Securing the future of pensions

PENSION PROVISION AND THE ECONOMIC CRISIS
JANUARY 2009

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About the NAPF

The NAPF is the leading voice of workplace pensions in the UK. We speak for 1,200 pension schemes with some 15 million members and assets of around £800 billion. NAPF members also include over 400 businesses providing essential services to the pensions sector.

1. Introduction

The current recession will undoubtedly affect pension provision in the UK. Financial constraints may cause sponsoring employers to rethink their strategy with regard to pensions, particularly in small companies.

In order to assess the likely impact of the recession on pension provision, the NAPF asked its member pension schemes for their opinions on how the financial crisis will affect pension provision in their own schemes and more generally across the UK. The questionnaire, which was distributed in January 2009, repeats questions asked as part of the NAPF Annual Survey[1] conducted in July 2008 before the sharp downturn in the FTSE thereby enabling a comparison of how the pensions outlook has changed in those intervening five months. 100 schemes responded to the survey with assets totalling £180.5 billion and just over 3 million members. Respondents included some of the UK's largest pension schemes. To put the results in context, 44% of those saving for retirement in a private sector employer – almost 3 million people – are saving in a defined benefit scheme. Large numbers of people, therefore, stand to be affected by any change in employer attitude.

The Annual Survey results showed relative stability in pension provision, with 28% of defined benefit (DB) schemes open to new members and large numbers of respondents predicting no change to their pension scheme. The relatively optimistic picture which emerged from the Annual Survey 2008 has changed significantly in the wake of the current economic downturn.

To complete the picture, we also sought the views of working people to gauge their confidence in pensions as a means of saving for old age as the economic downturn has unfolded.

Finally, we present an action plan for the Government, regulators and the industry with a series of steps that could help protect and strengthen pension provision in the UK.

[1] NAPF Annual Survey is based on responses from over 300 fund members. It is a valuable reference source for the pensions industry while helping policymakers and regulators understand the challenges that pension funds face.

2. The employer perspective

This section presents the employer perspective on pension provision resulting from the economic downturn. Firstly, employers were asked about the actual changes they intend to make to their own pension scheme. We then asked for their views on how pension provision across the UK would be affected. Finally, employers gave their opinions on potential changes to the design of DC schemes and steps which the Government and the Pensions Regulator (tPR) could take to assist pension schemes.

Changes to open DB schemes[2]

Figure 1 shows that the number of respondents saying that they expect no changes to their open DB scheme has dropped from 37% to 23%. Whereas in July last year, just 21% expected to switch new employees to some form of DC scheme, 45% of schemes now respond that they expect to switch new employees to either occupational or contract-based defined contribution (DC). A further 14% expected to keep their current DB scheme but make changes to reduce the risks or costs to the employer, up from 10% in July 2008 whilst 7% predicted they would switch from their current arrangement to one containing more risk-sharing with scheme members, an increase of 3% over the past five months.

The future of pension provision has also become more certain, it would appear. Perhaps reflecting the economic uncertainty last year, 22% of respondents did not know what changes were in store for new employees last July. This has now reduced to just 7%.

The ONS Occupational Pension Scheme Survey 2007[3] states that there are 2,240 open DB schemes in the private sector in the UK. Therefore, over 1,000 DB schemes could face closure to new entrants over the next five years.

