course of their career and their length of service.
- In Defined Contribution (DC) pension schemes, a pension fund is built up with the contributions from the member and/or the employer. The Government incentivises members to contribute into these pensions by offering tax relief on members' contributions. The final pension paid out will be related to the returns on the assets in which members' funds are invested (after charges) and the way that the resulting pension pot is converted into a retirement income. If an annuity is taken, the annuity rate available at the time that the member retires will affect the member's final retirement income.
- Private sector pension schemes can also have a combination of DB and DC features. These schemes are often called hybrid schemes.

The decline of Defined Benefit pensions in the private sector in the UK
Active membership in DB pension schemes in the private sector in the UK peaked at around 8 million members in 1967 and has declined since the late 1960s.[1] By 2011 there were only around 1.6 million members actively contributing to DB schemes in the private sector.[2]

There are a wide range of factors that have contributed to the decline of private sector DB pension schemes in the UK by increasing the risks and associated costs of sponsoring DB pension schemes. These factors include:

Increased Life Expectancy: Increases in life expectancy over the last 30 years due to medical advances and improved lifestyles have meant that people are living longer. For example, in 1981 the average male life expectancy at age 65 was estimated as being 14 years. In 2011 it was estimated to be over 21 years.[3]

Higher life expectancy increases the amount of money that DB schemes need to pay out because pensions have to be paid for longer.

Investment risk: Investment risk can be a significant issue for sponsors of DB schemes. The returns on bonds and equities will affect the funding position of DB schemes. Where a scheme is in deficit, lower returns will increase the level of contributions required to close the deficit. Over the last decade, bond yields and equity returns have been volatile, and over the longer term the outlook for investment returns remains uncertain.

Inflation: The value of the pension received and the cost of providing pensions may be affected by changes in price inflation. In DB schemes revaluation of accrued benefits and indexation of pensions in payment are key parts of scheme design. There is a cap on mandatory indexation and revaluation in DB schemes. For the scheme sponsor the cap reduces the level of inflationary risk but it does not eliminate it entirely.

Wage inflation can also increase the cost of providing DB pensions. For example, if an active member of a final salary DB scheme receives a substantial increase in pay at the end of their career, this can disproportionately increase the cost of providing the resulting annual pension.

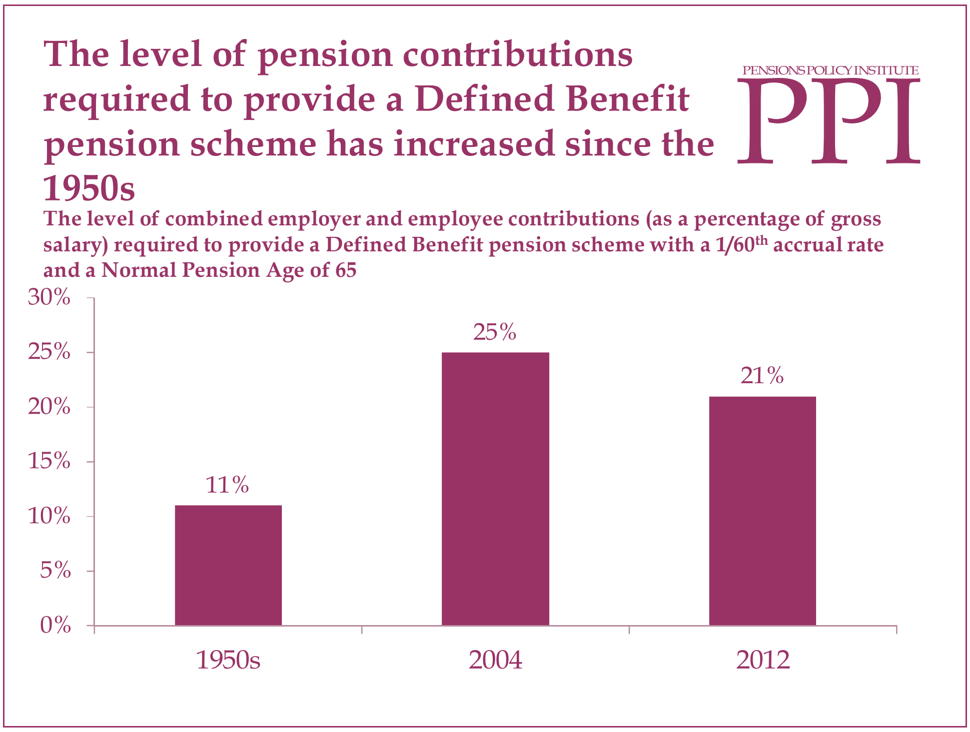
Changes in regulation and legislation: Many different pieces of legislation have been introduced since the 1970s, predominantly with the aim of protecting individual pension rights. However, many of these changes have also led to increased costs for DB schemes, or reduced the attractiveness of providing DB pensions. These include:

