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The changing landscape for private sector Defined Benefit pension schemes

Contents

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Introduction

Occupational pensions, where the employer (or company sponsor) runs pension arrangements for its workforce on a collective basis, have been the mainstay of voluntary pension provision in the UK for many years. Of these occupational pensions, Defined Benefit arrangements have long been the most common. These types of pension schemes provide employees with a pension that is related to years of service and to earnings, either earnings in the last few years before retirement (final salary schemes), or earnings over a whole career (career-average schemes).

Occupational pension provision in the private sector, and in particular Defined Benefit (DB) provision, has been declining. Both the number of private sector employers offering these schemes and the number of employees covered by such provision are falling. At the same time the number of Defined Contribution (DC), or money-purchase, pension schemes has been increasing.

In this paper we bring together published administrative and survey data to provide a comprehensive evaluation of what the DB landscape in the private sector looks like today and how it got there.

This paper focuses on DB provision made by private sector employers in the UK. It does not cover the public sector schemes operating for central and local government, the NHS, teachers, the army, police and fire services. These schemes were examined in previous PPI research and further work will be forthcoming.

Chapter 1 describes current DB provision in the private sector, using scheme survey data to assess its size and composition. It also describes recent trends to show how provision has changed over the last few years.

Chapter 2 looks at what has been influencing the behaviour of scheme sponsors, and considers various factors that have affected the costs and risks of running a DB scheme.

Chapter 3 focuses on how DB scheme sponsors have been changing provision in recent years, providing examples to illustrate some of the issues raised.

Chapter 4 presents the views of three external commentators on the future of DB provision. These pension experts provide a range of views on the issue.

There is a high level of uncertainty as to what may happen to occupational pensions in future. By assessing trends and their key drivers, together with a range of government and scheme sponsor responses, this paper aims to offer an evidence base on which to consider the future of DB schemes in the private sector.

Summary of conclusions

The private sector Defined Benefit (DB) landscape is not a homogenous one. Schemes of varying size, with contrasting histories, and in separate industries, have very different characteristics.

In general though, occupational Defined Benefit pension provision in the private sector in the UK has been declining:

- The majority of DB schemes in the private sector (60%) are now closed to new members or are in the process of closing down completely.
- Although the number of open DB schemes in the private sector has fallen, fewer DB schemes have closed in recent years.
- Smaller DB schemes are more likely to be closed to new members than larger schemes.
- A significant proportion of all members (43%) are in DB schemes that are still fully open to new members. Not all of these members, however, are active members and some are existing pensioners.
- Only one quarter (26%) of scheme members are active members (i.e. are accruing a pensionable service) and many of them (42%) are now in closed DB schemes.
- The majority of active members are in a small number of large schemes, which tend to be better funded than small schemes.
- Total contributions into DB schemes, and employers' special contributions in particular, have been increasing to help reduce the deficit between assets and liabilities.
- Contribution rates to DB schemes are increasing, and tend to be higher than contributions in Defined Contribution (DC) schemes.
- Scheme sponsors are moving away from providing DB schemes and are instead offering DC.

A number of factors have influenced this decline. Better than expected improvements in longevity, low investment returns, increased legislation and regulation, and broader economic factors have all added to the costs and risks to sponsoring employers of providing a DB pension scheme.

In response to these factors, scheme sponsors have been changing DB provision in a number of different ways:

- ***Reducing deficits.*** Scheme sponsors have taken measures to increase scheme assets and / or to reduce liabilities.
- ***Changing investment strategy.*** Pension schemes have been attempting to reduce the size of the deficit or to help stop deficits growing by changing their investment strategy.
- ***Reducing the risk and / or level of pension provision.*** Many DB schemes have been closed to new members and the replacement schemes are predominantly DC schemes, which can be less generous, place greater risk on the employee and have lower take-up rates.

However, some employers have adopted hybrid or risk-sharing schemes, which spread the costs and risks of the pension scheme between employers and employees.

- ***Winding up or selling on pension provision.*** Although still relatively uncommon, buy-outs are becoming a viable option for some employers. A buy-out is when a company sells a closed but fully funded pension scheme to a third party, usually an insurance company.

The future for Defined Benefit schemes in the private sector remains uncertain. The cost pressures on DB schemes from rising longevity and uncertain investment returns are likely to remain, and pressures could be increased or reduced by planned government interventions.

An important factor is likely to be the new national system of Personal Accounts with auto-enrolment from 2012. Auto-enrolment is likely to lead to higher participation in existing DB and DC schemes and it is uncertain how employers will respond to the extra cost pressures they will face from increased participation. They will have a choice about whether to retain an existing pension scheme or, alternatively, to close their provision and instead offer Personal Accounts.

Cost pressures may or may not be offset to a certain extent by government initiatives, such as, the Deregulatory Review. The Review aims to provide further flexibility for scheme sponsors to share the costs and risks associated with DB pensions.

The PPI asked a panel of pension experts for their views on the future of DB pension schemes. Although there is not a consensus about the future for DB schemes, there was a general agreement that how the sector evolves will largely depend on how employers and government respond to the underlying cost pressures, the introduction of Personal Accounts, and the possibility for deregulation. And it is clear that DB provision, if it survives in the private sector, is likely to look very different in the future to the DB provision of the recent past, with potentially fewer schemes and more use of risk-sharing arrangements.

Chapter 1: The current private sector Defined Benefit pension landscape

The private sector Defined Benefit (DB) landscape is not a homogenous one; schemes of varying size, with contrasting histories, and in separate industries have very different characteristics. Recent trends, however, suggest that DB occupational pension provision in the private sector has declined in recent years:

- The majority of DB schemes in the private sector (60%) are now closed to new members or are in the process of closing down completely.
- Although the number of open DB schemes in the private sector has fallen, fewer DB schemes have closed in recent years.
- Smaller DB schemes are more likely to be closed to new members than larger schemes.
- A significant proportion of all members (43%) are in DB schemes that are still fully open to new members. Not all of these members, however, are active members and some are existing pensioners.
- Only one quarter (26%) of scheme members are active members (i.e. are accruing a pensionable service) and many of them (42%) are now in closed DB schemes.
- The majority of active members are in a small number of large schemes, which tend to be better funded than small schemes.
- Total contributions into DB schemes, and employers' special contributions in particular, have been increasing to help reduce the deficit between assets and liabilities.
- Contribution rates to DB schemes are increasing, and tend to be higher than contributions in Defined Contribution (DC) schemes.
- Scheme sponsors are moving away from providing DB schemes and are instead offering DC.

Defined Benefit (DB) occupational pension schemes provide employees with a pension that is related to earnings, typically earnings in the last few years before retirement, and years of service. The link, however, could be with earnings over the whole career, for example, a career-average pension. The implication of this type of pension is that the employer carries the risk that the investment returns earned will meet the pension promises made.

Unlike in DB schemes, in Defined Contribution (DC), or money-purchase, schemes the employer usually contributes a specified amount, usually expressed as a percentage of salary. The actual level of pension received by the employee at retirement will depend on the accumulated fund, investment returns earned on the fund, and on the annuity rate available when the employee converts his / her pension fund into an income.[1] As a result, the employee bears the risks of low investment returns and that a low annuity rate is available at the point of retirement.

A small number of private sector schemes are neither pure Defined Benefit nor Defined Contribution arrangements but have elements of both types of schemes. These ***hybrid*** or ***risk-sharing*** schemes have evolved to provide employers with some degree of cost and benefit predictability while at the same time providing members with a more reliable pension than may be available under a pure Defined Contribution plan.

Career-average schemes are often classed as risk-sharing schemes. In this paper we include them under the umbrella of Defined Benefit because even though the benefit is not 'defined' in terms of a member's final salary and years of service the benefit is still 'defined' in terms of their average salary.

In this paper, ***hybrid schemes*** refer to schemes that have a combination of DB and DC features. For example, ***sequential hybrid schemes*** offer a DC element for members below a certain age and a DB element for those above it. ***Combination hybrids*** on the other hand provide benefits that accrue on two scales simultaneously; for example, DB for part of the benefits and DC for the balance.[2]

To describe the current shape of DB provision, this paper mostly refers to ***The purple book***, a joint publication by The Pensions Regulator (TPR) and the Pensions Protection Fund (PPF). ***The purple book*** is the most comprehensive and representative study of UK private sector DB schemes to date (see Box 1). The study, however, only provides a 'snap-shot' of the current market. To describe how the DB sector has changed over time other sources are used, in particular the Government Actuary Department's (GAD) ***Occupational pension schemes survey***[3] and the Office of National Statistics' (ONS) ***Pension Trends***.

[1] In occupational DC schemes the level of a member's pension will depend on their share of the collective fund but in a personal or stakeholder pension, each member will have their own fund
[2] DWP (2005)
[3] From 2006 the ***Occupational pension schemes survey*** is managed by the ONS

Box 1: ***The purple book***

The purple book is the first edition of the ***Pensions Universe Risk Profile***, a joint study by The Pensions Regulator (TPR) and the Pensions Protection Fund (PPF). The report is based on a sample of 5,772 schemes, covering 12.6 million members, and at the time was thought to represent over 50% of the likely total of schemes and over 85% of total membership.[4] It focuses on the risks faced by Defined Benefit pension schemes, predominantly in the private sector, but also provides the most comprehensive description available of the UK's current Defined Benefit landscape.

The figures in this paper that refer to the report concern the sample only and have not been grossed up to the universe of schemes. Although the sample is skewed towards larger schemes (implied by the scheme to membership ratio) it is not thought that the inclusion of the remaining schemes will change findings based on aggregate or weighted results.

The majority of DB schemes in the private sector are closed to new members

Historically in the UK, private sector pensions were predominantly provided by employers and most of these occupational pensions were final salary arrangements. After 1988, when personal pensions were established, employer provision started to change and new products, such as Group Personal Pensions[5] (GPPs), entered the market. They were followed by stakeholder pensions[6] in 2001, when the Government compelled companies with more than five employees not already offering a pension to their staff to offer access to a pension scheme. There was no legal requirement, however, for employers to contribute to the scheme.

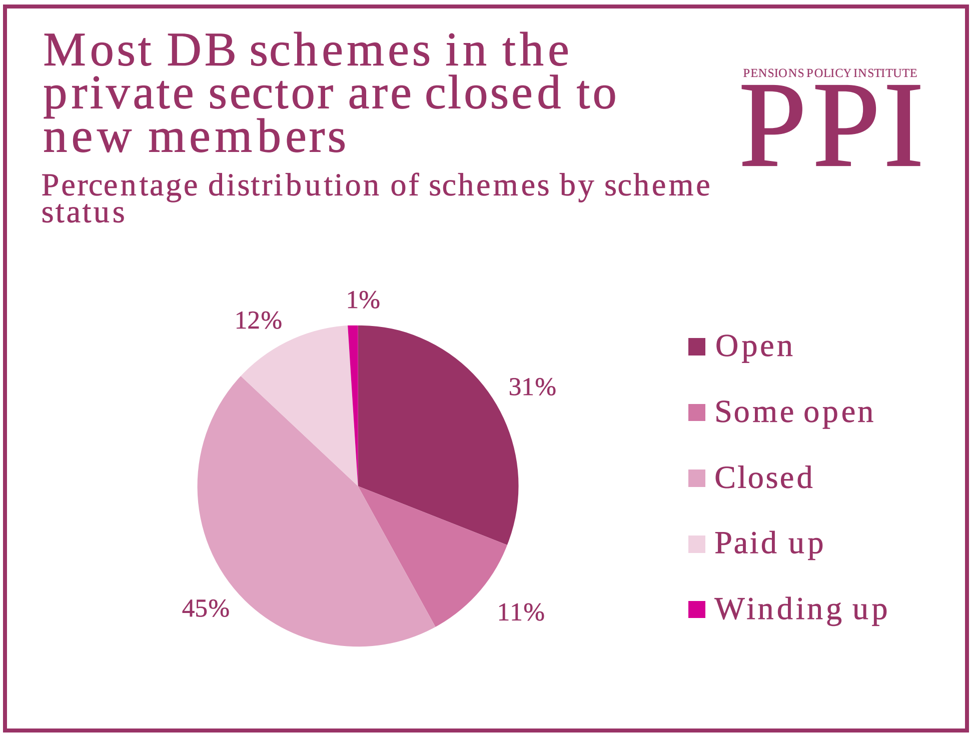
Today, there are around 10,800[7] predominantly private sector DB schemes in total and around 15 million members in the UK.[8] Not all of these schemes, however, remain open to new members and not all members are active members. DB schemes can be in different states, depending on whether new members can join and/or on whether the benefits of existing members continue to accrue:

[4] TPR/PPF (2006) page 14
[5] See Glossary
[6] See Glossary
[7] TPR/PPF (2006) page 15. The exact number of schemes is uncertain. For example, since the publication of ***The purple book*** in 2006, the PPF have started providing monthly updates showing the latest estimated funding position, on a s179 basis, of almost 7,800 predominantly private sector DB pension schemes in the UK – they have called this the PPF7800 index. According to their latest note, the sample of 7,751 they have used is close to the current best estimate of the universe of PPF-eligible DB schemes. However, according to the ONS's ***Occupational pension scheme survey 2006*** there were at least 13,400 DB schemes in the private sector in 2006.
[8] PPI estimate using figures from TPR/PPF (2006). Estimate includes active members, members with deferred pensions and current pensioners. The total number of members in DB schemes in the private sector is uncertain. In the 1st release of the ***Occupational pension schemes survey 2006***, ONS estimate that there are around 16.5 million members in private sector schemes, but this is not split into DB and DC.

- ***Open schemes*** continue to accept new members into the scheme and the benefits of existing members continue to accrue.
- ***Closed schemes*** do not admit new members but existing members can continue to accrue benefits.
- ***Frozen (or paid-up) schemes*** do not admit new members and in addition, no further benefits accrue. The benefits of existing members for earlier service, however, continue to be held and invested in the scheme.
- Schemes that are ***winding up*** are in the process of settling benefits in order to close the scheme permanently. These are schemes in the final stages of closing down altogether.
- There are also schemes that are ***sectionalised***, meaning that some sections of the scheme have different status types. Such schemes, with some sections open and some sections closed, may have a Defined Benefit section that is closed to new members and a Defined Contribution section that is open to new members.

Around 60% of DB schemes in the private sector today are closed to new members or are in the process of closing down completely (Chart 1). This split is broadly 45% of closed schemes plus 12% that are frozen (or paid up) and a further 1% winding up permanently.

Chart 1[9]



[9] TPR / PPF (2006)

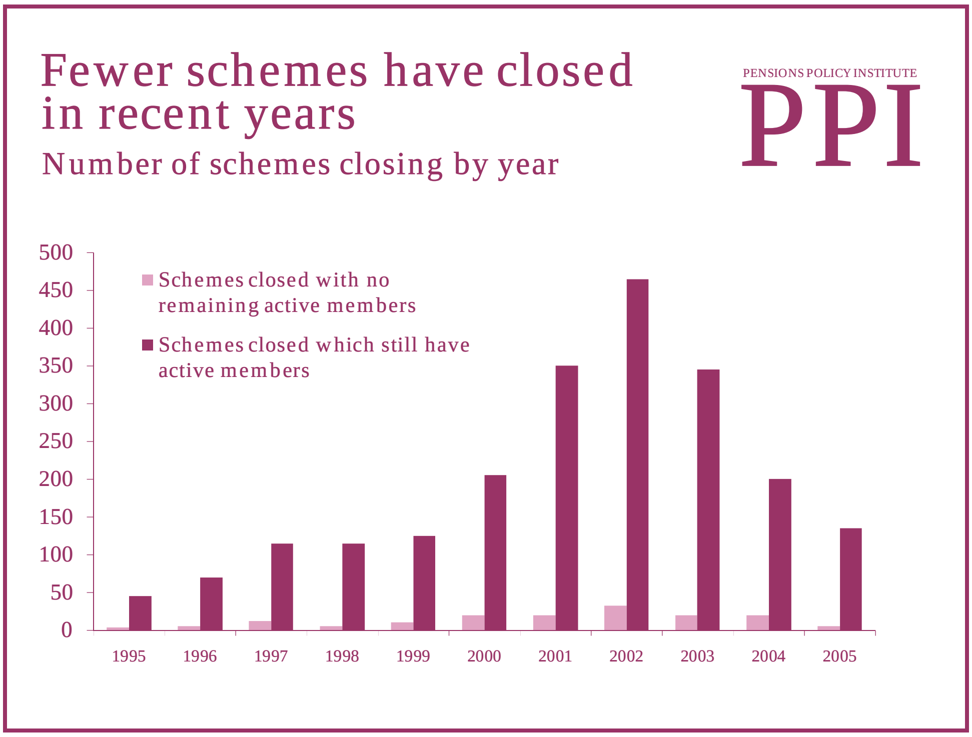
The number of open DB schemes in the private sector has fallen, but fewer DB schemes have closed in recent years

Defined Benefit provision in the private sector is in decline. In 2000, there were around 6,500 open DB schemes with at least 12 members. Five years later there were around 2,500 open schemes of the same size left – a reduction of around 60%.[10]

This relatively short-term snapshot, however, may conceal a more benign trend. Information on the number of DB schemes that have closed since 1995 shows that the number of closures peaked in 2002 and that fewer schemes have been closing in recent years (Chart 2).