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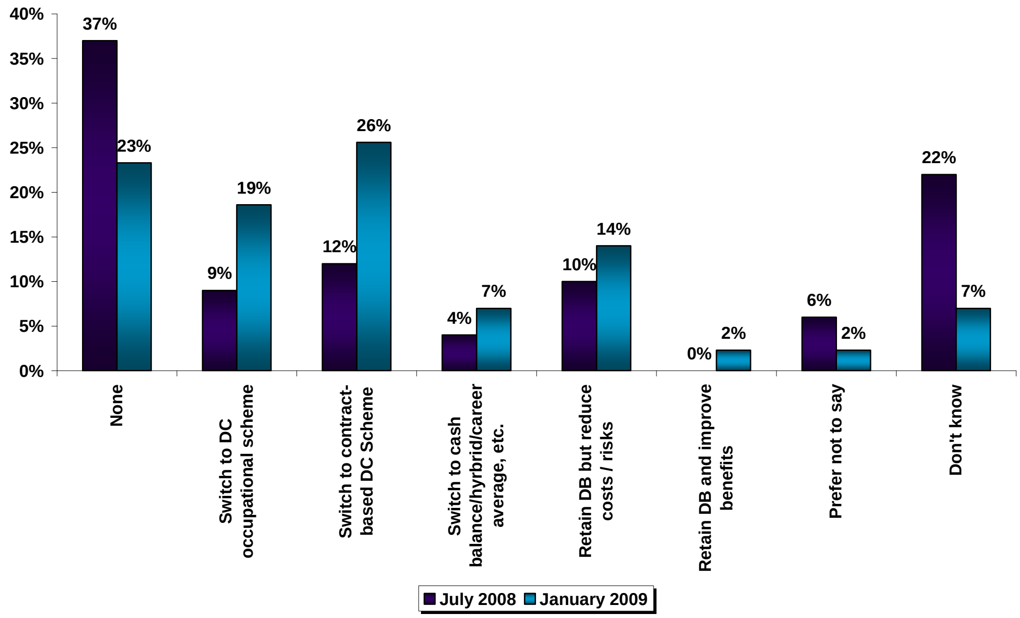
[2] *An open DB scheme is one that new employees can join and accrue rights as well as existing members of the scheme.*

[3] *ONS Occupational Pension Scheme Survey (2008)*

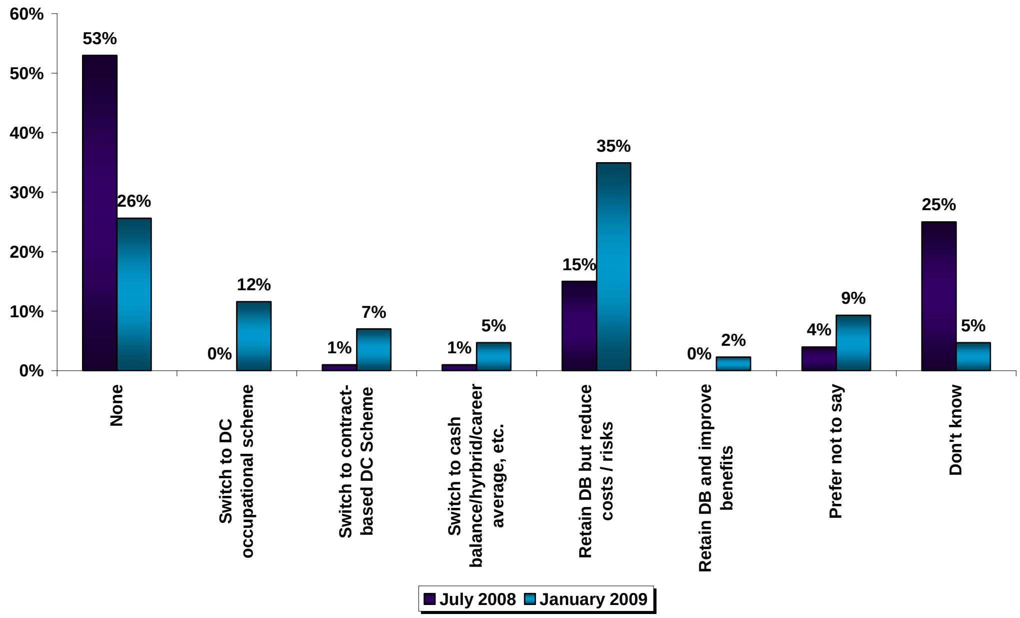
Figure 1. Expected changes for new employees in open private sector DB schemes