- measures to protect members' rights and the security of pension benefits;
- changes in the taxation of pension funds;
- EU regulations, such as equal treatment of men and women's pensions;
- tighter accounting standards for DB pensions;
- revised standards for DB pension scheme funding.

However, the Government recently changed the measure of inflation required to be used for the indexation and revaluation of DB pensions from the Retail Prices Index (RPI) to the Consumer Prices Index (CPI). Those DB pension schemes that are able to make this change are likely to reduce their costs of providing a DB pension.

As a result of these factors the cost of providing DB pensions has increased significantly. It is difficult to measure the precise effects that each of these factors has had on the cost of sponsoring DB schemes. However, PPI analysis suggests that between the 1950s and the early 2000s, the cumulative impact of all of these changes meant that the total level of pension contributions required to fund a typical final salary scheme increased from approximately 11% of salary to 25% of salary (i.e. the combined employer and employee contributions required on an ongoing basis). Since then the required pension contributions have fallen to 21% of salary despite increasing longevity, mainly as a result of changes in the measure of inflation used for indexation from RPI to CPI (Chart A).

Chart A[4]



It has therefore become harder to fund DB schemes. The funding position of a DB scheme is measured as the ratio of the assets held in the scheme compared to the liabilities owed to current and future pensioners for service completed to the date of the valuation. The funding position provides a snapshot of the situation at a given point in time.

The different risks associated with DB provision will affect the value of scheme liabilities, and therefore the funding position of a scheme. For example, rising longevity will lead to an increase in the estimated liabilities of the scheme.

What strategies are DB pension scheme sponsors and trustees pursuing in response to the challenges affecting pensions in the private sector?
In recent years, trustees and sponsors of DB schemes have adopted a wide range of strategies to help mitigate the increased costs and risks associated with DB pension provision.

Improving the scheme funding position: By increasing contributions to the scheme or by assigning contingent assets to increase the security of members' benefits. Employers' special contributions have increased from around £11.9bn in 2007 to around £16bn in 2011.[5] In addition, the use of contingent assets assigned to increase the security of DB schemes has risen, with the number of contingent assets set aside increasing from around 750 in 2010/11 to around 900 in 2011/12.[6]

Changing benefit structures: Changes in the structure of private pension provision have been significant in recent years. Only 16% of DB schemes were still open to new members in 2011, compared to 36% in 2007.[7] While most employers have changed provision to DC, others have offered membership of hybrid schemes (which combine elements of DB and DC provision). Employers may decide to make the same level of contributions to a DC pension offered in replacement for a closed DB scheme. However, typically the replacement DC schemes are less generous than the previous DB schemes offered to employees.