This could suggest that DB provision in the private sector is nearing a steady state, with only those employers committed to providing a Defined Benefit pension remaining. The trend, however, could also be temporary; reflecting more favourable short-term conditions, for example an upturn in the stock market, or the barriers to closure of DB schemes becoming harder to overcome.

Chart 2[11]



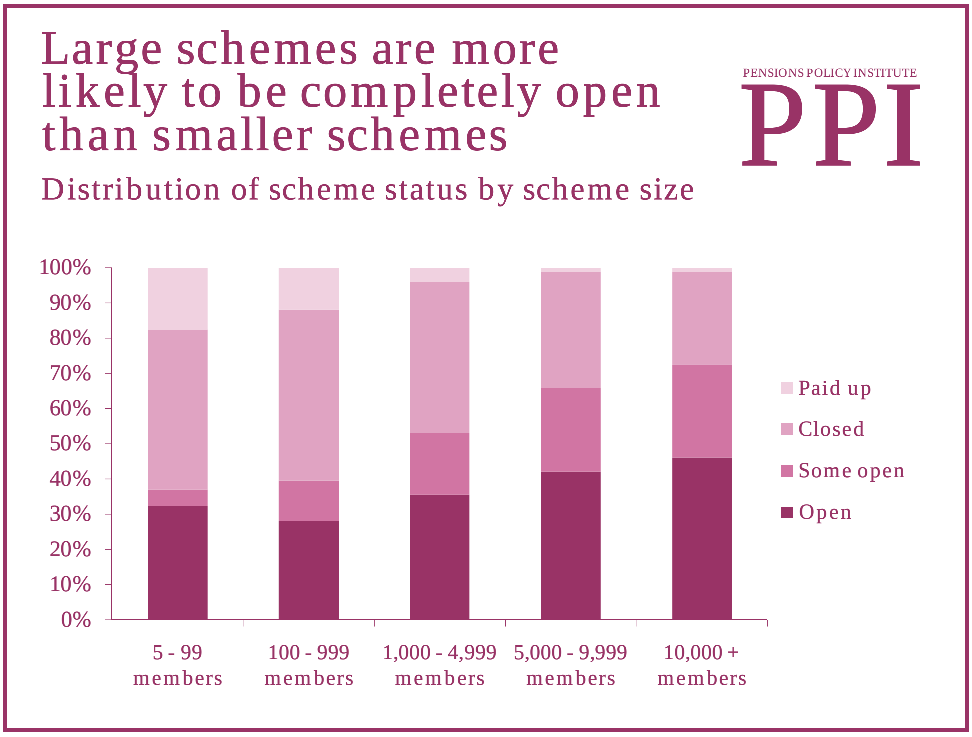
[10] GAD (2003); GAD (2006). Estimates for all schemes can not be made because the information held for schemes with fewer than 12 members is thought to be unreliable.
[11] TPR / PPF (2006)

Smaller DB schemes are more likely to be closed to new members than larger schemes

Today an estimated 45% of DB schemes are closed to new members with a further 13% frozen or in the process of winding-up. Only ten years ago as few as 10% of schemes were closed to new members.[12] But changes in DB provision have not been uniform across schemes of different sizes, with smaller schemes closing faster than larger ones (Chart 3).

47% of schemes with less than 1,000 members are now closed, whereas only 27% of schemes with at least 10,000 members are closed to new members.

Chart 3[13]



A large proportion of members are in DB schemes that are open to new members

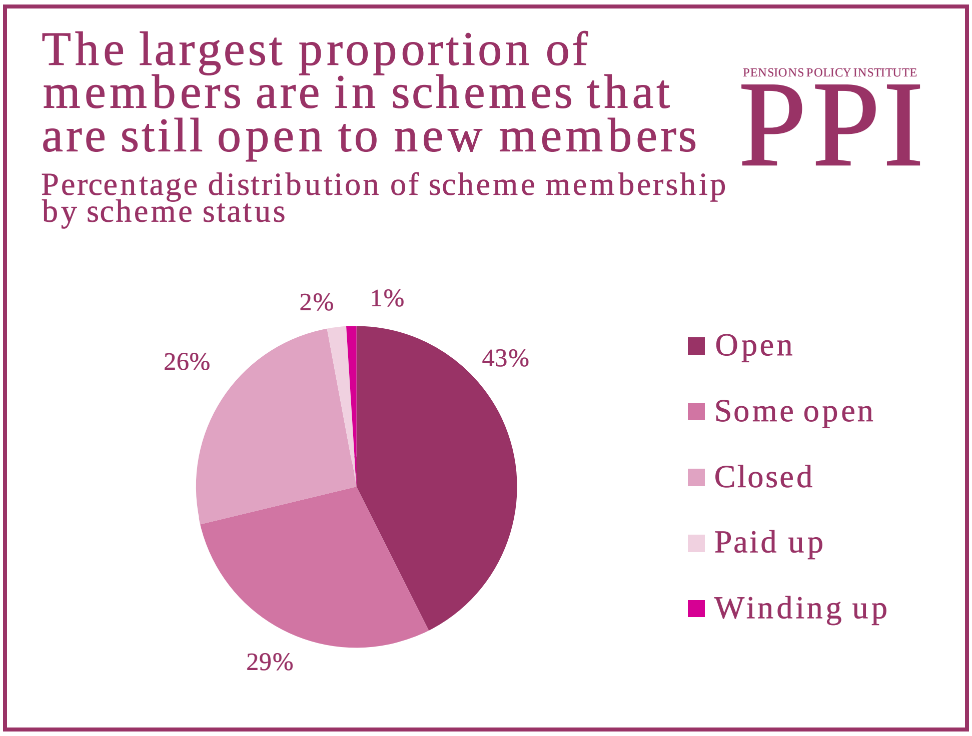
Earlier we saw that the majority of DB schemes in the private sector are closed to new members. The picture, however, is more positive when looking at the number of members by scheme status. 43% of members, the single largest group, are in schemes that are still open to new members (Chart 4). This is because large schemes are more likely to be open than smaller schemes.

However, some members are in DB schemes that have some sections that are closed to new members, while some sections within the scheme remain open. There is some uncertainty regarding the exact status of

[12] Quoted in NAPF (2006) Response to White Paper
[13] TPR / PPF (2006)

these schemes. For example, many could be DB schemes that have closed the DB section to new members and that now have a DC section that is open. Others could be DB schemes that have closed the final salary section and transferred members into a career-average scheme. If we include members that are in schemes with some sections open and some sections closed, then 72% of DB members, by far the largest group, are in schemes with some sections open to new members.

Chart 4[14]



Although a large proportion of members belong to schemes that are still open, not all of these members will be active members who are still accruing entitlements to a pension benefit. A member of a DB scheme can be in one of three categories:

- ***Active members*** are employees that are still accruing a pensionable service in the scheme.
- ***Deferred members*** are previous active members of the scheme who are no longer accruing pensionable rights, because they left either the scheme or the company that sponsors the scheme.
- ***Pensioners*** are those members who are receiving a pension payment from the scheme.

Schemes that are frozen (or paid-up) and schemes that are in the process of winding up no longer have any active members.

[14] TPR / PPF (2006)

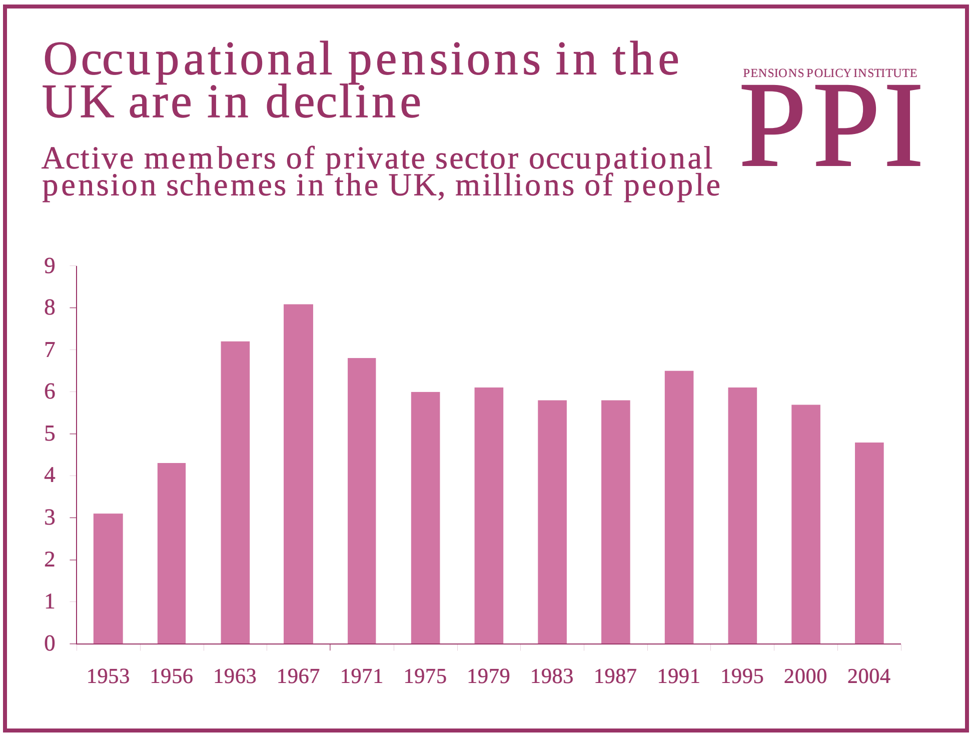
Only a quarter of DB scheme members are active members

There are currently around 15 million members in DB schemes in the UK but only one quarter of them (or around 3 - 4 million[15]) are active members. The biggest group are members with deferred benefits, representing around 41% of the membership, while the rest (33%) are pensioners.[16]

Active membership of private sector occupational pension schemes is in decline

In the 1950s and 1960s, active membership of occupational schemes in the private sector (i.e. both DB and DC) was growing and peaked at around 8 million active members in 1967 (Chart 5). After this, active membership started to decline and fell by around 40% in the period between the peak in 1967 and 2004, even though employment had risen by around 16%.[17]

Chart 5[18]

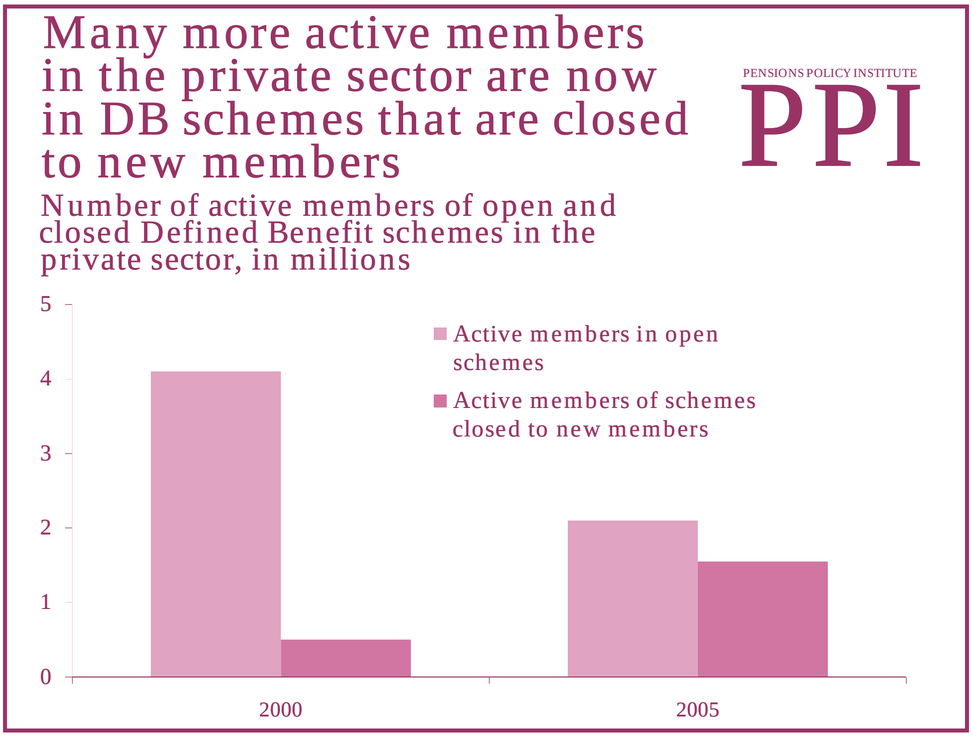


[15] Estimates using figures from TPR / PPF (2006) suggest that there were around 3.8 million active members in 2006. Estimates from ONS (2007) put the figure closer to 3.35 for 2006.
[16] TPR / PPF (2006)
[17] LFS (2007); according to the LFS employment increased from 24.5 million in 1971 to 28.4 million in 2004
[18] For the years 1953 to 2000 see GAD (2003); for 2004 see ONS (2007). Figures are also available from the Pensions Commission website, Figure 3.24 of the First Report, ***Challenges and Choices.***

Nearly half of active members are in DB schemes that are closed to new members

Today there are fewer active members in DB schemes in the private sector than there have been in the last 40 years, and a greater proportion of active members are now in closed schemes. In 2000, the vast majority of active members were part of an open DB scheme (Chart 6). Out of the estimated 4.6 million active members, around 90% were in open schemes. Only five years later the picture was very different. Out of an estimated 3.66 million members still accruing a pensionable benefit in 2005, the proportion in open schemes had fallen to under 60%.

Chart 6[19]



As more active members are now in closed DB schemes the number of deferred members is set to rise. Already deferred members are a large group. In ***The purple book*** sample 41% of the membership (or 6 million people) are deferred members. However, this does not mean than 41% of people have a deferred pension since some people may have a number of deferred pension entitlements spread over a number of schemes and could be counted in the active membership group too.

Nevertheless, the increasing number of deferred members could have an impact on the type of relationship some schemes have with their sponsor, since deferred members may have a weaker connection to the pension scheme.

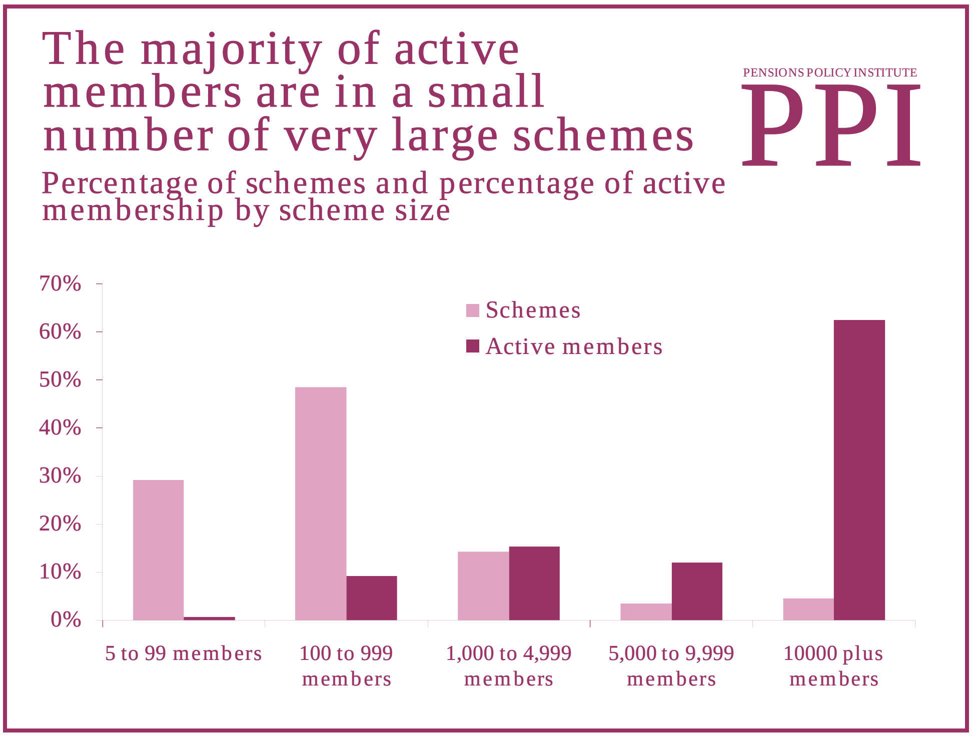
[19] GAD (2003); GAD (2006)

The majority of active members are in a small number of large schemes

Both the distribution of schemes and the distribution of the active membership by scheme size are highly skewed. A small proportion of very large schemes account for a very large proportion of active members (Chart 7).

