UK Defined Benefit (final salary) pension schemes are not safe.

INTRODUCTION

A DB scheme is only as good as the employer who provides it.

The forthcoming Pensions Green Paper *must* address the problem of pension scheme 'wind-ups'. At the moment, there is no protection for members who have not yet retired from their company final salary scheme. If the employer becomes insolvent, they could end up with no pension at all, (as well as losing their job) and, even an employer making huge profits can decide the wind up their scheme at short notice, leaving members who have not yet retired with only a fraction of their promised pension benefits. All this is completely legal!

The current situation makes a mockery of our pensions laws and regulations. We have the most amazingly complex legislation, because of successive changes added to existing rules, rather than replacing the old ones each time. This is guided by the principle of 'no retrospection' - existing pension rights must not be damaged, even marginally. The laws do not allow an employer to change the terms of its scheme, so as not to even slightly damage pension rights of the members, they stipulate that Member Nominated Trustees should be appointed to help look after members' interests, the Pensions Regulator (OPRA) fines employers if every penny of contributions isn't paid on time. But what is the point of all this, when members who have paid in loyally for over 30 years can actually lose their *whole* pension! Even a company making big profits, complying fully with the law, can wind-up its scheme, leaving many members with only 40% of promised pensions. **Effectively, our pension laws protect the pennies, while the pounds disappear out of the door. In focussing on tiny details, the regulations have lost sight of the big picture!**

None of the many official Government Reviews we have had in the last few years have produced proposals to give proper protection to pension contributions. But Government must accept some responsibility, since pension rules did not allow people contributing to an employer's scheme to diversify their investments and contribute to any other pension. Without protection, this is like financial advisers recommending clients to invest only in one share - and also betting their job on this too. If the company fails, they lose their pension and their earnings. It's completely wrong. There is no such thing as a totally safe private sector pension scheme, just as there is no such thing as a safe share on the stock market. Nobody knows whether a particular company will collapse.

SUMMARY

The Problems:

1. **There is no protection in place for people who are not yet retired, when their final salary pension scheme is wound up after employer insolvency.**

2. **Most people think that their pensions are protected, but they are not. Even after the 1995 Pension Act, the introduction of the Minimum Funding Requirement (MFR), official Government Reviews such as the Myners Review and Pickering Report, an employer's final salary scheme may provide no pension at all for members who have contributed loyally for 30 years or more.**

3. **The final salary pension is not 'guaranteed' by employers at all for those who are still working – people do not generally realise this. If the employer decides to wind up the scheme, or becomes insolvent, people not yet retired may get substantially reduced pensions or even no pension at all.**

4. **Pensioners already retired (even Directors who have taken early retirement) have priority over those still working – who may not even get their own contributions back, if the assets in the scheme are insufficient on wind-up, after having to pay pensioners first. One of the big problems is that the 1995 Pensions Act (which was designed to protect pensions after the Maxwell case!) introduced a particular 'order of priority' which must be followed, when a scheme's employer becomes insolvent and there are not enough assets in the fund. This order of priority says that the assets of the fund must be spent on pensions already in payment, plus their full inflation-linked increases, before the pension promises of members who have not yet started drawing their pension can be paid. This means that, if the cost of providing the inflation linked pensions takes up all the fund's assets, the other members of the scheme can end up with nothing. So the law has protected the pensions, but not the contributions.**

5. **Indeed, it is often the best and most loyal workers in a company that end up with least protection. Those who have left the firm and taken a transfer value, or those who have been made redundant with an early retirement package, will all have payments which are safe. In addition, even people who have transferred large sums of money in from another employer's scheme could lose all that money, if the new employer becomes insolvent and the scheme's assets are not sufficient to pay all the promised pensions for those not yet retired.**