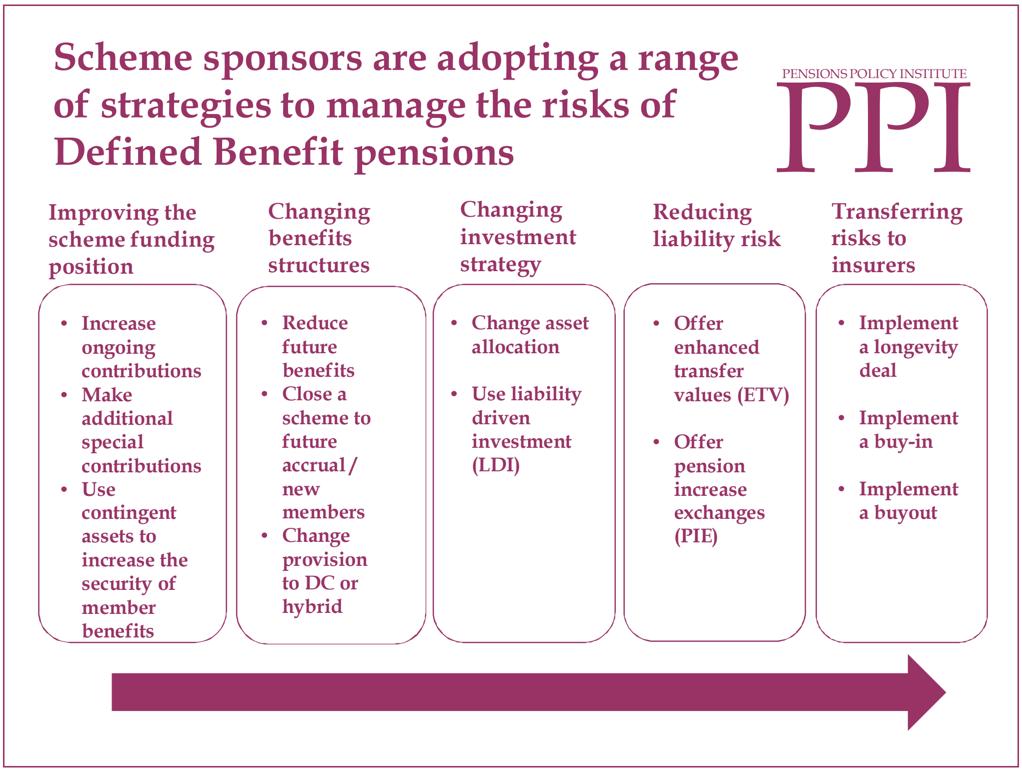
Changing investment strategy: DB schemes may change their asset allocation as a way to achieve diversification in their portfolios and reduce some of their investment risk. Schemes may also change their asset allocation to reduce risk by better matching their liabilities. DB schemes have been moving away from equities towards investing in bonds, which better match their liabilities. In 2006, 60% of all assets in DB schemes were invested in equities and 30% in bonds. By 2011, DB schemes had reduced their exposure to equities to over 40% of total assets, and had increased the proportion held in bonds to around 40%.[8] Another strategy to better match liabilities is to use derivatives-based techniques such as Liability Driven Investment (LDI). The total value of LDI assets under management in the UK has increased from £243bn at the end of 2010 to £312bn at the end of 2011, an increase of almost 30%.[9]

Reducing liability risks: Two of the most common strategies to reduce liability risks are the use of incentive exercises such as Enhanced Transfer Values (ETV) and Pension Increase Exchanges (PIE). An ETV allows deferred members to transfer out of the scheme in exchange for a statutory amount plus an enhancement in respect of the pension given up. A PIE involves exchanging some of the member's right to a pension that increases in line with changes in prices for a higher but non-increasing or fixed-increasing pension. Since 2008, there have been around 80 ETV exercises, involving around 90,000 members.[10] The use of PIEs has also increased in recent years. An industry working group set up by the Government has recently published a code of conduct on incentive exercises.[11]

Transferring risks to insurers: Risk-transfer deals such as longevity deals, buy-ins and buyouts have reached around £40bn since 2007.[12] This represents less than 3% of total liabilities in DB schemes.[13] This may indicate that, subject to market capacity and affordability, risk-transfer deals could increase in the future.

Often, schemes move from one end of the spectrum of strategies to the other to manage the costs of DB pension provision (Chart B). For example, schemes may start by improving the scheme funding position or by changing the structure of benefits by increasing the scheme Normal Pension Age or lowering accrual rates. They may also change investment strategy or aim to reduce liabilities through Enhanced Transfer Values or Pension Increase Exchanges. Finally, they may decide to transfer risks to an insurer by implementing a buy-in or a buyout.