Around 80% of schemes have fewer than 1,000 members but they only account for around 10% of active membership. In contrast, schemes with 10,000 or more members, representing around 5% of ***The purple book*** sample, account for 63% of active members.

Chart 7[20]



The funding position of schemes is volatile

The funding position of a scheme is determined by calculating the scheme's assets and liabilities. Although assets are commonly measured by their market value, there are different ways to measure liabilities. In ***The purple book***, TPR / PPF provide funding estimates based on three separate methods for determining a scheme's funding position (Box 2).

[20] Estimates using figures provided by The Pensions Regulator. The distribution of schemes includes schemes that are open, closed or that have some sections open. The distribution of members only includes active members.

Box 2: ***Estimating liabilities***

Several standards are available to describe the funding position of DB schemes. In ***The purple book***, TPR/PPF provide funding estimates based on the following three definitions:

- Section 179 of the Pensions Act 2004 (s179) is a measure of pension liabilities enacted for the purpose of calculating the Pension Protection Fund levy. The s179 basis is, broadly speaking, what would have to be paid to an insurance company to take on the payment of PPF levels of compensation.
- The Financial Reporting Standard 17 (FRS 17) is an accountancy standard for DB schemes that requires surpluses or deficits to be reported in employers' balance sheets. It prescribes that liabilities are valued using a discount rate set with reference to AA corporate bonds.
- Measuring liabilities on a full buy-out basis is done when a company wants to sell a closed but fully funded pension scheme to a third party; usually an insurance company. This measure is useful to highlight the cost of transferring all risks to an insurer.

There is an additional standard called Section 19 of the International Accounting Standards (IAS 19) which is similar in nature to FRS 17.[21] Note that there are sometimes important differences between the valuations that the standards produce. This is because, for example, under s179 estimates of liabilities exclude any indexation of benefits accrued before April 1997.[22]

The funding position of a scheme as measured by any of the above standards only provides a partial picture of the financial strength of a scheme. The difference between a scheme's assets and liabilities says very little about the financial position of the company sponsoring the scheme. For example, a scheme that happens to be in surplus one day could be less secure than a scheme in deficit. This could be because the scheme in surplus belongs to an employer that is close to insolvency, while the scheme in deficit is linked to an employer on a strong financial footing, and with a strong covenant.

Legislation has now been passed trying to address the problem of under funded pension schemes belonging to bankrupt firms (see Chapter 2) but the fact is that standards like s179 and FRS 17 only capture part the complex relationship between a scheme and its sponsor.

Depending on the measure used, the aggregate position of DB schemes may vary considerably. For example, as of 31st March 2006 the value of aggregate deficits for schemes in ***The purple book*** sample was £33.8 billion on an s179 basis and £88.6 billion under FRS 17. The equivalent figure when measured on a full

[21] Section 19 of the International Accounting Standards (IAS 19) is an international standard that is also widely used and is closely related to FRS 17. The standard forms part of a convergence project aiming to eliminate a variety of differences between International Financial Reporting Standards and the US system.
[22] See TPR/PPF (2006) Chapter 4 for more details

buy-out basis was significantly higher at £440.4 billion. The figure is higher when measured on a buy-out basis because insurance companies will use a lower discount rate[23] to value liabilities and will charge a premium for the risk of taking on the pension promises of the scheme.

The value of surpluses or deficits is not determined only by the measure used but is also largely dependent on when the assets and liabilities are measured. For example, in June 2002 the aggregate pension deficit of the FTSE 100 companies stood at around £40 billion on an FRS 17 basis. The deficit then peaked at around £90 billion in 2003 but has since improved, standing at around £2 billion earlier this year.[24] More recent estimates show that the pension schemes of FTSE 100 companies had in fact a net surplus of £12 billion under the IAS 19 accounting standard as at mid-July 2007, a large improvement from the £36 billion deficit last year.[25]

Surpluses or deficits can vary so much because measures such as s179, IAS 19 and FRS 17 provide only a snapshot at a given point in time. FRS 17, for example, requires pension funds to show all investment assets at their market value as they happen to be at the end of the financial year. In reality, the value of such investments will fluctuate on a day-to-day basis. Trustees using these valuations for making decisions with regard to funding strategy could find them of limited use, preferring instead to rely on more long-term measurements of liabilities, for example, given during the actuarial valuation of the fund.

Larger schemes are better funded than smaller schemes

The funding position of schemes also varies by the size of schemes. For example, in March 2006, schemes with between 5 and 99 members in ***The purple book*** sample had an average funding level of 81%. In comparison, schemes with 10,000 members or more had an average funding level of 96% (Table 1).

Even though on average these very large schemes were not fully funded, on aggregate their assets were valued at £2.1 billion more than their aggregate liabilities when measured on an s179 basis. This is possible because average funding levels take an average of the ratio between assets and liabilities for each individual scheme. In contrast, schemes with fewer than 1,000 members had a combined deficit worth around £14 billion in March 2006.

According to ***The purple book***, very large schemes comprise 64% of liabilities but only make up 43% of deficits, while accounting for 82% of surpluses.[26]

[23] See Glossary
[24] Watson Wyatt Worldwide ***Pensions Deficit Index;*** for monthly updates of the funding position of the 7,500 schemes in the PPF sample see http://www.pensionprotectionfund.org.uk/index/ppf_7800_index.htm
[25] Lane, Clark & Peacock (2007)
[26] See TPR/PPF (2006) page 28

This could help explain why a larger proportion of them remain open to new members when compared to smaller schemes.

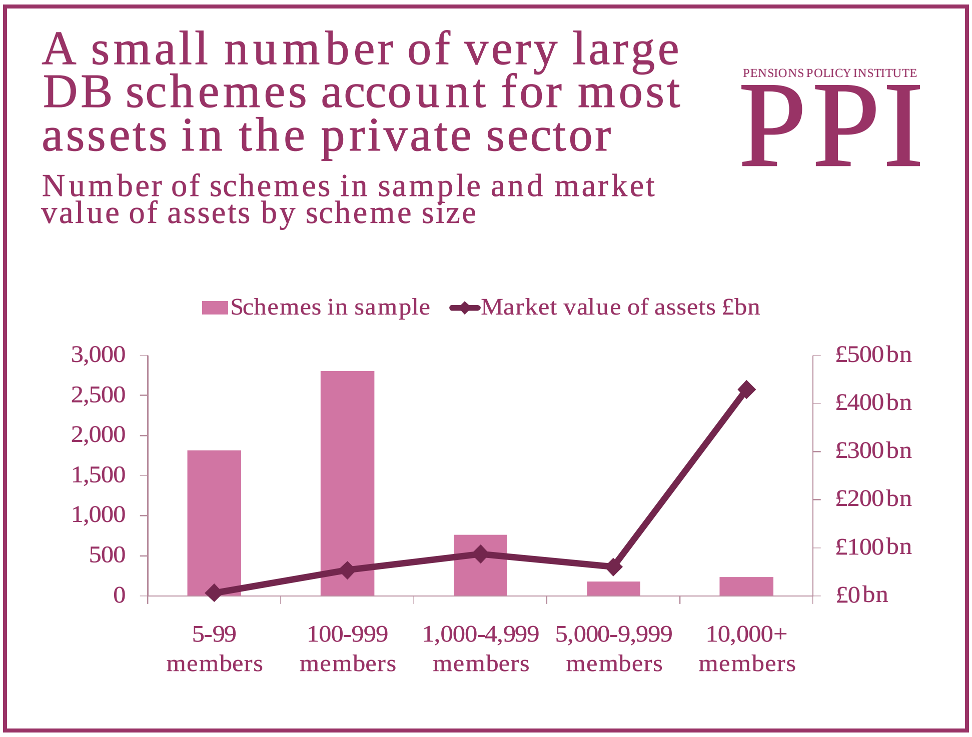
Table 1: Average funding level and aggregate funding position under s179, by scheme size[27]

	5 to 99 members	100 to 999 members	1,000 to 4,999 members	5,000 to 9,999 members	10,000+ members
Average funding level	81%	78%	83%	89%	96%
Aggregate surplus / deficit £ billion	-1.4	-12.6	-14.9	-7.0	2.1

A small number of very large schemes account for most assets

Not only are larger schemes better funded, they also account for the vast majority of assets. A very small number of very large schemes account for the majority of assets in private sector DB schemes (Chart 8). Schemes with 10,000 members or more account for 68% of total assets but only make up around 4% of the number of schemes in ***The purple book*** sample.

Chart 8[28]



[27] TPR / PPF (2006) page 29
[28] TPR / PPF (2006)

Total and average contributions to DB schemes are increasing

In 2002, the increase in the combined level of employer and employee contributions into DB schemes started to accelerate (Chart 9). In 2005 total contributions to funded occupational private pension schemes,[29] of which the majority are private sector DB schemes, totalled £42.1 billion.[30] This was made up of £35.1 billion of contributions from employers plus £7.0 billion from employees.

To put this in context, total contributions into personal pension schemes (which includes GPPs and stakeholder pensions) totalled only £14.7 billion.

Chart 9[31]

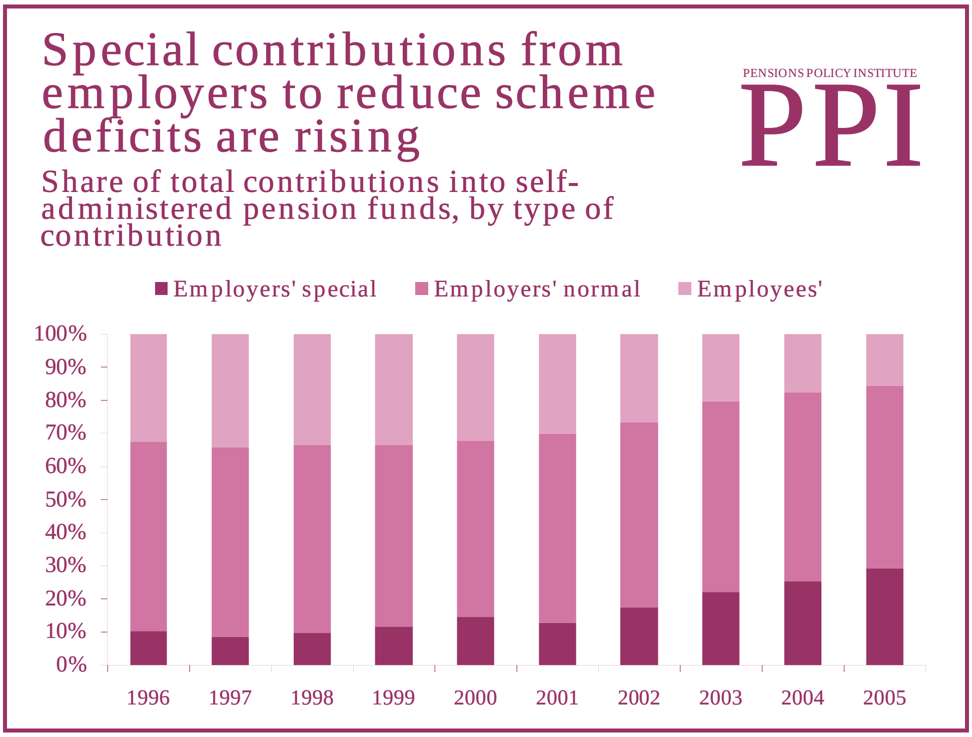
Average employer and employee contribution rates to DB schemes have also been increasing. In 2002 the average employer contribution was 11.5% of total earnings, while employees contributed 4.3%. By 2007 average employer contributions had nearly doubled to 22.6%, while employees contributed 6.1% on average.[32] Average contributions to DC schemes have also been increasing but remain at around half the level seen under DB schemes.[33]

29 See Glossary
30 ONS (2007 PT) Table 8.12; funded occupational pension schemes in the private sector include private sector DB, private sector DC and may include funded local government schemes run by the private sector
31 ONS (2007 PT) Table 8.12
32 ACA (2007); figures exclude nil employer contributions made into 28% of stakeholder pension schemes
33 Also see ONS (2007)

Much of the growth in contributions is driven by an increase in ***special contributions*** (Chart 10). Employers' special contributions are generally lump-sum payments to reduce any deficit between the assets and liabilities of DB schemes.

In 2005 special contributions accounted for at least 25% (or £10.8 billion) of total contributions to self-administered pension funds,[34] most of which again are DB schemes in the private sector.[35]

Chart 10[36]



Private sector DB schemes are more generous than private sector DC schemes

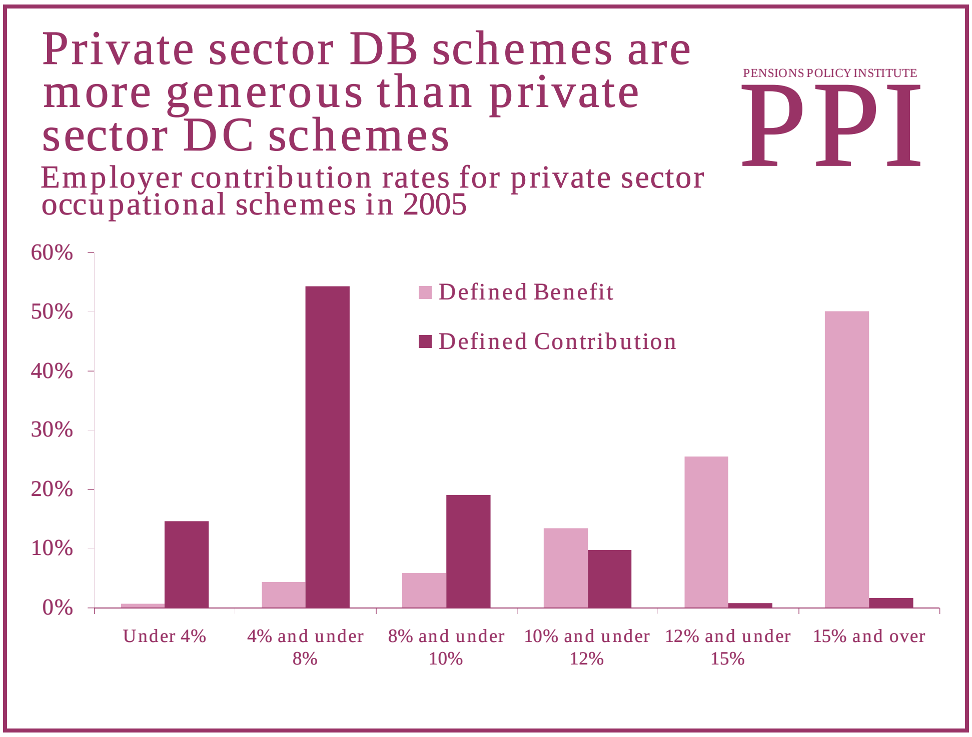
Private sector DB schemes are more generous in the sense that the employer contribution is on average higher than that offered in DC schemes. For example, the average employer contribution rate in 2005 was 16% of salary for DB schemes compared with 6.3% for DC schemes (Chart 11).