6. **At the moment, even fully solvent employers can just decide to wind up their pension schemes. If they do not want to keep running their final salary scheme, it is quite easy for them to just walk away from their liabilities. Employers in the past have generally referred to their schemes as 'guaranteed' pensions, but the law currently allows them to just decide to wind up the scheme and leave members short-changed. The law only requires an employer to pay in to their scheme enough to provide pensions for members who have not yet retired at a level specified by what is called**

the 'Minimum Funding Requirement' or 'MFR'. This is supposed to be the legal minimum funding level which will ensure that there are enough assets in the scheme to provide the pensions promised to pensioners in full and for all other members to have at least a 50/50 chance of getting their full pension promise. However, the actuarial assumptions used in this MFR funding level are so out of date, and have not been updated, that in practice the level of funding the employer needs to put in is much lower than that actually needed to provide the workers' pensions. In fact, at the moment, the funding level will only buy about 40% of the pensions promised to workers under age 45. Even if the employer can well afford to pay in more, the law does not require them to. In fact, Government announced two years ago that it will be replacing this MFR funding requirement, but it has not yet decided what to replace it with. In the meantime, final salary scheme members are losing out substantially by this inadequate funding requirement.

7. **Government rules prevent people from contributing to a private pension, if they are in their employer's scheme. This means most people have had no way of providing any other retirement income for themselves, yet their pension contributions are not properly protected. People can contribute for over 30 years and end up with no pension. This is like encouraging people to put all their money into one share on the stock market. However strong the company is, no-one would ever be advised to do this with their life savings (and their job), but that is what happens when an employee is in their employer's final salary scheme. If they cannot hold more than one pension (and this only became possible last year– and still only for some people, not all) they cannot diversify their retirement assets.**

8. **Government, therefore, surely has an obligation to make sure that people's pension contributions are protected, but they have not done so.**

This fundamental flaw in their design needs to be addressed urgently.

Possible solutions:

There are changes we can make to solve this problem. Policies to provide some safeguards should be divided into two areas. Firstly to protect members of schemes whose employers become insolvent and secondly, to protect members of schemes whose employers decided to wind the scheme up, but remain solvent.

For schemes winding up due to employer insolvency:

- **mutual insurance (e.g. to provide at least a minimum level of pension to all final salary scheme members on insolvency). An insurance levy –similar to the ABTA scheme for travel agents – which would guarantee at least some minimum level of pension for all final salary pension scheme members – whether retired or not. Other financial products are protected, such as bank accounts up to about £30,000 or financial services compensation up to about £48,000, but pension contributions are not. Other countries protect their schemes in a variety of ways, why do we not do the same?**

• a change of priority order on wind-up. It would seem fairer to suggest that the scheme's assets should be shared among all the members in a more equitable manner. Perhaps the order of priority should be changed so that pensions already being paid should only be met in full up to a certain maximum amount, then workers (called 'active members') and former members of the scheme who have not yet started receiving pensions (called 'deferred members') should be provided with a particular minimum level of pension and only then would larger pension payments for retired pensioners and inflation-linked increases be met.

• protect Directors' pensions last. If Directors' pensions were only protected after all other pension liabilities had been met, I think we would find that final salary schemes would be much better funded than they currently are!

• legislate maximum time within which the scheme must be wound up – perhaps 2 years. It currently takes many years for most schemes to wind up and this lengthy delay is unreasonable. Fees paid to trustees and administrators in connection with the winding up process are all met from the scheme assets first and this means less money is available to pay pensions with. Of course, the longer schemes take to wind up, the higher these fees are likely to be. In addition, until the winding up process is complete, members not yet receiving a pension will not know how much they can expect to receive. This means they cannot make any proper plans for funding their retirement.

• a central discontinuance fund backed by Government. This fund would allow pension schemes to keep investing the assets of the fund on an ongoing basis, rather than buying annuities and deferred annuities for members. This would need a Government guarantee, and is a less likely option.

• Allow people to pay into more than one pension scheme at a time, to allow them to build up pension rights outside their employer's scheme, if they want to. This is called 'full concurrency' and at the moment, not everyone is allowed to diversify the pension contributions like this. From last year, people earning under £30,000 and can pay into an employer scheme and a stakeholder pension at the same time, but for other people, and before last year, this has not been possible.