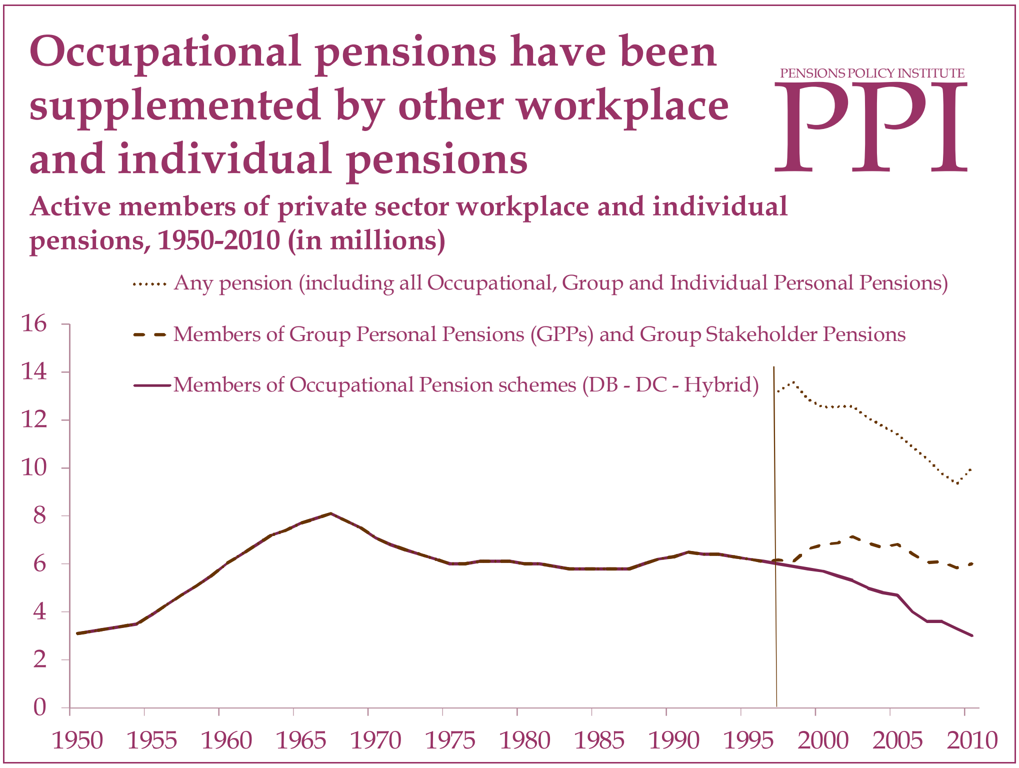
Chart B



Active Membership of Defined Benefit schemes is now concentrated in a small number of large schemes. In 2011, around 200 DB schemes, or just over 3% of all DB schemes, had 10,000 or more members (including active, deferred and pensioner members). However, these 200 DB schemes contained around 65% of all active members in DB schemes.[14] Future decisions taken by a small number of very large DB schemes may therefore have a significant impact on future levels of active membership in DB pensions.

The growth in Defined Contribution pension schemes
As membership in DB schemes in the private sector in the UK has declined there has been growth in the membership of other types of private pensions, and in particular, in DC pensions (Chart C).

Chart C[15]