Employees also contribute more under DB arrangements. The average employee contribution rate in 2005 was 4.4% of salary for private sector DB schemes compared with 2.7% for DC schemes.[37]
Although contribution levels to DB pensions are higher than contribution levels to DC pensions, this does not necessarily mean that employers'

[34] See Glossary; although these are all private sector schemes the figures will include self-administered schemes of local authorities and employees previously employed in nationalised industries.
[35] ONS (2005)
[36] ONS (2005)
[37] ONS (2007 PT)

contribution rates reduced as they switched from DB to DC. Increasing contribution rates in DC schemes in recent years suggests that the switch from DB to DC could be helping reduce the large disparity in generosity between DB and DC. However, it is very difficult to know if employers previously offering a DB scheme are maintaining their contribution levels in the new DC schemes.

Chart 11[38]



Pension provision is moving away from DB towards DC

Today there are between 3 and 4 million active members in private sector DB schemes but there has been a steady decline in membership since 1991. Around 1.5 million of active members (or 42%) are today in schemes that are closed to new members.[39]

The number of active members in DC occupational pension schemes in the private sector has remained relatively constant in recent years, and stands at around 1 million.[40] The proportion of employees accruing pension rights in DB schemes has fallen from 34% in 2005 to 32% in 2006 while the proportion in DC pensions has increased from 26% to 30%.[41] Alongside this there has been considerable growth in the number of employees with individual pension arrangements, all of which are on a DC basis.

[38] ONS (2007 PT) Table 8.3
[39] GAD (2006)
[40] GAD (2003); GAD (2005); GAD (2006)
[41] ABI (2006)

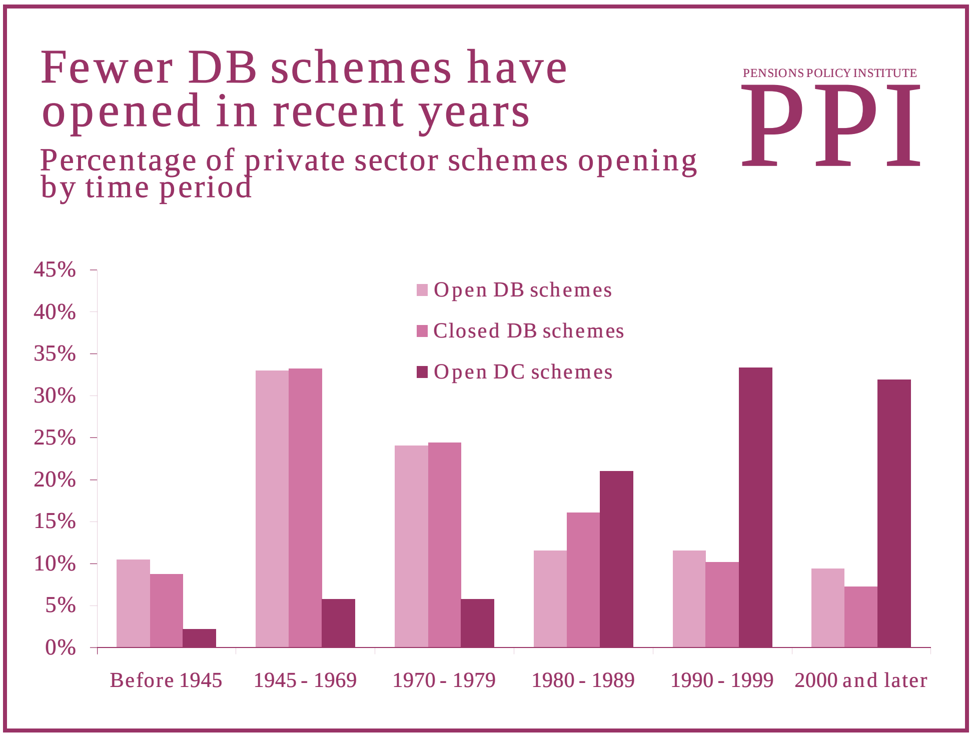
Fewer DB schemes have opened in recent years

The proportion of active members in DB schemes that are closed to new members has increased from around 10% in 2000 to around 40% in 2005 (see Chart 6). Consequently, an increasing number of active DB members are now part of a fixed group that can only reduce in size, as members leave the company (become deferred members) or retire (become pensioners).

Therefore, if take-up levels in open schemes do not change, active DB membership can only grow in future if new DB schemes are set up at a quick enough pace to offset the impact of scheme closures. But the evidence suggests that new schemes are not opening at a sufficient rate. In fact, in recent years fewer DB schemes have opened than at any other period (Chart 12).

Chart 12 helps to illustrate the decline of DB schemes and the emergence of DC. It shows the proportion of existing private sector occupational schemes by when they were founded. Around a third of open DB schemes were set up between 1945 and 1969, whereas only around 5% of DC schemes started then. In contrast, around a third of existing DC schemes were founded after 2000, compared to only around 10% of existing DB schemes.

Chart 12[42]



[42] ONS (2007 PT)

Chapter 2: What has affected the provision of Defined Benefit pensions?

Chapter 1 describes how DB provision in the private sector has changed in recent years using the most up to date available data. This chapter looks at what could be influencing the change in provision and, in particular, what drivers have led to the decline of Defined Benefit pensions. These underlying drivers fall under the following themes:

- Inherent uncertainties e.g. longevity and investment returns
- Increased legislation and regulation
- Broader economic factors
- Attitudes to pensions

Most of these factors have increased the costs and/or risks to sponsoring employers of providing a DB scheme, and in the past some of the costs and risks may have been hidden by a lack of accounting transparency.

Inherent uncertainties

There are some inherent uncertainties that could increase the cost and risks of providing DB schemes:

Longevity risk

Longevity risk refers to uncertainty about how long current pensioners will live and about how long future pensioners will live beyond pension age. A DB scheme sponsor bears this risk by setting a retirement age and the pension benefit rates. Pensioners living longer could mean an employer's pension scheme becomes increasingly costly, as benefits would have to be paid for longer.

For example, in 1980, when many DB schemes had predominantly male members, the average male life expectancy at age 65 was estimated as being 12 years.[43] Today it is 20 years.[44] In addition, there are now more women participating in the labour market and, therefore, in DB schemes. Women, on average, live longer than men. The average life expectancy of a woman at age 65 today is 22 years.

It is the responsibility of a scheme actuary to estimate future trends in longevity. However, longevity has tended to be consistently underestimated.[45] Even today, when the problems associated with underestimating life expectancy are well documented, there are still examples of schemes making relatively optimistic life expectancy assumptions. For example, the majority of FTSE 100 companies have lower

[43] GAD (2003) ***Historical Interim Life Tables 1980-82***
[44] GAD (2006) Life expectancy principle projections – cohort based www.gad.gov.uk/Life_Tables/docs/2004/20045yrGBcohort1981web.xls
[45] Pensions Commission (2004) page 124

life expectancy assumptions than the estimates provided by the PA 92 tables with 'medium cohort' life expectancy.[46]

Although it is difficult to know without the benefit of hindsight whether optimistic assumptions mean that schemes are underestimating life expectancy, getting mortality rates wrong can lead to significant underestimates of pension liabilities. As such, wrong estimates can ultimately cost scheme sponsors who do not put enough money aside to meet their pension obligations.

The cost of providing for each 65 year old pensioner in a scheme would increase by 3% if mortality assumptions are off by just one year. This rises to 8% if the assumptions are off by three years and to 13% if they are off by five years.[47] For FTSE 100 companies alone the cost could be significant. Each year of extra life expectancy adds around £12 billion to UK pension liabilities for the top 93 companies with a DB scheme.[48]

Market risk

Market risk refers to changes in inflation and long-term interest rates, and to volatile investment returns. Pension funds invest in a range of assets, such as equities and bonds, and the investment return on these assets will vary as markets fluctuate.

Investment return risk can be a particular problem for DB scheme sponsors as they have an obligation to provide their members with a certain level of pension, regardless of the performance of the stock market or bond yields.

In 2004, nearly three quarters of employer respondents in the manufacturing sector said that their main concern about the future of their pension scheme was ***reduced investment returns leading to increased costs***.[49] More recently in 2006, more than a third of smaller businesses offering a DB scheme were very concerned about ***the performance of investment markets***, while more than half were quite concerned.[50] However, views are likely to reflect the conditions of the time that they are taken.

From 1974 to 2000 the average annual real return on UK equities was 13%, whereas the very long-term historical average is 5.5%. This period of high equity returns meant that many pension funds developed a surplus - when

[46] LCP (2007) page 30. The PA 92 tables with medium cohort life expectancy are the assumptions used by the PPF for all schemes. They are prepared by the Continuous Mortality Investigation Board (CMIB) of the Institute and Faculty of Actuaries. The original PA 92 tables included an allowance for future improvements in life expectancy. Subsequent research in 2002 showed that certain people, particularly the cohort born between 1925 and 1945, were living longer than expected. The 'medium cohort' adjustment reflects these improvements in mortality rates.
[47] Figures from the Prudential quoted in ***The purple book*** page 48
[48] LCP (2007)
[49] EEF/AON (2004)
[50] ACA (2006)

the net present value of the pension promises was less than the market value of the assets of the pension fund. With UK DB pension schemes heavily invested in equities, increasingly expensive pension promises appeared affordable, even with smaller contributions. Sponsoring employers took this opportunity to reduce contributions – often referred to as ***contribution holidays***.[51]

However, some employers were also required to reduce contributions by government policy. By the early 80's, the Government had become concerned that companies were using large pension fund contributions as a means of reducing their corporate tax bill in years of high profit. The Finance Act 1986 required schemes to identify whether they had a surplus of 5% or more on a statutory basis, and to take action to remove the surplus within 5 years or lose some of their tax-exempt status.

Contribution holidays became problematic when the stock market hit a downturn in early 2000 and pension funds entered a period of low equity returns and relatively low global interest rates. Large pension fund deficits occurred when the net present value of the pension promises became greater than the market value of the assets of the pension fund. These market trends also had the effect of deterring some trustees from investing in equities, instead opting for lower-risk bonds, which are likely to produce lower investment returns than equities.[52]

Volatility of long-term interest rates is perhaps the primary source of uncertainty when it comes to forecasting the evolution of company pension liabilities.[53] Since the accounting standard FRS 17 prescribes that discount rates[54] have to be set with reference to AA corporate bond yields, the link between liabilities and interest rates has become clearer and more transparent than in the past.[55] In recent years, falling long-term interest rates, and therefore discount rates, have increased the net present value of pension liabilities using this measure.

Inflation is also a factor, through its effect on interest rates and on wages:

- If inflation falls, as it has been doing in the last ten years, investors will demand less compensation to take on the risk of investment returns being eroded. This means lower nominal interest rates, which in turn means lower discount rates.
- But it is not just investors that take note of inflation. Employees will base their wage demands on expected rises in prices. It is this uncertainty about wage levels that adds an extra layer of uncertainty when calculating future pension obligations, which for DB schemes depend on future salaries.

[51] See Glossary
[52] TPR / PPF (2006) page 66; ONS (2005) page 11
[53] Watson Wyatt (2007) ***Gilt yields and pension liabilities: a long term perspective***
[54] See Glossary for definition of discount rates
[55] Watson Wyatt (2007) ***Gilt yields and pension liabilities: a long term perspective***

Increased legislation and regulation

The number and scope of legislative and regulatory rules have been increasing since the 1970s. The aim of much legislation affecting pensions has been to increase the protection of early leavers' and pensioners' rights, and to make occupational pension scheme provision fairer and more transparent. The Government would argue that the policies have helped maintain public confidence in pensions. But in certain cases, critics have argued that these rules have added to the cost of pension promises.[56]

Increased regulation

Government regulatory policy focuses on three main themes: to increase the level of members' benefits; and / or to increase the security of members' benefits; and / or to improve the running of schemes:

- ***To increase the level of members' benefits***. A sponsoring employer of a DB scheme is expected to pay sufficient contributions to ensure that the promised pension benefits are paid once the employee retires. However, until recently the level of guarantee backing a pension promise has not been clearly defined.

  A key change to pension schemes over the last 20 years has been the replacement of discretionary benefits by guaranteed benefits; in particular, increases to pensions in payment (i.e. pensions already being paid to members in retirement) and to pensions in deferral (i.e. pension rights of members that are no longer contributing into the scheme).[57]

  For example, early leavers were granted greater protection under the Social Security Acts of 1973 and 1985. Initially, only those who stayed in the scheme for more than 5 years were entitled to a preserved pension. Then the time limit was reduced to 2 years. This reduced the cross-subsidy from early leavers to stayers, which had previously helped to keep costs down.

  Statutory increases to pensions in payment originated in the Pensions Act 1995. The original law stated that post 1997 accrued rights were required to increase in line with the Retail Price Index, capped at 5%. This requirement is called Limited Price Indexation[58] (LPI) and is often cited as having a large impact on the cost of running DB schemes.[59] Later revisions to the law in the Pensions Act 2004 reduced the requirement. From 6 April 2005 any pension built up in a salary-related scheme now has to increase in payment by 2.5% per annum, or in line with the RPI if this is less.[60]

[56] See Watson Wyatt press release July 25th 2007
[57] Campbell et al (2006)
[58] See Glossary
[59] See Fidelity (2007)
[60] See Pensions Advisory Service: ***Limited Price Indexation***

Analysis commissioned by the Deregulatory Review (Box 3 on page 43) suggests that through the abolition of LPI, private sector companies running DB schemes could save in the region of £1 billion per year.[61] This would equate roughly to 3% of total employer contributions into funded occupational schemes, of which most are DB schemes in the private sector, or 7.5% of total company contributions into FTSE 100 schemes.[62]

- ***To increase the security of members' benefits***. The Pension Protection Fund (PPF), established in 2005, is intended to provide compensation should an employer with an underfunded pension scheme became insolvent.[63] This is done by pooling the assets and liabilities of all DB schemes; so that, broadly speaking, well-funded schemes can subsidise weaker schemes through a levy that is charged to all of them.[64]

  Recently the PPF announced its intention to collect £675 million in levies for the financial year 2007/08,[65] more than twice the amount collected in 2006 because of under-collection in that year. The higher levy will place additional costs that may have more of an impact on smaller companies, who are more likely to have underfunded schemes and fewer options for raising funds. The PPF also said the cost of the levy for weaker schemes could increase from 0.5% to 1.25% of liabilities.[66]

  In 2006, 60% of respondents of a sample of companies running a DB scheme were already concerned about the actual cost of the PPF levies and over 50% worried about the principle behind the PPF, despite initial business support.[67]

- ***To improve the running of schemes.*** The Pensions Act 2004[68] introduced tighter regulations for DB scheme funding, which came into effect from September 2005.

[61] In the analysis, they authors assume 22% of active members in private sector DB schemes are in schemes that hypothetically abolish LPI for services going forward and that these schemes stay open.
[62] Total employer contributions into funded occupational pension schemes were £35.1 billion in 2005 and company contributions by the FTSE 100 were £13.4 billion in 2006.
[63] Members of schemes that belonged to employers that became insolvent prior to the establishment of the PPF are eligible for financial support through the Government's Financial Assistance Scheme (FAS)
[64] The issue of cross subsidy is complex. In reality, the PPF raises money to fund its compensation payments by: transferring the assets of pension schemes that enter the PPF, collecting an annual levy from all eligible pension schemes, recovering further assets from the insolvent employer as a major creditor and from returns on its own investments. The decision on the total levy to be collected each year is based on the results of a long-term risk model, while the distribution of the levy is based on the level of scheme funding and the probability of the sponsoring employer becoming insolvent over the next year but with a cap on the amount any scheme should pay.
[65] PPF website, FAQ: Pension Protection Levy 2007/08
[66] See ***The Pensions Protection Levy 2007/08*** fact-sheet http://www.pensionprotectionfund.org.uk/
[67] CBI/Mercer (2006 PS)
[68] DWP (2005) Press Release www.dwp.gov.uk/mediacentre/pressreleases/2005/mar/pens2205.asp

> Trustees of schemes providing defined benefits must now adopt a new statutory funding objective. This requires the scheme to have sufficient assets to cover an actuarial estimate of the amount needed to pay the benefits when due. Trustees must prepare a statement of funding principles specifying how this objective will be met along with a schedule of contributions specifying rates of contributions due to be paid by the employer and by active members.
>
> If the statutory funding objective is not met, the trustees must prepare a recovery plan to correct the shortfall within a specified period. This process is to be monitored by The Pensions Regulator (TPR), which has powers to seek additional funding for a pension scheme.