<u>Additional Solutions for schemes winding up when employer still solvent</u>

There are several policies required to address the problems of employers not being required to put in enough money to make up the total value of promised pensions when they wind up their scheme:

• Require consultation and a proper period of notice: Employers should be required by law to properly consult their workforce about winding up the scheme and explain why and how they propose to change the pension arrangements. Pensions are 'deferred pay' and workers should have protection of these rights, in a similar way to protection of earned income. Employers cannot change other terms of work without proper consultation, so why should this not apply to pensions too? If the employer really cannot afford

to run the scheme, they should give the workforce proper information about what they are doing.

- **Require employers to give, say, 12 months' notice of intention to wind up the scheme. This will give time for consultation to take place or for workers to make necessary alternative arrangements to replace any contributions and benefits lost when moving away from the defined benefit scheme. It should not be so easy for employers to just walk away from their pension promises. They have been able to do so easily, partly because most workers just do not understand pensions and have not always realised how much they will lose when the scheme winds up. Employers should be required to explain to their workforce exactly what the implications of moving away from the final salary scheme are. This will involve exploring how much lower contributions might be, what other benefits are being lost (such as life and sickness insurance) and what likely pension the members will get from the winding up process.**

- **Change MFR funding calculation: Either the outdated assumptions of the MFR funding level calculation must be updated, or preferably the MFR should be abandoned and a requirement should be put in place that solvent employers should meet their liabilities properly. It should not be so easy for a solvent employer to just walk away from his or her promised payments. However, it could be that the use of deferred annuities would not be required, as long as an acceptable alternative is found.**

- **Require employers to offer financial advice to members who are losing final salary or defined benefit promises. When an employer removes the final salary pension, the employee will be taking on additional risks and responsibilities. In almost all cases, a money purchase scheme will cost the employer less than the final salary scheme, so the likely pension and other benefits for the workforce will be lower. Employers should have a duty to provide time for each employee with an independent financial adviser, to help them plan their finances properly for their retirement.**

- **Give members the option of not buying out their pensions with expensive deferred annuities, but transferring the sum due to them into a money purchase arrangement, if they prefer. This would also need to be done with financial advice, but would mean a lower cost to the employer, so the advice cost could be justified by the cost saving involved in winding up the scheme more cheaply.**

DETAILS

Successive Governments and official pension reviews have not put in place proper protection to actually guarantee any level of pension to scheme members who have not yet started drawing a pension from the scheme. Only those who have already retired are really protected. Their rights have to be met first, plus any inflation-linked increases. After these pensions are paid, the deferred pensioners (former workers) and workers who are still contributing may not even get their contributions back! This fact is not yet appreciated by policymakers and is not reflected in the Pickering or Sandler reviews. Even after Maxwell, the 1995 Pensions Act, the Myners Review and all other recent debates and Reviews of pensions, this fundamental flaw in the design of UK final salary and defined benefit (or 'DB') schemes has not been focused on. In the present circumstances, allowing employers to make membership compulsory again cannot be contemplated, since it entails too high a risk for scheme members who have not yet retired. Likewise, compelling people to contribute to an employer's DB scheme could result in mis-selling for those who lose their contributions, or receive much lower pensions than 'promised', on wind-up.

Current legislation allows employers to renege on their pension promises. Employers are not allowed to cut workers' wages for doing the same job, but the 'deferred pay' arrangements of pensions can be cut at a stroke. An employer running a DB scheme can simply walk away from his obligations and wind up the scheme. He could close a subsidiary company, and wind up that company's scheme. Worse than this, the Directors can - and have, in some cases - retire early before winding up the scheme, to ensure that they get their huge pensions paid in full, whereas the workers may get nothing.

Government rules mean that people are not allowed to contribute to any other pension plan, if they are in their employer's scheme. Recent stakeholder legislation has introduced partial concurrency, but only those earning less than £30,000 can have a pension outside their company scheme. Normal rules of finance would recommend diversification of savings, not putting all one's eggs in one basket, but many people have been forbidden from doing this. This is rather like an IFA recommending his or her clients to put all their money into one share on the stock market. If that company goes bust, they could lose all their money. No IFA would recommend this – it is madness. Yet for members of final salary schemes, not only are all their savings perhaps tied up in their company scheme and, therefore, unprotected if the company fails, their job is at risk too. So they can lose their earnings and their pension. Government rules have prevented diversification and failed to protect members' contributions and this situation is simply not generally known. People think that their final salary pension schemes are safe. They think they have been protected by law since the Maxwell scandal, but this is simply not the case. Surely, then, Government should make sure that the contributions to company scheme are properly protected.

