HOW WE KILLED FINAL SALARY PENSIONS IN THE UK

We ARE in a pensions crisis and it is one caused by our reliance on final salary pensions, which have become too expensive.

A UK final salary scheme now costs three times as much as a US scheme!

Corporate UK cannot afford this. Profits will suffer, competitiveness is being lost.

This will affect everyone, not just companies and scheme members. Local authorities will have to make huge rises in council taxes to fund their pension liabilities and public sector pensions will be a big drain on public finances.

Schemes have relied too heavily on equity returns and did not factor in the probability of falling markets or an ageing membership profile as schemes matured.

Instead of building up surpluses while schemes were young, everyone tried to get their hands on this tempting pool of money. The surpluses have been used up in many ways:

- The Inland Revenue decided to tax any surplus above 105% funding, so there was no incentive to let the surpluses build up
- Employers used pension funds to hide the costs of industrial restructuring
- Employers took contribution holidays, instead of building up surpluses in the good times
- Successive Governments heaped huge extra costs on schemes over the years (Not just removal of ACT relief, costing £5billion a year, also index-linking, costing an extra 20%, spouse cover, an extra 20%, early retirement, an extra 30%, plus costs of MFR, SRI, OPRA, compliance, complex tax regulations etc. etc.)
- Benefit enhancements
- Lower retirement ages
- Increased longevity

To cap it all, despite reams of pension law, members' pension rights are not protected. When schemes wind up, employers may walk away with paying less than half of what they had promised and members of insolvent schemes may get nothing at all. This cannot continue.

State pension spending is forecast to stay around 5% for the next 50 years, so Government thinks we are OK. We are not.

In other countries, there is a more generous State pension. In the UK, we have tried to shift the costs of funding pensions onto the private sector, but this means our companies are at a severe competitive disadvantage relative to the rest of the world. Having to support huge pension commitments will mean future profits are at risk, but competitors will not have this handicap

We have been so short-sighted. We need to address this NOW.

The risk is that future generations of pensioners will not have enough to live on, meaning more poverty, less consumption and lower growth in the economy.

The Green Paper proposals have not grasped the scale of the pensions crisis, or the fact that we must manage the move away from final salary schemes urgently and sensibly. The debate should start immediately. The problems will not go away.

DETAILS

Pensions are in trouble, yet there is an air of complacency in recent Government publications which is deeply disturbing. The start of the 21st Century is a watershed for UK pension provision. Until recently, we were generally considered the best pensioned country in Europe - primarily due to good final salary schemes. We had built up a strong retirement savings culture, and most people aspired to have a good employer's scheme to rely on. Suddenly, we are realising that perhaps these pension 'promises' have become unaffordable, particularly for private companies. Even in the public sector, Council taxes will soon have to rise sharply, to pay for local authority pensions, and spending on other public sector pensions will soar. This is not sustainable.

Government says this isn't a crisis, but companies are suddenly having to find huge amounts of money to shore up their pension schemes, which is hitting profits and share prices. It is no wonder companies are closing their schemes and switching to money purchase arrangements. In addition, thousands of workers, like those at ASW, are finding that, after saving all their working lives in a scheme which was fully funded on Government measures and was supposed to offer them a 'guaranteed' pension, our laws don't protect them and they may get no pension. In addition, with Government policies to increase reliance on means-testing plus scandals, mis-selling and high charges people are becoming frightened of putting money into pensions altogether. Confidence has collapsed.

What's gone wrong?

Problems have been building for years, but pension fund surpluses, high equity returns and over-optimistic actuarial assumptions made our system appear affordable. Legislators, employers, consultants and members seemed to expect that pension funds would always be in surplus, and everyone tried to get their hands on this pool of assets. Instead of letting surpluses build up when schemes were young, to pay for pensions of increasing numbers of retired members over time and cushion against equity declines like we've recently experienced, the surpluses have been raided and whittled away.

So what has happened to these surpluses?

Successive Governments have heaped huge extra costs on pension schemes over the years. The Inland Revenue even decided to tax the surpluses, which discouraged employers from building them up. Everyone talks about Gordon Brown's 1997 removal of ACT relief costing £36billion, but the Tories imposed huge burdens too. MFR, compliance, complex regulations, index-linking, the list goes on. Many of these changes were actually designed to protect members, but have ended up making our schemes increasingly unaffordable. *These extra costs mean that the average UK final salary scheme is now three times more expensive to UK companies than in the US.*

But, it's not all Government's fault. Over-optimistic investment and longevity assumptions allowed employers to take contribution holidays, so funding has been inadequate. In addition, employers used pension funds as a cheap source of industrial restructuring, hiding the costs of labour force reductions in early retirement packages. This caused a knock-on effect of encouraging people to expect to retire at younger ages and, as they are also living longer, pensions must be paid for much longer than anyone predicted, so again costs have risen.

Government complacency is based on official forecasts suggesting public spending on pensions to 2050 will remain around 5% of GDP, even though pensioner numbers will rise by 40%! Most other European countries expect spending to rise sharply to around 12% of GDP by then. Partly, this is because our State pension is lower than anywhere else – but that is not exactly something to be proud of. The fact that the State will be spending so much less on pensions means two things. Firstly, many more older people will be living in relative poverty, which will mean less spending in the economy. Secondly, we have shifted much of the costs of pensions onto companies or individuals, who will need to pay much more for pensions in future, thus sapping the competitive strength of our companies.

This is worrying from a long term growth perspective. Relying on final salary schemes to fund the costs of supporting older people, when our competitors are funding most of this centrally will be a significant drain on UK firms, who will not be competing on level terms. Past private sector pension promises will detract from future profits and reduce growth. Not only this, but pension funds are becoming more mature and will no longer be buying equities in the same proportions as before. The market is losing its marginal buyers and, with the problems in life assurance companies too, it is hard to see the supply/demand balance being favourable for UK equities. If the equity market performance is depressed, companies may find it harder to raise capital and growth prospects will again be hit.

What is the answer to all this? Firstly, we need to recognise what is happening. Then we must adapt policies and expectations to match reality. As long as we fail to recognise that we are moving to a DC environment and to manage that change effectively, we will not be starting to address the pension problems of the future. Final salary schemes cannot survive into the future, employers cannot afford to underwrite these open-ended liabilities any more and we must all learn to plan our future finances without relying on employers to do this for us. Gradual and flexible retirement will be essential to improve living standards at older ages, and will also improve growth prospects for the economy as a whole. The pensions problems will not go away and much needs to be done to sustain a secure future for the older members of our society. Let's hope policymakers realise this soon.