Three quarters of firms with DB schemes report that rising pension costs have significantly reduced company profits and around one third have reduced investment in the business, up from 50% in 2004 despite the level of deficits remaining roughly the same.[69] This could reflect the increased attention to pension funding following the introduction of the new regulatory regime.[70]

Although it is difficult to measure the effects that each of these factors have had (i.e. longevity risk, market risk, legislative or regulatory changes), the Pensions Commission estimated that the combined impact of all these changes had increased total long-term costs (i.e. the combined employer and employee contributions required) of a final salary scheme from approximately 10-12% in the 1950s to 22-26% today.[71]

Recently the Deregulatory Review stated that ***the ever-increasing regulatory burden surrounding DB schemes*** was one of several ***important reasons for the flight from DB***.[72] Legislative changes can also have the additional impact of increasing scheme administration costs. 74% of a sample of employers running small DB schemes said they were very concerned about ***the increasing burden of management time running schemes***, and 71% about ***the impact of legislation on benefits and funding costs***.[73]

There is a perception that increased regulation has resulted in higher costs for employers. In reality, it is difficult to measure what impact the new rules have had on the cost of running DB schemes. Scheme sponsors report concerns about increased regulation but it is difficult to prove that the regulations have directly influenced employer behaviour. And one must also consider what the counterfactual would be. Part of the policy rationale of the increase in regulation, and the added security it has brought, may have played a role in supporting consumer confidence in pensions. But once again this is difficult to measure.

[69] CBI / Mercer (2006 PS)
[70] CBI / Mercer (2006 PS) page 12
[71] Pensions Commission (2004) page 123
[72] See letter to Mike O'Brien dated 25 July 2007 from the deregulatory review paragraph 7
[73] ACA (2006)

Tighter financial accounting procedures

FRS 17 is an accountancy standard for DB schemes, fully operational from 2002/3, that requires surpluses or deficits to be reported in the employers' balance sheets.[74] It prescribes that discount rates be set with reference to AA corporate bonds. The intention of the standard is to ensure that financial statements reflect the true value of a company's assets and liabilities, and that the full costs of providing an employee pension are disclosed. The requirement also means that the costs of providing employee retirement benefits are recognised in a financial year in which the benefits are earned by employees.

Prior to the introduction of FRS 17 it was possible for employers to 'smooth out' the volatility in the underlying assets and liabilities of their pension funds. This reflected the fact that pension funds were long-term undertakings. Today, FRS 17 requires that pension funds state the value of their assets at the market value at the end of each financial year. This means that FRS 17 deficits or surpluses will be influenced by the value of the stock market on that day.

New accountancy requirements, such as the FRS 17, have made the costs of running a DB scheme more apparent by requiring that a measure of the pension fund's net liabilities is disclosed on the company's balance sheet. And, although FRS 17 has added transparency to a company's accounts, it may have inadvertently made DB schemes less attractive to sponsoring employers and trustees.

The size of a deficit is also sensitive to the assumptions used by scheme actuaries to estimate the size of liabilities; for example, the rate of wage increases, the rate of investment return on pension scheme assets, the discount rate,[75] the rate of inflation, and life expectancy. Small changes in these assumptions can lead to large changes in the estimated size of the liabilities. Even though actuaries must advise companies on ***an entity's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits,***[76] employers still have some discretion as to what assumptions to use. Therefore, comparing schemes on this basis can be problematic as the assumptions may differ between schemes.

Some companies with underfunded schemes could be tempted to use their discretion over these core assumptions to help reduce the perceived value of their pension liabilities. Even though less conservative assumptions may give markets a misleading value of pension liabilities, it is currently not mandatory under FRS 17 or IAS 19 to disclose the assumptions relating to life expectancy, and some companies do not disclose this information.

[74] Under EU regulations, FTSE100 companies will be required to report under a new financial standard, IAS 19, which is largely similar to FRS 17
[75] See Glossary
[76] See the Actuarial Profession website www.actuaries.org.uk

In 2006, 76 out of 93 companies in the FTSE 100 with a DB scheme provided sufficient information to derive basic mortality statistics.[77]

In order to promote transparency, the Accounting Standards Board (ASB) recently published a set of voluntary guidelines. They include six principles that the ASB believes should be considered when providing disclosures in financial statements. The ASB encourages employers to provide the principal assumptions used to measure scheme liabilities and how sensitive liabilities are to changes in the assumptions used. Such practices may help overcome scepticism among the investment community regarding the true valuation of liabilities based on undisclosed assumptions.[78]

Even without additional regulation, trends in corporate governance show a general move to more prudent assessments of pension risks. This new rigour has increased awareness of unsustainable pension liabilities and has put pressure on company directors to reduce deficits and, ultimately, to close schemes.[79]

Changes to the tax system

The tax system affecting pension funds can also change. The removal of tax relief on UK equity dividends in 1997, known as Advanced Corporation Tax (ACT), is an example.[80] The rationale for abolishing ACT relief was to remove the incentive for companies to distribute more of their profits as dividends while reinvesting less in their own businesses. The Government hoped that removing this incentive would stimulate growth in the economy.

Therefore, ACT was removed so that the tax system for dividends was no longer more advantageous for pension schemes than for basic rate taxpayers. Some critics have argued, however, that the change has resulted in a significant reduction in investment income for pension schemes.[81] In reality, the cost to pension schemes and the effect on government finances is less certain in the long term.[82]

There have been positive changes too. The simplification of the pension scheme taxation system in 2006 is an example; these changes replaced the system of eight tax regimes for pensions with just one.[83]

[77] LCP (2007)

[78] PCS (2007); this is a small survey of 40 analysts, 41% currently believe IAS 19 is an underestimate of the true size of pension liabilities

[79] Campbell et al (2006)

[80] In 1997 the Labour government abolished dividend tax credits for company pension funds.

[81] ***The Telegraph*** (16 October 2006) ***Brown's raid on pensions costs Britain £100 billion***

[82] See PPI (2005 BN)

[83] As of 6 April 2006 (A-Day), a single tax regime replaced the many different rules that had previously governed the taxation of pensions. This was intended to offer simpler and more flexible retirement arrangements for employers and individuals.

Broader economic factors

DB schemes are also subject to broader economic trends. Certain trends could directly influence the provision of DB schemes, but are difficult to measure. This section comments on three such trends:

- ***The nature of the job market and increased employee mobility***. Both employer and employee attitudes are important to the provision of a DB scheme. Employers are more likely to remain committed to providing a DB scheme if they perceive such schemes to be a useful recruitment and retention tool.

  On the other hand, a DB scheme may not be the most appropriate pensions saving vehicle for all employees. For example, for employees who frequently switch jobs a portable Defined Contribution scheme may be more suitable. Or, for some workers whose earnings diminish as they approach retirement a career average scheme would be more appropriate than a final salary scheme.

  Working patterns are changing. When DB schemes were first established the workforce was mainly male and jobs tended to be for life. This is no longer the case. The employment rate for women has risen from around 56% in 1971 to around 70% in 2005 but women are still more likely to be working part-time than men.[84] Also, women are more likely to be economically inactive than men, taking career breaks to care for children or the disabled.[85] So employers could see advantages in providing a flexible DC scheme to cater for a more flexible workforce.

  A number of government initiatives have been introduced recently to encourage employers to hire older people and to encourage people to retire later.[86] A fundamental aspect of this is that older workers should have more opportunities to work flexibly, including more opportunities for part-time working. For these older part-time workers, salary decreases at the end of their working life could make a final salary pension scheme less lucrative.

- ***The nature of business cycles/company longevity***. Companies have a lifespan and the UK's economic structure is constantly changing. Of all the companies in the FTSE 100 when it was set up in 1984, only 38 remained in the index 20 years later.[87] The primary threat to DB schemes is insolvency of the sponsoring employer.[88]

[84] LFS (2006)
[85] PPI (2003)
[86] To encourage employers to retain older staff the Government introduced The Employment Equality (Age) Regulations (2006). From October 2006 age discrimination in employment and vocational training was outlawed. To induce workers to retire later, the Government has changed the rules concerning private pensions. It now allows people to defer their tax-free lump sum and to redeem their private pension with their employer while continuing to work for that same employer past retirement age.
[87] Lord Turnbull, House of Lords, ***Hansard,*** 4 May 2006 Column 576
[88] Standard and Poor (2005)

DB schemes have long been associated with the manufacturing sector. Today, 36% of private sector DB schemes in ***The purple book*** sample belong to sponsors in manufacturing, even though the sector only accounts for roughly 15% of GDP, a share that has been falling over time.[89]

- ***Lack of competitive pressure.*** Once rival firms stop offering DB to new hires, a company can follow suit without necessarily harming recruitment prospects.

Attitudes to pensions

If employees do not value pensions then employers will not value pension provision as a recruitment and retention tool.[90] Factors that could influence the value that employees and employers put on pension provision include:

- ***Unclear interaction between private saving and state benefits.***[91] Due to the complex interaction between private pensions and means-tested benefits, some employers are unsure as to whether it is always in the best interests of some employees to save in an occupational scheme, especially low earners.[92]

- ***Lack of confidence in the financial services industry.*** This could create a barrier for employers and employees to increasing private saving.[93] 20% of people say that one reason why they have not joined a pension is that they do not trust providers, while 18% say that they are worried about poor returns from saving.[94]

This chapter shows that several factors have contributed to the decline in DB provision in the private sector. Of these factors, larger than expected improvements in longevity has potentially placed the largest pressure on private sector DB schemes. In the next section we see that schemes have been changing their pension provision in a number of different ways in response to the underlying pressures on DB schemes.

[89] TPR / PPF (2006) chart 3.8
[90] DWP (2007 AP) Table 7.6
[91] See PPI (2006)
[92] The Employer Task Force on Pensions (2004) page 6
[93] The Employer Task Force on Pensions (2004) page 6
[94] ABI (2006)

Chapter 3: How are scheme sponsors responding?

DB pension provision in the private sector has been changing. Although there are common underlying drivers affecting employers' willingness to continue offering DB schemes, this chapter shows that scheme sponsors have been changing provision in a number of different ways:

- ***Reducing deficits.*** Scheme sponsors have taken measures to increase scheme assets and to reduce liabilities. To increase assets they can make additional contributions, increase contribution levels or set aside contingent assets. To reduce liabilities they can attempt to reduce benefits or raise the Normal Retirement Age.

- ***Changing investment strategy.*** As part of wider risk management exercises carried out by trustees, some schemes have changed their investment strategy in an attempt to reduce the size of the deficit or to help stop deficits growing. Strategies will not only depend on the funding position of the scheme and the scheme maturity, and therefore on the risk profile faced by trustees, but will also be influenced by the financial strength of the sponsor.

- ***Reducing the risk and / or level of pension provision.*** Many DB schemes have been closed to new members and the replacement schemes are predominantly DC schemes, which can be less generous, place greater risk on the employee and have lower take-up rates. However, some employers have adopted hybrid or risk-sharing schemes, which can spread the costs and risks of the pension between employers and employees.

- ***Winding up or selling on pension provision.*** Although still relatively uncommon, buy-outs are becoming a viable option for some employers.

This chapter looks at how scheme sponsors are reacting to the underlying drivers affecting DB schemes, described in the previous chapter, using recent case studies where possible to help illustrate some of the issues raised.

Deficit reduction strategies

Despite recent gains from rising stock markets and bond yields, the funding position of DB schemes remains uncertain. As of 31st March 2006, DB schemes in ***The purple book*** sample had an aggregate deficit of £88.6 billion on an FRS 17 basis.[95] This position, however, is likely to be different today as the value of the underlying assets and liabilities continually changes.

For example, a survey from early 2007 showed that the aggregate pension deficit of the FTSE 100 companies had fallen from around £40 billion to £20 billion on an FRS 17 basis during the previous 12 months.[96] A more recent

[95] TPR / PPF (2006) page 28
[96] ***Financial Times*** (27 March 2007) ***Biggest pension funds' deficit falls by 40%***

survey estimated that FTSE 100 companies had a combined surplus in their pension schemes in mid-July 2007.[97]

In general, to reduce a deficit a pension scheme needs to increase assets and /or reduce liabilities. To increase assets, trustees and sponsoring employers can:

- ***Make additional contributions to the scheme.*** By 7 April 2006, the schemes in ***The purple book*** sample had made special contributions to reduce deficits worth approximately £9.8bn. Cash injections are an immediate, short-term measure and seem to be becoming increasingly prevalent. Nearly half of a sample of 355 relatively large firms had made additional lump-sum contributions in 2006. Lump-sum contributions averaged 10% of scheme assets among larger employers with over 5,000 employees.[98]

  For example, in 2006 British Airways added £500m to its pension scheme and Royal Mail added £2bn, and in January 2007 M&S announced plans to inject £500m towards its deficit through an extensive property portfolio and redeeming secured bonds deal. These additional cash contributions paid into a pension scheme are recognised by the Pension Protection Fund and can reduce a company's levy bill.

- ***Increase contribution levels.*** This can mean increasing employers' and / or employees' annual contribution levels. Employer contributions (including special contributions) to DB schemes have increased from around £11bn per annum in 2001 to £26bn in 2004.[99]

  Although two-thirds (68%) of employers running a DB scheme have increased members' contributions and 60% of the remainder plan to do so next year,[100] increases in costs have not usually been shared equally between employers and employees. It is estimated that DB contributions have risen from 15.8% in 2002 to 22% of earnings in 2005 but that the percentage paid by the employer has increased by 5% while the employees' share only increased by 1.2% over the same period.[101]

- ***Use contingent assets to increase pension scheme security.*** Contingent assets are assets held by a third party that are only available to the pension scheme when a specific ***contingent event*** occurs.[102] For example, Marconi set up a separate account to hold contingent assets.

[97] LCP (2007)
[98] CBI / Mercer (2006 PS)
[99] See ONS (2005 PT)
[100] CBI / Mercer (2006 PS)
[101] ACA (2005 PTS)
[102] For more information see The Pensions Regulator (2006) ***Contingent Assets*** www.thepensionsregulator.gov.uk/schemeFunding/contingentAssets/index.aspx

Other types of contingent assets include security over some of the sponsoring company's assets, or a letter of credit or bank guarantee from a third party. A less common approach is for a pension scheme to acquire an ***issue of guarantee***, or ***captive arrangement***, from a general insurance company.[103]

Marconi

Most of the telecommunications company Marconi was bought out by Ericsson in January 2006. Its UK pension fund liabilities were retained by the remainder of the company, re-named Telent. At the time of Marconi's sale, the company pension fund had a £109m deficit. The transfer deal, agreed with The Pensions Regulator, involved a transfer of £185m from the sale proceeds to the pension scheme.

It was also agreed that an account of £490m be set up, held by a third party, for the potential benefit of the pension scheme. The proceeds of this account will be paid either to the scheme or back into the business depending on how future events affect the funding of the pension scheme.[104] The account will be held by a trust separate from both Telent and the pension fund. This strategy has also been used by National Grid and BAE Systems.[105]

In early 2007, one out of every five DB schemes in the private sector claimed that the sponsoring employer had either pledged or was considering the use of contingent assets to help cover the risks associated with DB provision.[106]

A contingent event could be company insolvency or when a scheme does not have sufficient funds to meet its benefit payment obligations.

The term ***contingent asset*** refers to both the type of asset involved and whether the third party owning the asset is connected to the scheme sponsor or not. Although contingent assets do not increase the assets of the scheme, and so do not affect the deficit, they do increase the security of members' benefits. This security is taken into account by The Pensions Regulator when assessing scheme funding. Contingent assets are also taken into account when calculating the Pension Protection Fund risk-based levy.

[103] This is tightly regulated by TPR
[104] AON (2006)
[105] LCP (2006) page 10
[106] See NAPF (2007)

Marks & Spencer
In its triennial actuarial valuation, M&S's UK Defined Benefit scheme at 31st March 2006 resulted in a deficit of £704m.[107] M&S has remained committed to the scheme; to reduce the deficit it has agreed with the schemes trustees that it will contribute £500m via an interest in a property-backed partnership. In addition, M&S intends to redeem outstanding secured bonds to the value of £317m, thus releasing properties with a current market value of £550m for use in the partnership.