No insurance is in place to ensure that people can get anything back from the scheme. Bank accounts, insurance funds, stockbroker and investment house funds, even holidays, are all protected at least to some minimum level. But pension contributions into private sector employer DB schemes are not! If the assets of the scheme are insufficient, workers may get no pension at all, even after contributing for 30 years or more! The MFR guarantees nothing. Even if fully funded on the MFR, this may only buy

40% of expected pensions for the workforce. And MFR valuations are only done every 3 years. So, if markets tumble during that time, the value of assets in the fund could fall dramatically and there are no safeguards to ensure that the level of pensions covered would be protected.

The official Government review by Paul Myners, recommended replacing the MFR with a new Myners 'transparency statement'. But this could provide even less security for DB scheme members. If the assumptions used are wrong, the fund's asset allocation could result in significant losses and mean that people are still not provided with any certainty of a level of pension they will receive.

And it is not just those whose employer becomes insolvent that are at risk. Even employers of solvent companies can decide to wind up their pension scheme and the pension promises of people who have not yet retired are unlikely to be paid in full. The situation surrounding winding up of DB schemes needs to be urgently addressed. The members of a DB scheme in wind up face two major uncertainties. When schemes wind up, it can take many years for pensions to be paid out, so not only do the active members not know how much pension they will receive, they also do not know when they will receive it! Independent trustees are appointed, who are paid large fees out of the fund, but are often slow in concluding the procedures required for finalising pension payments.

Britain's DB schemes have been structured in a manner which is much more protective of employers than the workforce. Pensioners are protected to a large degree, but those not yet retired are not. Even if they are aged 64, and about to retire, they may not get any pension at all. And even if members have transferred money in from other employers' schemes, that money an be used to pay someone else's pension and the person who transferred a large sum of money in could still get no pension at all. Solvent companies can just walk away from their pension obligations by winding up their schemes. In this case, companies are only obliged to contribute the equivalent funding that would meet the MFR basis. In practice, in today's markets, as this is a long-term standard, this currently only covers about 40% of the liabilities to younger non-retired members, so that DB pensions are not actually 'guaranteed' at all. Most people do not realise this.

Government must act to rectify this grossly unfair situation. People do not realise the risks until it is too late and almost everyone generally believes that pensions are protected by law. They have been encouraged by successive Governments to put their money into pensions, have been contributing in good faith for many years and are then being dreadfully let down by the UK pension system.

<u>If nothing is done...</u>

Without such safeguards, many members of DB schemes will find that a money purchase (or DC) scheme may have been preferable for them. DC pensions will most probably be the provision of the future. They can accommodate more modern working practices, can be transferred easily from job to job and are readily identifiable as belonging to the individual. They are not at the mercy of the employer, they are more transparent than DB, more accountable and more flexible. DB is old fashioned, unsafe and unreliable, especially in the form of 'final salary' schemes. Government must introduce some insurance protection, or a central discontinuance fund, and/or change the order of priority of meeting liabilities on wind up to protect workers in these schemes. The current DB system is letting many people down. In fact, the most loyal and valued workers can often be the ones who lose out, because others who were made redundant will get their pensions paid first and there may be nothing left over for those still working for the company when it winds the scheme up!

Compulsory pension contributions into DB schemes, without proper safeguards for all members, cannot be justified. This needs to be addressed urgently.

Politicians, commentators and almost all DB scheme members seem to have been either unaware of, or unconcerned about this situation. As more schemes wind up, more and more people will be affected by this and it is Government's responsibility to ensure that proper protection is in place. Government policy aims to encourage more people to put money into pensions, the Pickering Report has tried to save DB schemes, we have built up a retirement savings culture which has been the envy of many other countries, but this flaw in the workings of the system must be addressed as soon as possible. Other countries manage to protect their DB scheme members – often with insurance based protection – why can't we?

Without some proper protection, serious consideration of compulsion of employee participation in employers' pension schemes is surely impossible!