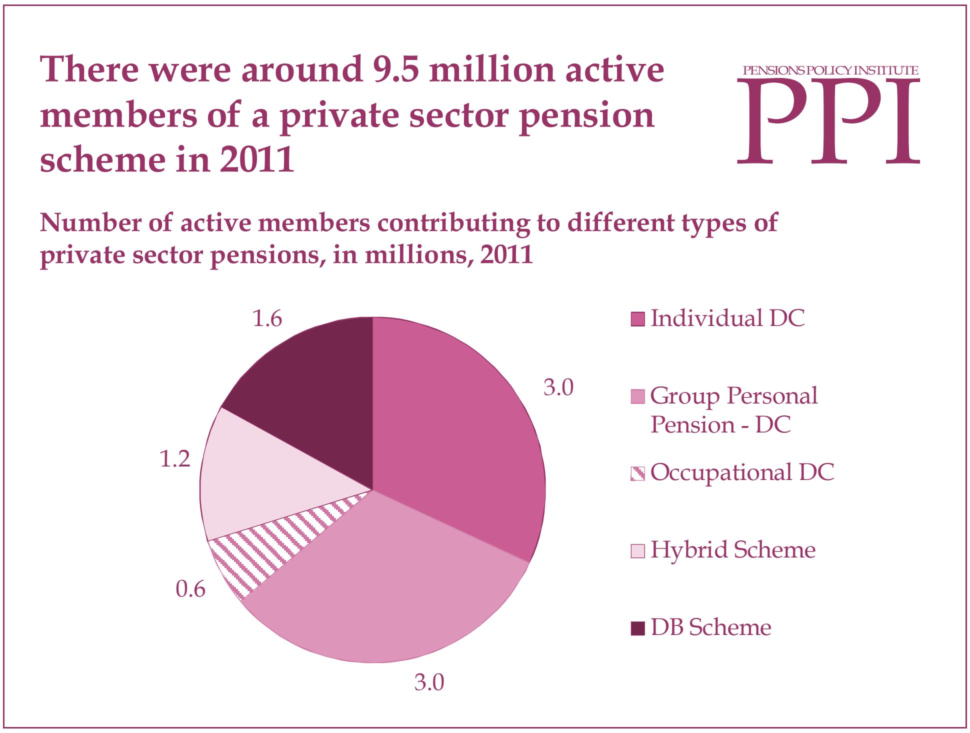


There are a wide range of DC pension schemes available in the UK. DC pension schemes can be organised as occupational schemes, typically run by a board of trustees, or they can be offered on a contract basis, usually provided by an insurance company.

DC schemes can also be sponsored by the employer, where the employer contributes into the scheme or runs the scheme on behalf of a group of employees (such as Group Personal Pensions and Group Stakeholder Pensions) or they can be taken out by individuals as individual personal pensions. After the introduction of individual personal pensions in 1987 there was a very rapid growth in individual pension arrangements.

Including individual pensions, there were almost 9.5 million active members of a pension scheme in the private sector in 2011. Of these, 6.6 million members, around 65% of all active members, were saving in DC pensions (Chart D).

Chart D[16]

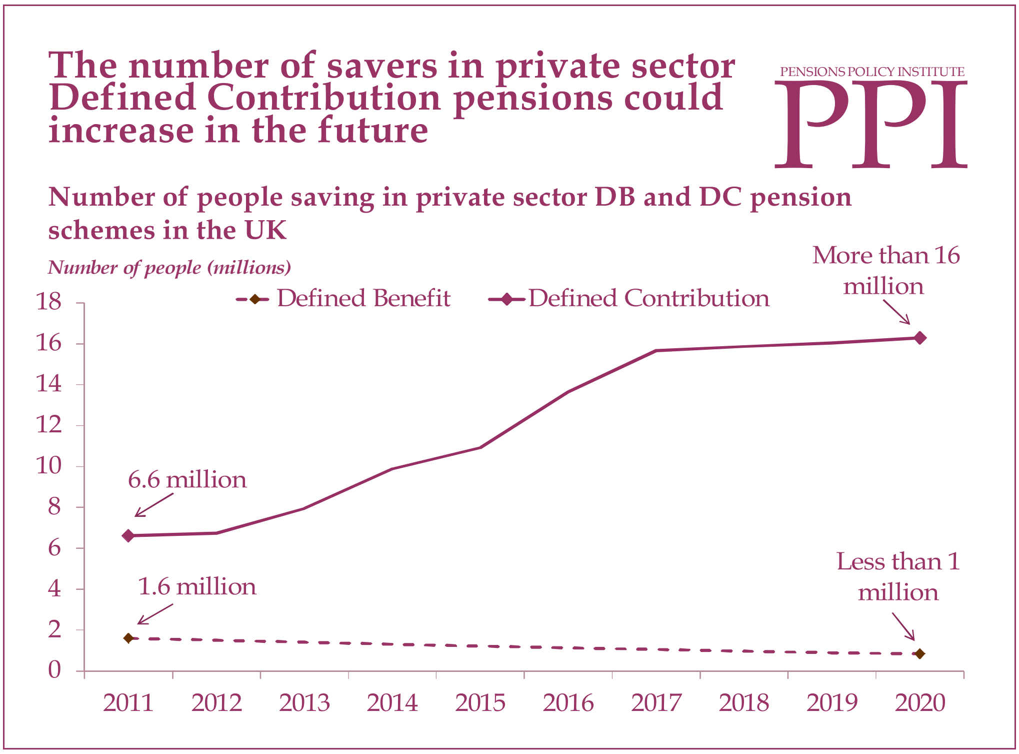


What is the future of pension provision in the private sector?
There are a number of policy changes that are likely to have a significant impact on the future of pensions in the private sector in the UK.