M&S's pension scheme will hold the properties with a current market value of approximately £1.1bn. These properties will be leased back to M&S at a fixed annual rate. This strategy will inject an instant £500m into the fund. In addition, a fixed annual allocation of c£50m will be made to the pension scheme out of the partnership profits for a 15-year period.

To reduce liabilities, trustees or sponsoring employers can:

- ***Reduce benefits.*** Prior to 11 June 2003, companies could seek approval from their pension scheme's trustees and members to reduce their pension benefits in order to ensure the survival of the company and the jobs of employees. Since then, however, protection for members has been significantly strengthened and it is unlikely that trustees would agree to this. Alternatively, an employer could offer its members something that is easier and cheaper to deliver in exchange for the benefit. For example, a cash lump sum if the members transfer to another scheme.

  Because legislation makes it difficult for scheme sponsors to reduce accrued benefits, many have sought to modify benefits for future service instead, in order to control their pension liabilities.

- ***Raise the Normal Retirement Age.*** An alternative way to reduce liabilities (and increase contributions if it is a contributory scheme) is to raise the Normal Retirement Age (NRA). Around one in ten DB schemes have already done this and another 11% are considering such a rise.[108] However, raising the NRA can be difficult for employers to negotiate and highly publicised deals in the public sector could have an impact on negotiations in the private sector. This is especially true for companies whose workforces are highly unionised.

  In 2006 a deal was agreed between the Government and public sector unions that the public sector retirement age would stay at 60 for existing employees. Later in the year, British Airways, an ex-public sector employer, faced strikes by its employees over increasing

[107] Marks & Spencer press release 23 January 2007
[108] CBI / Mercer (2006 PS)

retirement age after an agreement could not be forged with the unions.

Over 60% of senior executives felt they would experience some form of impact as a result of the Government's settlement on public sector pensions.[109] Of those that expected to be affected, 63% believed it would make it difficult to remove early retirement options and nearly 60% felt it would make it more difficult to negotiate with trade unions and employees.

British Airways

In November 2006, British Airways publicly stated that it wanted to significantly reduce its £2.1bn pension fund deficit.[110] The company has agreed to increase its one-off cash injection from £500m to £800m, to increase annual contributions from £235m to £253m, and to make additional £50m annual contributions for the next three years.

However, the success of the deal may depend on whether British Airways staff accepts a cut in future benefits and / or an increase in the scheme's normal retirement age for pilots and cabin crew from 55 to 65 and from 60 to 65 for ground staff.

Change investment strategy

How schemes change their investment strategy will depend on a wider risk management assessment that will in turn be influenced by many factors. If a scheme is fully funded trustees will have no pressure to fill a deficit and so can invest a higher proportion of assets in less risky bonds. In ***The purple book*** sample, fully funded schemes invested on average around 30% of their assets in gilts and fixed income products while schemes with a funding level below 60% only invested around 20% in such assets. On the other hand, schemes with relatively large deficits will be under more pressure to attempt to close the gap and so often invest a higher proportion of their assets in equities.[111]

When making investment decisions, trustees will also consider the financial strength of the sponsor, which can ultimately act as a funder of last resort. There is little information regarding how the employer covenant and the strength of the sponsor influence investment decisions. What is clear is that schemes with a strong employer will have less pressure to fill a deficit if trustees feel that the covenant is strong and that the employer can make good any deficit that exists.

When trustees consider whether or not to change the investment strategy, the final choice will usually depend on which of the following two

[109] CBI / Mercer (2006 PS)
[110] ***Financial Times*** (16 November 2006) ***British Airways sweetens offer to fund pension deficit***
[111] TPR / PPF (2006) chart 7.3

objectives they are trying to meet; to attempt to reduce the size of the deficit, or to help prevent the deficit from growing:

- ***Reduce the deficit.*** A scheme can attempt to make assets work harder in the investments that are made but at the cost of increasing the overall risk for its members. This is a difficult strategy to pursue and measuring success is problematic. Some trustees and employers have been using alternative assets, such as Private Equity funds, high yield bond funds, emerging markets and enhanced indexation.

- ***Prevent the deficit from growing.*** To avoid an escalation of the deficit, some schemes are exploring alternative investment strategies, such as Liability Driven Investment (LDI). This strategy aims to match a scheme's assets to the size of its liabilities. In practice, this tends to mean diversifying the investment strategy into a wider range of asset classes while controlling risk relative to liabilities. This approach allows the pension scheme to more carefully manage market risk (for example, changes in interest rates and inflation) and to reduce the large swings in deficits as volatile stock markets fluctuate. It does not protect the scheme from non-investment factors, such as increasing longevity and inaccurate actuarial assumptions.

  In early 2007, 17% of DB schemes in the private sector had adopted a liability-driven investment strategy, while a further 30% said this was under consideration.[112] Although LDI strategies are being used more often, in some cases they have not been a long-term solution. For example, WH Smith adopted this strategy in 2004 before closing its DB scheme completely in 2007, and in 2001 the retailer Boots switched to an LDI approach, only to move its pension fund assets back into equities in 2003.

Today, new products and innovations are giving trustees the possibility of achieving both objectives:

- ***Prevent the deficit from growing while achieving higher returns.*** Some recent product innovations now offer schemes not just the opportunity to match pension funds to their liabilities but also provide the chance for added return. These products are sometimes called LDI plus or alpha funds, and they aim to generate a return that beats the liabilities by 1% or 2%.

Regardless of how well funded a scheme is and what the relationship is like with its sponsor, asset allocation strategies will often reflect the maturity of the scheme (i.e. the profile of its members). If the proportion of current pensioner liabilities relative to total liabilities is high, then trustees tend to allocate a higher proportion of assets to bond-like products, reflecting the need to match more closely pension payment profiles. In ***The purple book*** sample, schemes with high pensioner liabilities

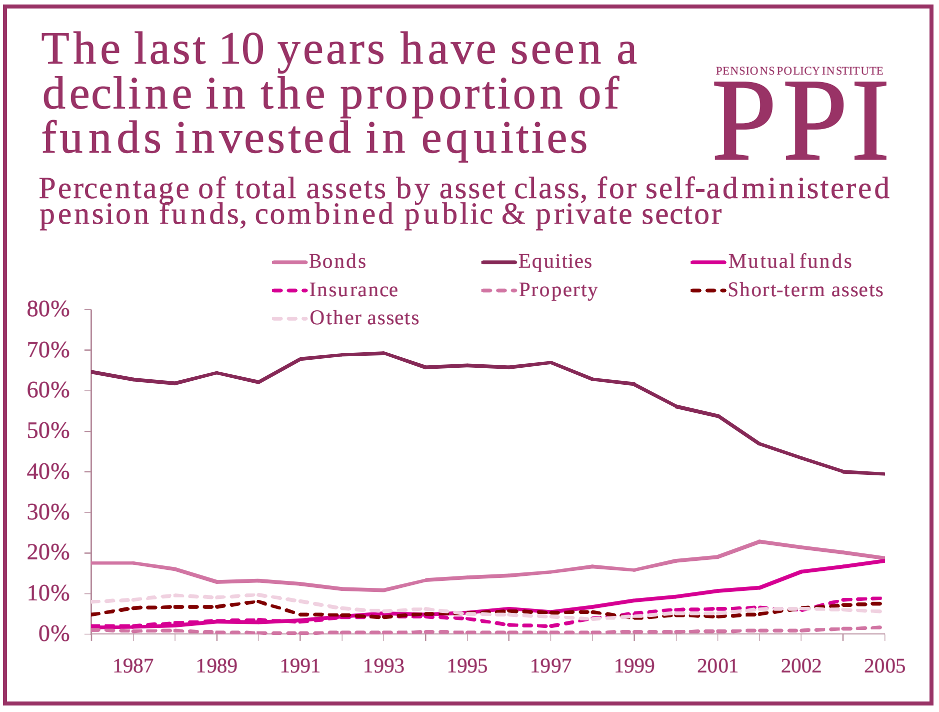
[112] NAPF (2007)

(i.e. 80%-100% of total liabilities) invested over 70% in gilts and around 20% in equities. Schemes with low pensioner liabilities (i.e. 0%-19% of total liabilities) invested less than 20% in gilts and around 75% in equities.

Whether to reduce deficits or to protect against large stock market swings, scheme actuaries, trustees and employers have taken increasingly prudent investment approaches in the last 10 years. This has involved investing in more secure assets, such as government securities that are linked to inflation, and investing less in equities, which can be more volatile.

Pension fund holdings of equities fell from around 65% in 1997 to 40% in 2005.[113] In contrast, the share in bonds increased from around 15% in 1997 to reach a peak of 23% in 2002 and then fell to 19% in 2005 (Chart 13). The recent increase in assets other than equities or bonds suggests that schemes have been diversifying their portfolios. Note, however, that changes in allocation are driven by flows of funds between asset types and by changes in asset values. For example, as the value of equities falls the allocation of equities relative to other asset holdings will also fall.

Chart 13[114]



To distinguish between active (conscious investment decisions) and passive (caused by movements in prices) asset allocation changes, in ***The purple book*** TPR/PPF looked at the flows into various asset classes. As expected, flows

113 This does not mean that pension funds only invest 40% of their assets in equities. Other investment vehicles like mutual funds and insurance companies will also have a portfolio of assets invested in equities. So the total proportion invested in equities is likely to be higher. For example, in a recent survey the proportion of pension funds assets invested in equities was closer to 60%. See NAPF (2007).
114 ONS (2005)

into equities reflect the performance of the stock market; there are positive inflows into equities when the stock market is falling but negative outflows when the stock market is rising.[115]

Until recently, schemes have had limited options to help them deal with longevity risk. New products are being introduced to mitigate some of the risk associated with rising life expectancy in the form of ***longevity bonds***, a type of asset that insures against rises in longevity. In fact several large investment banks have made their intentions public to create a new securities market for this purpose.[116]

Different strategies over time

Over time, some employers have explored different investment strategies. One example is WH Smith, which in order to cap liabilities closed its scheme to new members. Then to manage its deficit better used an LDI strategy before closing its scheme to existing members (see Box).

WH Smith

WH Smith closed its scheme to new members in 1995. Despite contributing £282m into its pension scheme over the last four years, the scheme had a significant deficit. At one point liabilities were greater than the market value of the sponsoring company. The pension scheme adopted a liability driven investment (LDI) approach in an attempt to stabilise the deficit, so that other measures, such as increased contributions, had more time to take effect.

Under the LDI strategy, adopted in October 2004, the fund switched its assets from bonds and equities in favour of interest and inflation hedged investment instruments. This meant investment returns more closely matched the payments that the fund needed to make. It also meant investment returns were likely to be less volatile than they would have been if the majority of the assets were invested in equities. However, a small proportion of assets (6% in October 2005[117]) remained invested in equities, to ensure the fund did not entirely lose out if the equity market performed strongly.

This was not enough to save the scheme. In January 2007 the company announced proposals to close its final salary scheme for existing members, currently around 11% of the workforce. Under the proposals, members will be switched to a DC scheme and their pension accruals going forward will be ***based on the level of contributions made, investment returns and the cost of buying a pension on retirement***.[118]

[115] See TPR / PPF (2006) page 68 chart 7.11
[116] See ***Financial Times*** (23 November 2006) ***Death rates spark the birth of a new market***
[117] ***Financial Times*** (13 October 2005) ***Lombard: Pensions lightning at WH Smiths***
[118] WH Smith press release 10 January 2007

Change pension provision

The nature of a DB scheme means that longevity and investment risk both fall on the employer. Given how difficult these two factors have been to predict, some employers with a DB scheme have sought to shift some of this risk on to the pension scheme members.

Closing the scheme

One way to do this is to change the pension provision altogether, starting by closing the scheme. A DB scheme can be closed in different ways:[119]

- ***Closed to new members but still open for future accruals.*** This is the most common approach taken by scheme sponsors – more than half (52%) of employers report closing their DB scheme to new entrants over the last 5 years.[120]

- ***Closed to both new members and to future accruals.*** Whether or not this is possible depends on the scheme's documentation. Closure to future accrual without triggering wind up may not be permitted, or may require trustee consent. Around 1 in 10 employers have closed their DB scheme to future accruals over the last 5 years.[121]

- ***Fully closed or 'wound up'.*** This is the last stage of a scheme's life cycle. When a scheme is winding-up it is in the process of settling benefits so as to permanently close the scheme. Then employers have several options as to how to deal with a closed scheme. If members' benefits are frozen the employer can continue running the scheme or it can sell it to an insurer. If the employer is insolvent and the scheme is underfunded, however, the scheme must be taken on by the Pension Protection Fund.

  Whether to wind up is a difficult decision. It could mean the employer has to pay a one-off contribution to cover the deficit, which could be financially difficult for the employer (see next section). Around 7% of employers claim to have placed one or more schemes in wind up.[122]

[119] Pensions Commission (2004) page 85
[120] ACA (2005 PTSR)
[121] ACA (2005 PTSR)
[122] ACA (2005 PTSR)

Rentokil
In December 2005, Rentokil became the first FTSE 100 company to close its DB scheme to new entrants and to existing members, although many smaller firms had already taken this step. Existing members have kept the benefits they have accrued, but these will now be uprated in line with prices rather than with wages between now and retirement age. The deficit at the time of closure was £350m. With an initial payment of £200m and a move to transfer some of the assets from equities to more low-risk assets, the company hopes to eliminate the deficit by 2012.[123]

When the scheme sponsor takes the decision to close the scheme to new members, regardless of whether existing benefits continue to accrue, it has to decide what type of pension arrangement, if any, it will offer as a replacement.

Some employers may decide to close their DB schemes without providing an alternative arrangement or may simply provide access to a pension, for example a stakeholder pension, without also offering an employer contribution. This means that the employer passes the entire cost and risk of pension provision to employees.

One increasingly common way for employers to remove the risk of providing a pension is to replace their DB scheme with a DC scheme for new entrants. This allows greater control and predictability of costs for the employer. The employer may choose to continue making the same contributions into the scheme but because what members receive from the pension will now depend on combined contributions, investment returns and annuity rates, their income from the DC pension is less predictable than the level previously anticipated under the DB arrangement.

In some cases, however, the change from DB to DC can also lead to a substantial decrease in employer contributions towards new benefits.[124] There is some evidence suggesting that the replacement schemes are often less generous, place much greater risk on the employee and have lower take-up rates.[125]

Some employers that have closed DB schemes have replaced the closed schemes with a risk-sharing or hybrid scheme. These schemes are often an attempt by employers to balance the risks and costs of providing a pension more fairly between them and employees.

[123] ***Economist*** (20 December 2006) ***Killing it off***
[124] Campbell et al (2006)
[125] For example, CBI / Mercer (2006); survey found that the average take up for DB schemes is 90% compared with 62% for DC schemes.

Hybrid or risk-sharing schemes
Total contributions into DB schemes have been rising. The burden of reducing deficits, however, has not been shared equally between employers and employees, with employers often accounting for most of the increases in contributions. It is this imbalance that may be persuading many scheme sponsors to shift the entire risk back onto employees i.e. by replacing a DB scheme with a DC arrangement. There are, however, alternatives. Employers could strike a compromise by sharing the risks associated with providing the pension between the employer and the members of the scheme.

Schemes that attempt to do this are known as ***hybrid*** or ***risk-sharing*** schemes but there is no single definition or description for them as they can vary significantly depending on individual arrangements. ***Hybrid pension scheme*** is a catch-all term for schemes that combine elements of DB and DC schemes. This can be done in a number of ways and is often used as a means for employers to share investment risk with employees and to increase scheme flexibility.

Unilever
The consumer goods company Unilever recently announced plans to close its final salary scheme to new members, offering instead a less generous hybrid scheme. The new scheme will have a DB component, based on a career average, covering pensionable earnings up to a threshold of £35,000 per annum. Above this threshold there will be a DC component.

From January 1st 2008, employee members of the existing scheme will be asked to increase their contribution to the fund from 5% to 7% of their salary. Alternatively, they will be able to join the new scheme. Pensioner members and deferred pensioner members will be unaffected by the proposed changes.