The introduction of automatic enrolment into private pensions from October 2012 is likely to lead to a substantial further increase in the number of individuals saving in DC pensions in the future. This is because almost 70% of members in DB schemes in the private sector are in schemes that are closed to new members or are closed to future accrual.[17] It is anticipated that most new pension savers will be automatically enrolled into a DC pension.

PPI projections suggest that if current trends continue then, following the introduction of automatic enrolment into private pensions, there could be over 16 million active members of DC pension schemes, compared to less than 1 million active members of DB pension schemes in the private sector by 2020 (Chart E).

Chart E[18]



If Solvency II requirements were extended to apply to DB pension schemes, the schemes would be required to hold an increased amount of capital to meet requirements designed to improve the likelihood they remain solvent under prospective stress environments.

The objective of the IORP Directive, introduced in 2003 (of which Solvency II could potentially form a part), is to provide a prudential framework for pension funds operating in EU member states based on minimum harmonisation and mutual recognition. It enables the establishment of pan-European pension funds that manage the pension schemes of employees in different member states.[19]

However, the potential capital requirement implied by extending Solvency II to DB pensions could put a further strain on the funding of DB pension schemes.

The Government is proposing to introduce a single-tier state pension above the Guarantee Credit level (for example £140 per week in 2010 earnings terms) for new pensioners.[20] The full details about how the single-tier state pension would operate are expected in a Government White Paper to be published in 2012. The introduction of a single-tier state pension could have significant effects on private sector pension provision and, especially, on DB schemes.

Currently, members of DB schemes can be contracted out of the State Second Pension (S2P), and employers receive a rebate on their National Insurance Contributions. Under a single-tier state pension S2P would be abolished and there would be no contracting-out. The removal of contracting-out rebates would put further pressure on the sponsors of DB schemes, as this would require an increase in funding from other sources or a reduction in the benefits offered to keep costs constant.[21]

The Government has recently discussed the possibility of introducing a new form of pension provision, described as 'Defined Ambition'. Although full details have yet to be announced, the aim of Defined Ambition is to allow for more risk sharing to be used in private sector pensions.

Risk-sharing refers to a pension arrangement in which the different risks of pension provision may not be borne completely by the employer or the employee. Defined Ambition pensions could therefore be a new type of pension in the UK, potentially operated under a different regulatory regime than either DB or DC pensions are presently.

There are international examples of risk-sharing schemes that might be used in the UK. For example, Collective Defined Contribution schemes, and Conditional Indexation schemes are used in the Netherlands, while in Denmark there is widespread use of Deferred Annuities among DC schemes.

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[13] PPI calculations based on PPF/TPR (2012) *The Purple Book* and Hymans Robertson (2011)
[14] PPF/TPR (2012) *The Purple Book,* Chart 3.7
[15] Source: ONS (2011), Table 3.6; (ONS) (2010) *Annual Survey of Hours and Earnings*; PPI analysis of the 2009/10 Family Resources Survey (DWP 2011); ONS (2012) *Labour Market Statistics.* Estimates are of membership of private sector pension schemes, and so exclude membership of public sector pension schemes (including the Local Government Pension Scheme). See Appendix 1 in the report PPI (2012) *The changing landscape of pension schemes in the private sector in the UK,* for more details. Available for download: www.pensionspolicyinstitute.org.uk
[16] Source: TPR (2011); ONS (2011); PPI analysis of the 2009/10 Family Resources Survey (DWP 2011) for individual personal pensions; ONS (2012). See Appendix 1 in the report PPI (2012) *The changing landscape of pension schemes in the private sector in the UK,* for more details. Available for download: www.pensionspolicyinstitute.org.uk. Totals may not add up due to rounding
[17] PPF /TPR (2012) *The Purple Book,* Table 3.3
[18] PPI analysis based on data from Department for Business, Innovation and Skills (2011) *Business Population Estimates for the UK and Regions*, DWP (2010) *Pension Provision Survey 2009*, ONS (2011) *Pension Trends* and the DWP (2008) *Labour Market Database*. For those individuals auto-enrolled, an opt-out rate of 33% has been assumed. There is assumed to be a decline in active membership of private sector DB schemes consistent with an 80% reduction in the number of open private sector DB schemes between 2007 and 2020. See Appendix 1 in the report PPI (2012) *The changing landscape of pension schemes in the private sector in the UK,* for more details. Available for download: www.pensionspolicyinstitute.org.uk
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