Unilever has said that its decision is unrelated to the current deficit of its scheme. Under the terms of an agreement made a year ago, Unilever has committed to make additional payments, including £510m in the three years to April 2008, aimed at eliminating the deficit within eight years.[126]

Hybrid schemes can provide a mixture of benefits. For example, a ***nursery scheme*** works like a DC for younger staff, but becomes related to final salary as the member gets older. Alternatives include DC schemes that guarantee that pension benefits will not fall below the level of a final salary scheme and DB schemes that cap the salary used when calculating the final benefit, incorporating a DC top-up for members who earn more than this. Other examples of risk-sharing schemes include ***cash balance plans***, ***underpin arrangements*** and ***combination hybrids***.

[126] ***BBC News*** (1 March 2007) ***Unilever to shut pension scheme***

Although some employers have set up risk-sharing schemes there is no reliable source of data on the actual number of such schemes. Survey data and anecdotal evidence suggest that risk-sharing is still restricted to a relatively small number of schemes. For example, one survey estimates that around 8% of companies have moved to hybrid arrangements and a further 19% are planning to do so in two years.[127]

Some organisations have been lobbying for changes to the law to make risk-sharing a more attractive alternative for scheme sponsors.[128] According to these organisations there is support for more risk-sharing; 72% of employers recently said that they favoured the promotion of new risk-sharing pension schemes.[129] The Government commissioned an independent Deregulatory Review in December 2006, and the Review reported in July 2007. The Government is expected to respond in October 2007 (Box 3).

Box 3: ***Deregulatory Review***

In December 2006 the Government established a Deregulatory Review of private pension legislation. The aim of the review was ***to examine regulation with the aim of simplifying and reducing the burden of legislation governing private pensions***.[130] The reviewers published their recommendations in July 2007 setting out a number of suggestions for changing existing legislation to encourage employers to retain good occupational pension provision. Much of their focus centered on how to promote more risk-sharing by scheme sponsors.

Importantly, the reviewers identified that there was already flexibility for risk-sharing under the current system.[131] In fact, some of their recommendations centered around the need to increase awareness of this, suggesting that the Government make ***clarifications*** on the effect of section 67, Pensions Act 1995, which protects accrued rights. They stated that ***changes that are not detrimental to a member's subsisting rights are not affected by section 67 at all*** and even that ***a change that is detrimental may be made with the consent of the affected member.***[132] They also agreed that existing regulations do not inhibit schemes from adjusting the normal retirement age for pensionable service.

In addition to this clarification, and to encourage more risk-sharing, the reviewers made recommendations for ***fine tuning*** the PPF risk based levy and compensation, which have often been listed as an impediment to more risk-sharing.[133] This is because any scheme that incorporates any kind of employer promise or underpin is currently classified as a scheme that is covered by the PPF and subject to the levy.

127 CBI / Mercer (2006 PS)
128 For example the ACA and Fidelity
129 See ACA (2007) Press Release ***Risk sharing is way to help bridge gap between private and public sector pension schemes***
130 DWP (2007 CP)
131 DWP (2007 IR) page 13
132 DWP (2007 IR) page 14
133 DWP (2007 IR) paragraph 92 and 95

Selling on provision

Although still relatively uncommon, ***buy-outs*** are becoming a viable option for some scheme sponsors. A ***buy-out*** or a ***bulk annuity deal*** is when a company sells a closed but fully funded pension scheme to a third party, like an insurance company, so severing the link between the employer and the closed pension scheme.

The insurer will take on the scheme's liabilities and will be responsible for paying retirement benefits to members. The advantage for the employer is a guarantee that the benefits will be paid and freedom from the financial risks of being responsible for providing the benefits. Under UK legislation, a scheme must be fully funded before it can be sold. Companies are allowed (by the regulator) to run under-funded pension schemes because their operating businesses offer members extra security. With no such operating assets, the purchasers of pension schemes are subject to stricter funding rules.

In a bulk annuity deal, a pension scheme pays an insurer a premium for taking on its pension commitments. The ***buy-out measure*** is the price an insurer or investment vehicle would charge to take over the pension liabilities. This will always be expensive, even for a scheme with a surplus, because the insurance company will charge an additional sum, based on the assumption that the pension scheme's assets will be invested largely in bonds, plus a margin for its own profit on top. Historically, a rough estimate of the price of a buy-out stands at around 130% of liabilities, as calculated by FRS 17.[134]

As more DB schemes close to new members, the potential for buy-outs could grow. However, not all companies will be able to afford this option. Activity up to this point has been limited to relatively small schemes. Due to their size and corresponding risk, very large schemes may never see buy-outs as a feasible option.

This is supported by recent survey data. It states that the majority of schemes (68%) are simply not interested in buy-outs at the present time. Of those that are, only 10% would be prepared to pay more than 120% of the liabilities when measured under FRS 17. Although the typical cost of buy-out is higher, this can vary from scheme to scheme.[135]

Even among those schemes that are considering it, the average time to buy-out is likely to be more than 12 years. Figures from the same survey suggest that activity has slowed. For example, actual transactions have fallen from a quarterly average of 84 buy-outs in 2006 to 62.5 in 2007.

[134] ***Financial Times*** (17 September 2007) ***Big Picture: New deals in UK pension buy-out market***

[135] See Aon Consulting Press Release (17 April 2007) ***Pension buyout market set to be a slow-burner, warns Aon survey;*** survey based on 150 UK companies operating a DB pension scheme between Nov 2006 and Feb 2007

Paternoster
In November 2006 the insurance company, Paternoster, completed its first deal since entering the bulk annuity market. Under the terms of the landmark agreement the assets of the Cuthbert Heath Plan were transferred to Paternoster. The pension scheme's assets are thought to be worth less than £10m.[136] In return, Paternoster will pay the pensions of about 50 people.

Since then Paternoster has been involved in at least nine more bulk-annuity deals, including the recent transfer of the Chartered Accountants' Employees Superannuation Scheme to Paternoster; payment of pensions of the 962 pensioners and 323 deferred members transferred to Paternoster during spring 2007.

Recent months have seen increased interest in the buy-out market. Start-ups, like Paternoster and Synesis Life, plus insurers, like Prudential and Legal & General, already offer this service. A host of banks and other insurance companies, including Axa, Aviva, Scottish Equitable, Goldman Sachs, Citigroup and an alliance between Aegon and UBS, have recently joined the competition for pension scheme buy-outs. Entrants to the market are attracted by the high margins that they hope can be earned from the premiums charged. However, bulk annuities are capital intensive, and insurers taking on the assets of DB schemes also take on the longevity and investment risk.[137]

Various factors could limit the size and scope of the buy-out market in future. Companies that offer this service need to have a sufficient amount of regulatory capital to be able to take on future pension scheme liabilities. Additionally, there needs to be enough capacity to meet future demand.

These capacity constraints mean that the buy-out market is likely to remain relatively small when compared to the value of existing pension liabilities. Some estimates of the value of capital held by the new buy-out firms stand at around £2 billion.[138] Given that such firms need to hold around 4% for capital requirements, this suggests that existing capacity among these firms could be around £50 billion of pension liabilities,[139] equal to around 6% of the value of total pension assets in the UK.[140]

Because of these capacity and cost constraints, some banks and private-equity firms are starting to offer alternatives to pure buy-outs. One

[136] ***Financial Times*** (10 November 2006) ***Mark Wood in bulk annuity deal***
[137] ***Financial Times*** (26 September 2006) ***Goldman seeks a move into corporate pension schemes***
[138] PPI estimate
[139] There is much uncertainty about the true value of existing capacity. According to one news article The Pensions Corporation alone has capacity worth £25 billion. See Financial Times (17 September 2007) ***Big Picture: New deals in UK pension buy-out market emerging***
[140] In 2005, total long term asset holdings of self-administered pension funds, most of which belong to DB schemes in the private sector, equalled nearly £900 billion see ONS (2007 MQ5)

example is that of Citigroup, which instead of closing a bought scheme decided instead to continue operating the scheme as a Trust (see Box).

Citigroup
In 2007 Citigroup became the first bank to take control of an external pension fund. The US bank has agreed to buy-out the £200 million closed pension scheme of Thomson Regional Newspapers (TRN). Although the scheme was in surplus on an FRS 17 basis at the time of the deal, Citigroup has now taken on the longevity and investment risk of the scheme.

Unlike other buy-outs, which replace a wound-up scheme with a series of insurance contracts with individual scheme members, Citigroup has instead opted to continue operating the scheme as a Trust. This strategy will see one new independent trustee and a Citigroup representative join the three existing member-nominated trustees.[141]

This model could make buy-outs relatively cheaper ventures than previous examples by getting around the need for an insurance company to maintain a buffer of solvency capital.[142]

A more recent example is the purchase of the Thorn pension scheme, as well as the smaller Thresher fund, by The Pension Corporation; a consortium backed by HBOS, Royal Bank of Scotland, ABN Amro and Swiss Re. The purchase was the largest ever corporate pension deal in the UK at £1.2 billion. Although the consortium intends to keep the schemes alive for the time being, the deal differs from Citigroup's transaction in one important way; it bought the relevant operating companies as well as the pension schemes, only to sell the bulk of the trading companies soon after.[143]

[141] See Glossary
[142] ***Financial Times*** (14 August 2007) ***Citigroup buys out Thomson pensions***
[143] ***Financial Times*** (17 September 2007) ***Big Picture: New deals in UK pension buy-out market***

Chapter 4: What is the future for Defined Benefit pension schemes?

Chapter 2 describes the underlying drivers influencing the DB sector. Increased longevity and poor investment returns have, in the past, resulted in large deficits and forced some employers to increase their contributions. Increased legislative and regulatory intervention has increased the cost of running DB schemes but has also helped identify the scale of the problem by making financial statements more transparent. Furthermore, the establishment of the Financial Assistance Scheme (FAS) and the Pensions Protection Fund (PPF) has helped protect the rights of existing members.

Chapter 3 uses case studies to illustrate how scheme sponsors have reacted differently to these underlying drivers. What remains uncertain is how companies will continue to react to these and future pressures. Evidence suggests companies will continue to change the nature of their pension provision. 8% of companies have moved to a hybrid arrangement and a further 19% are planning to do so in the future.[144] Many more are expected to switch to DC schemes.

Future government policy may have an impact on DB provision

The future for Defined Benefit pension schemes in the private sector remains uncertain. The cost pressures on DB schemes from rising longevity and uncertain investment returns are likely to remain, and pressure could be increased or reduced by planned government intervention.

Personal Accounts

The main proposal in the May 2006 White Paper[145] was the introduction of a new pension saving scheme of low cost, portable personal accounts. Auto-enrolment into a private pension scheme will be introduced for all employees, along with a minimum contribution from employers of 3% of band earnings.[146] Employees who choose to stay opted-in to a personal account scheme will contribute at least 4% of their earnings within a specific earnings band.[147] Employers will add to this with a 3% contribution of band earnings and the Government will add at least 1% through tax relief. Employers who offer a good occupational pension scheme will be exempt from having to offer a personal account, but they will need to follow the auto-enrolment and minimum contribution requirements.

[144] CBI / Mercer (2006 PS)
[145] DWP (2006 SR)
[146] The self-employed will be able to opt in to personal accounts but will not benefit from an employer contribution
[147] The band earnings have been proposed at between £5,000 and £33,000 a year

There has been much debate about how the new personal accounts scheme will affect existing provision. The Government has stated that ***the personal accounts scheme is designed to be an addition to the already diverse market for pension products and not to replace existing employer-sponsored provision***.[148] There is, however, much uncertainty regarding how employers will react to the introduction of auto-enrolment and compulsory contributions.

Some organisations have warned about the possibility of employers ***levelling-down*** their pension provision.[149] This refers to an employer auto-enrolling (some) staff into a scheme on less favourable terms than would have been available in the absence of the reforms. Employers may do this to control the significant increases in costs that they may face as a result of auto-enrolment. Within private companies with 20 or more employees, the proportion of staff in a pension averaged 60% where the company used automatic enrolment. Where the company used a traditional opt-in joining method[150] average membership fell to 41%.[151]

The introduction of auto-enrolment is likely to increase the number of employees saving in company pension schemes, and should therefore also increase the cost to employers of providing a pension scheme unless they make some changes to the design of the scheme to offset the increased cost.

One estimate of the total potential cost to employers (currently offering contributions above the minimum required by the reforms) of auto-enrolling all eligible employees into a pension scheme on existing terms is between £1.5bn and £2.5bn a year.[152] However, these estimates present a possible outcome under a set of assumptions on say, existing contribution rates. The PPI will also publish its own set of projections under different scenarios later in the year.

Some employers with well funded schemes, a strong financial position and a strong covenant, who value their DB scheme as a recruitment and retention tool, may absorb the increase in costs. For other employers, the overall increase in pension costs could be mitigated by a reduction in the employer contribution for each member or through a lower increase in pay.[153]

Others, despite wishing to continue to provide a DB scheme, may not be able to bear the full cost of auto-enrolment and will have no choice but to close the scheme to new members or even to future accruals. There will also be employers who will see the introduction of the reforms as the

[148] DWP (2006 PA) page 135
[149] NAPF (2006 MSMS); ABI (2007)
[150] See Glossary
[151] DWP (2006 EPPS)
[152] NAPF (2006 MSMS); the estimates include the cost of auto-enrolling employees into DB or DC arrangements that are currently contributing above the minimum required by personal accounts.
[153] DWP (2006)

right time to switch from a DB scheme to an equivalent DC arrangement or even to the default personal account system.

Because each employer is different, and because the decisions they will face are likely to depend on their own unique circumstances, how overall provision will change will remain uncertain even after 2012 as the full impact of auto-enrolment is felt. This is because many employers are unaware of the reforms to private pensions and more importantly, are unaware of the likely impact the reforms will have on costs. A third of employers were unaware of the proposed reforms to private pensions in early 2006 while half of employers currently contributing towards their employees' pensions said that the recommendations would not result in an increase in their total pension contributions.[154]

Increased pressure on scheme sponsors from auto-enrolment may or may not be offset to a certain extent by the final outcome of the Deregulatory Review, and potential further flexibility for scheme sponsors to share the costs and risks associated with DB pensions.

Deregulatory Review

In order to simplify the current legislative and regulatory landscape with the aim of promoting existing DB provision and encouraging more creativity in scheme design, the Government set up a Deregulatory Review in its May 2006 White Paper.[155] The review published its recommendations in July 2007 (see previous chapter for more details). Although the recommendations were welcomed by the Government, it has not yet responded, so it is unclear which recommendations will be taken forward and how the law might change.

Under the current legislative framework, DB schemes have some flexibility to change existing rules, which they can use to help curtail costs. For example, schemes can increase their members' normal retirement age or change the accrual rate for new members.

Changes to the law could increase this flexibility further by giving schemes discretion over the rate of pension increases before and / or after retirement or by making it easier for schemes to change their rules in relation to promises already made. But there is no guarantee that this will be sufficient to stem the flow away from DB. Despite the flexibility that already exists, many sponsors have chosen to drop DB schemes altogether in favour of DC arrangements.

[154] DWP (2006)
[155] DWP (2006 SR)

What is the future for Defined Benefit schemes?
Because there is so much uncertainty regarding how DB provision in the private sector will continue to change and on how employers will respond to the reforms, the PPI has asked three expert commentators what they believe to be the future for DB schemes in the private sector. These views are set out in the following pages.

Although there is not a consensus about the future for DB schemes, there was a general agreement that how the sector evolves will largely depend on how employers and government respond to the underlying cost pressures, the introduction of Personal Accounts, and the possibility for deregulation. And it is clear that DB provision, if it survives in the private sector, is likely to look very different in the future to the DB provision of the recent past, with potentially fewer schemes and more use of risk-sharing arrangements.

The views that follow are the personal views of the commentators. They are not the views of either the PPI or the organisations that the commentators represent.

Dr Deborah Cooper

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The UK pensions market has been characterised by a mixture of Defined Benefit and Defined Contribution provision, balanced by willingness and ability to continue in work.

At the start of the 20th century, only very select groups of workers were provided with 'traditional' Defined Benefit pension schemes, although Friendly Societies also provided some access to pooled savings schemes. Most employees, particularly the very poor, were expected to work until they dropped, either in the private sector or via the workhouse. The better off relied on their own saving, or inherited wealth.

Over the past 100 years, the sources and balance between these different strands of retirement provision has altered. Until 1985, state Defined Benefit provision grew steadily:

- In 1908, the workhouse was replaced with a means tested defined benefit – the old age pension – for the very old (over age 70, at a point when life expectancy at birth was less than 55).
- The amount of the old age pension was increased in real terms (for example, in 1926, 1948 and 1958);
- The age at which the old age pension commenced payment was reduced, and the eligibility criteria widened (for example, state pension age was reduced to 65 for both men and women in 1926, and to 60 for women in 1940);
- In 1948 the basic state pension was introduced with payment ages of 65 for men and 60 for women
- After various attempts at extending state provision, the state earnings related pension scheme (SERPS) was introduced from 1978.

Occupational pension provision also grew until the 1970s, by which time virtually all occupational provision was made via final salary schemes. The growth and choice of design was partly buoyed by the difficulties governments had in delivering state earnings related provision. Since then, the number of employees with access to occupational provision has stagnated and, more recently, fallen.

However, until the 1980s, private sector final salary schemes were not the inflation proofed security they appear today. Instead, they had all the characteristics of a hybrid, with risk sharing between employer and employee. The risks might not have been shared equitably and scheme members might not have appreciated the risks they carried, but nonetheless they existed. The extent of risk sharing meant that employers had some discretion over the overall cost of the scheme, sometimes choosing to augment benefits and sometimes not.

In the last few decades of the 20th century, legislation removed the degree of discretion and increasingly loaded risk on to employers, prescribing, for example, preservation, mandatory indexation and the level of buy-out debt. Those employers who made some defined benefit provision found that the hybrid contract they believed they had entered into changed inexorably into one in which they bore all the risk.

Employers' attitude to future pension provision has been tainted by concern that governments would continue to intervene in defined benefit design, and because of the legacy they carry in respect of accrued rights. In response they have sought to reduce their exposure the quickest way possible, by moving to Defined Contribution (DC) provision. However, the growing reliance on DC provision is likely to attract more government intervention, particularly as the share of retirement income provided by the State declines. The move towards quasi-compulsory employer provision the Government proposes to introduce via Personal Accounts and the Pension Regulator's document on governance in DC schemes is evidence of this.

Increased reliance on DC provision will also make more apparent the risks employees face in having to rely on financial markets. Managing these risks whilst complying with more regulatory intervention will increase the cost of DC provision so that its attraction for employers, relative to defined benefit design, should decrease. Some employers will step back from pure DC arrangements into the shared risk world of hybrid design they inhabited prior to the ***fin de siècle*** regulatory extravagance of the 20th century. However, the way risks are shared between employers and employees, and between different groups of employees and pensioners, is likely to be different. For example, employers' desire to reward one group more than others may be handled differently, rather than via a final salary design that can be accused of cross subsidising high fliers; this would have the advantage of making it easier to protect the value of accrued benefits, without losing control of cost. Longevity risk might be reduced by targeting a lump sum benefit, or by designing a floating retirement age.

With good reason, small employers have rarely made defined benefit provision for their employees. However, medium and large employers have always been well placed to help their employees manage the risks of pension planning, provided they can control their exposure to liability. By targeting a relatively low level of benefit, by responding imaginatively to government intervention that imposes new costs, perhaps many more employers can deliver a good deal for their employees through sponsored retirement savings.

Eddie Thomas

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There is no doubt private sector DB schemes are in sharp decline and will continue to be so for many years. Most DB schemes are closed to new members, some to all future accruals, and new schemes are only being set up in exceptional circumstances. In short, the norm now is for DB schemes to be seen as a 'problem' to be disposed of as quickly as possible rather than as a benefit to the ongoing business.

In contrast, the DB principle has been maintained in the public sector and does not look like giving way at present. It is very uncertain how long this discrepancy can be maintained, but it is likely that the cost burdens of public sector deficits will force benefit reductions in the future.

The reasons for the decline in private sector DB schemes are well documented and well understood, as outlined in the earlier chapters of this report. The likely long-term effects are less documented. In the past pension changes have usually come about in response to current external pressures; there has been little or no advance planning and employers' pension decisions have usually been driven by financial and legal considerations rather than by HR, social, moral or even competitive reasons. It is unlikely that this will change; it will take decades for DB to come back into favour if indeed it ever happens. And if it does, it will be because other systems, such as DC have been tried and failed.

The future for existing private sector DB schemes will depend on the strength of the employer covenant. Those with strong covenants will either seek to fund deficits (most have deficits) as quickly as possible (these are not really large in relation to corporate profits), or provide alternative forms of security and seek ways to 'de-risk' schemes. Some companies will seek to avoid investment risk at the expense of higher returns whereas others will be prepared to run a higher level of risk in the belief that it will be rewarded in the longer run. However, run off will happen sooner than may be anticipated and a point will be reached where these companies are prepared to countenance the buyout cost in order to be able to wind up schemes completely. When this will be will to an extent depend on how competitive the buy out market becomes and on its capacity.

The future for other schemes is much more uncertain. These include schemes where the covenant is weak, or where the employer's long term commitment is uncertain (private equity ownership). Some schemes in this category are virtually 'orphan' schemes already; others may be regarded as heading fast in that direction, for example, DB schemes for charities. Trustees of these schemes will have to show the Wisdom of Solomon, judging how much risk to take and how hard to push the employer for contributions, and have reservoirs of time and patience. Good trustees will become harder to recruit. A few schemes may pull through, but many others will slip further into deficit. The risks they face are still numerous and any one could knock a scheme out. There will be a temptation on trustees to continue to pay full benefits for as long as possible, and to try to accommodate employers to stay in business. The Pensions Regulator will be susceptible to similar pressures. Unfortunately, these tendencies will only defer and exacerbate the problems.

The inevitable conclusion is that many schemes will finish up in the PPF. Employers with good covenants will resent the increasing costs of the PPF and will therefore hasten to wind up their own schemes completely. It is difficult to predict the future for the PPF but it is almost certain to be modified. Costs will increase, benefits may have to be reduced and eventually the government of the day (or more accurately, taxpayers) may have to subsidise it. There is of course, no political rationale for promising this in advance.

In spite of all ambitions to the contrary, more pension legislation will be enacted. It would be foolish to think that the current arrangements provide the solution for the next 25 years. The government will not want to be responsible for growing PPF liabilities and a growing need to rob Peter to pay Paul. It will seek ways to enable schemes with deficits to continue thereby avoiding many company insolvencies. Eventually, there will have to be some give which allows trustees to reduce benefits themselves (much in the way that the PPF reduces benefits) in order to stay solvent. Abolishing the need for guaranteed pension increases would be a good start.

In 30 years time, you will be able to count the number of DB pension schemes on one hand.

Joanne Segars

Joanne Segars is Chief Execute of the National Association of Pension Funds. Joanne was a member of the Opra Board from 1996-2001 and is a Governor of the Pension Policy Institute.

UK occupational pension provision is in a far healthier state than many would have us believe. As the analysis in this report shows, there is still a lot of occupational pension provision in the private sector in the UK, and much of it remains DB, even if not always the traditional final salary schemes.

However, the pressures on DB schemes continue to mount. Whilst some employers will modify their DB schemes, as the case studies in this report show, others will move away from DB towards DC (trust and contract-based). Already more people join DC schemes each year than DB and there is nothing to suggest that this trend will start to reverse.

The challenge, then, for government, policymakers and organisations like the NAPF is to ensure there is an environment in which the current stock of occupational pension saving can continue by easing the pressures schemes face and ensuring there is a new pensions 'deal' in which working people get a good quality, secure, pension at a price which is affordable for the scheme sponsor.

Achieving this goal means addressing three challenges.

Challenge No 1: de-regulation

The higher costs associated with increasing life expectancy, and an increased regulatory burden in which 'best endeavours' benefits have become firm promises, mean that there is now a fundamental imbalance in the nature of the pensions deal with the risks and costs of providing DB schemes having swung too far in one direction. It is this 'certain uncertainty' principle (it is certain the costs of running your DB scheme will rise, but is uncertain by how much) that is the cause of many scheme closures.

And it is this certain uncertainty principle that the government must address in its current deregulation review by giving some certainty back to scheme sponsors. The importance of deregulation should not be underestimated: in a recent survey of NAPF members, over a third said deregulation would be the single most important thing the government could do to encourage employers to maintain DB schemes.

Six areas were identified by pension funds as being in need of urgent action by government:

1. Relaxation of s75 employer debt regulations in cases of legitimate corporate transactions to allow corporate activity to take place without additional requirements being placed on the pension scheme.
2. Permitting the return of surplus to the employer with the agreement of the trustees.
3. A move to a principles-based regulatory regime, where the outcome would be prescribed but trustees and sponsors would have flexibility in applying the process.
4. The introduction of a limited statutory override to allow specific changes to be made where the trust deed and rules may prevent changes being made.
5. For future accruals, moving to a system of conditional increases to pensions in payment.
6. For future accruals, reducing the requirement to revalue deferred pensions from 5% to 2.5% a year.

The first two do little to reduce the costs of running schemes, but they send important messages to the finance directors who are taking decisions about DB pensions today that they are in control of their own destiny. In an era when employers are questioning their commitment to DB, changes in these areas should not be underestimated.

Items 3 and 4 should provide trustees and scheme sponsors with the flexibility they need to apply rules in a way that suits them.

Items 5 and 6 start to get to the heart of the matter and really address the terms of the Government's de-regulation review announced in the May 2006 White Paper, namely rebalancing the costs of providing occupational pensions whilst not placing at risk members' security. Moving to the Dutch system of conditional indexation for pensions in payment where by schemes aim to fund for increases but if the funding position of the scheme is such that it would be financially disadvantageous would help reduce scheme costs by around 16%. Reducing the ceiling on revaluation of deferred pensions would reduce schemes' costs by around 11%.

A new risk-sharing regulatory regime did not score highly on NAPF members' list of priorities. Perhaps this reflects the immediacy of their needs and the pressures they are facing.

The de-regulation review presents Government with a real opportunity to demonstrate to scheme sponsors that they are committed to seeing good quality occupational pension provision in the UK thrive.

Challenge No 2: Personal Accounts
The NAPF has supported the introduction of Personal Accounts in 2012. It is right that the millions not currently saving for retirement have an opportunity to do so. Auto-enrolment and mandatory contributions,

combined with low management charges in a well governed scheme are the right foundations on which to build.

But pension reform brings added pressures on today's occupational schemes. The requirement to auto-enrol from 2012 will add a further £1 billion to the running costs of today's workplace schemes. If employers are not to take the line of least resistance and level down there is a need to ensure that Personal Accounts remain a targeted intervention, just as the Government intends them to be.

The Government has taken some welcome steps, eg by setting the Personal Accounts contributions ceiling at £3,600 a year, placing a ban on transfers in and out of Personal Accounts, and allowing a limited waiting period for occupational schemes.

As the Personal Accounts Delivery Authority starts its work on putting the flesh on the bones of Personal Accounts it is essential that the final design of Personal Accounts is complementary to today's workplace schemes and does not compete with them.

Challenge No 3: DC provision

Nevertheless, where some DB will remain, for most people the future shape of pension provision in the UK will be DC. There is inherently nothing wrong with this. There is a lot of good quality DC provision in existence, and the NAPF has never been an organisation that has fallen into the trap of 'DB good, DC bad'. But it does raise new issues which will need to be considered.

First, members will need to be told about the choices they face, both in the accumulation phase – especially around schemes' investment options – and the decumulation phase, and be able to navigate those choices in a way that delivers the right outcome.

Second, they will need to be aware of the risks they are facing if there is not to be a crisis of confidence resulting from poor understanding in 30 or so years time when today's DC scheme members reach retirement. Given today's low levels of financial literacy, we are a long way from being able to say these problems have been cracked.

As DC grows, and as workers become more sophisticated consumers of DC, more sophisticated ways of delivering DC will be needed, in particular the default funds that will come to dominate the UK pensions investment landscape.

Conclusion

There is a lot that is good in the UK pensions system. Today's occupational pensions – DB and DC – are providing high quality pensions to millions of working people. With the right policy decisions from Government, it can remain that way for sometime to come.

Glossary

Accrue – Pension benefits building up in a pension fund.

Active members – Current employees who are contributing (or have contributions made on their behalf) to an occupational pension scheme.

Actuary – A professional advisor who applies financial and statistical theories to solve issues involving longevity probabilities and other contingencies. This includes advice on risk management, assessing how likely an event may be and the costs associated with it and estimating future trends.

Annuity – Purchased with an individual pension pot, which has been built up in a Defined Contribution pension scheme, to provide a pension that is usually payable for life.

Auto-enrolment – Pension scheme enrolment technique proposed to be used in personal accounts, whereby employees are automatically enrolled into the scheme without the employees having to make a separate application for membership. Employees are able to opt out of the scheme if they prefer, whether to make alternative provision or otherwise. The self-employed can also opt in to personal accounts but will not benefit from an employer contribution.

Bond – A debt investment with which the investor loans money to a borrower (company or government) for a defined period of time at a specified interest rate.

Closed scheme – A pension scheme that does not admit new members.

Contribution holiday – A period of time in which pension contributions are temporarily suspended.

Deficit – A pension fund has a deficit when the net present value of the pension promises is greater than the market value of the assets of the pension fund.

Defined Benefit – In DB schemes the pension payable is related to earnings, typically earnings in the last few years before retirement, years of service and the accrual rate. The link, however, could be with earnings over the whole career, for example, a career-average pension.

Defined Contribution – In DC schemes the employer usually contributes a specified amount, usually expressed as a percentage of salary. The actual level of pension received by the employee at retirement will depend on the accumulated fund and on annuity rates.

Discount rates – The discount rate is used to calculate the present value of the projected pension benefits.

Employer covenant – This refers to the relationship between a sponsor of a scheme and the scheme. The nature and strength of the employer's covenant will depend on its ability and willingness to meet the costs of members' benefits.

Equity – A share, or any other security, representing an ownership interest.

Funded occupational pension schemes – Pension schemes in which pension contributions are paid into a fund, which is invested and pensions are paid out of this pot.

Group Personal Pension – A personal pension scheme that is organised through the employer but still takes the form of individual contracts between the employee and the pension provider.

Liability – The debts owed by an organisation or individual.

Limited Price Indexation – A legal measure that means benefits from an occupational pension scheme must increase by at least a set rate each year. It only applies to benefits earned after 5 April 1997. Benefits earned before this date are covered by the Guaranteed Minimum Pension (GMP).

Longevity – Length of life.

Member – A person who has joined a pension scheme.

Member-nominated trustees – Under UK law, one-third of trustees of an occupational Trust must be made up of member-nominated trustees (MNT). A MNT is a trustee that has been voted into position by some or all of the scheme's members.

Normal retirement age – The earliest age at which a member is entitled to receive benefits on his/her retirement from employment to which the scheme relates.

Occupational pension scheme – A pension scheme that is provided via the employer.

Open scheme – A scheme that continues to accept new members.

Pension benefits – The pensions and lump sums that members receive from their pension when they retire.

Pension rights – The pension benefits that have built up for a pension scheme member.

Price indexed – Increasing each year in line with inflation.

Retail Price Index – This is an average measure of the change in the prices of goods and services bought for consumption by the vast majority of households in the UK.

Security – General term covering all investments, such as equities and bonds.

Self-administered schemes – An occupational pension scheme where the administration is carried out directly on behalf of the trustees and not handed over to an insurance company.

Stakeholder pensions – A personal pension product which complies with regulations which limit charges and allow individuals flexibility about contributions.

State Pension Age – The age from which state pensions are normally payable. This is currently 65 for men, and 60 for women. SPA will increase from 60 to 65 between 2010 and 2020 and then to 68 for everyone by 2050.

Surplus – A pension fund has a surplus when the market value of the assets is greater than net present value of the pensions promise.

Traditional opt-in - Any pension scheme enrolment technique, where the employee has to elect to join the scheme, and no special measures are in place to ease or hasten the employee's decision: they usually have to complete an application form, which may be lengthy, in order to join.

Trust – Under this legal arrangement, named people (trustees) hold pension assets on behalf of, and in the best interests of, a separate group of people (beneficiaries).

Trustee – The person(s) or company appointed to carry out the terms of the trust.

Underfunded – A pension scheme's assets are less than its liabilities.

Winding up – When a pension scheme is discontinued or 'closed' to future accruals, it can begin a process of settling benefits and transfers its obligations to another legal entity.

Wound-up scheme – This is a scheme that has notified the Pensions Regulator that it has completed winding-up procedures

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