Base: 43 respondents with open DB schemes

The 2008 NAPF Annual Survey revealed a pattern of some stability. Then, 53% of responding schemes predicted that there would be no changes for existing members of open private sector DB schemes. As a result of the economic crisis, the proportion predicting no change has halved, and now stands at 26% (see figure 2 below). Where previously just 1% of schemes thought that existing members would be switched to a DC scheme, 19% now believe this to be the case. A more likely response will be for employers to retain their current DB arrangement for existing staff but to take action to reduce the costs and/or risk to the employer. The number suggesting this as a course of action has more than doubled, from 15% to 35%.

Figure 2. Expected changes for existing members of open private sector DB schemes



Base: 43 respondents with open DB schemes

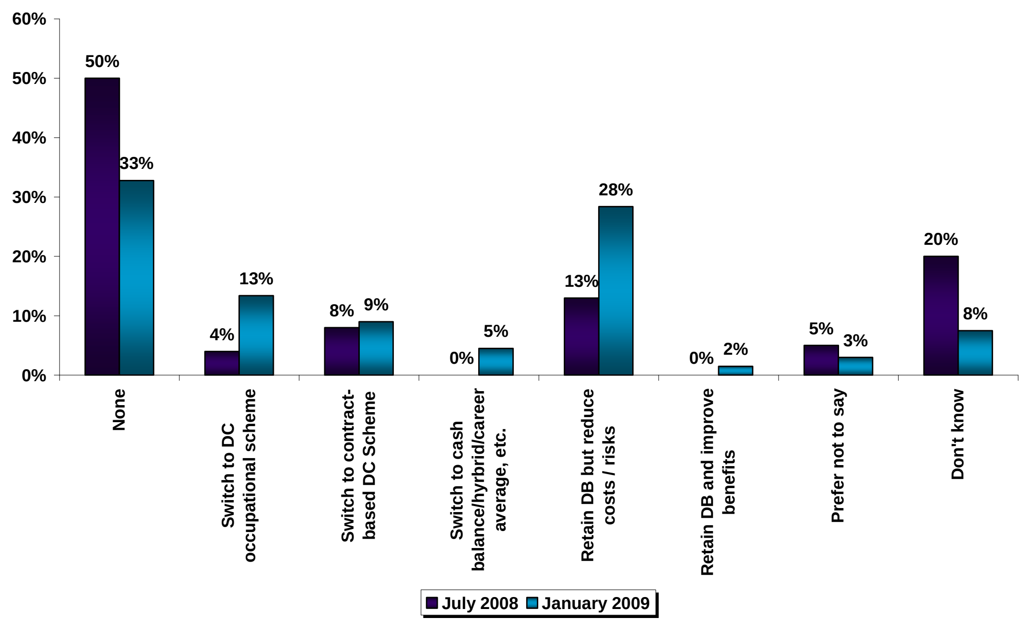
It is clear from the results that the pension provision of a very large number of UK employees will be directly affected by the economic crisis. Schemes that plan to switch to some form of DC or hybrid provision for existing members in the sample have a membership of just over 800,000 and assets of £7.9 billion. Schemes that plan to retain DB provision for existing members but make moves to reduce the cost or risks to the sponsoring employer have a membership of 1 million people and an asset value of £72 billion as they include some of the largest schemes in the UK.

Changes to closed DB schemes[4]

There was a similar shift in expectations of changes to private sector DB schemes which are closed to new members but open to future accrual. 50% of respondents believed in July 2008 that there would be no changes to their closed scheme. This figure has fallen by one third and now stands at 33%. The number of schemes reporting that they will switch members to an occupational DC scheme has jumped from 4% to 13%. As with changes for existing employees in open schemes, closed schemes are now twice as likely to retain their DB arrangement but move to reduce costs or risk – 28% of schemes now, compared to 13% last July. Respondents expecting to switch to a contract-based DC arrangement have remained relatively stable with an increase by 1% to a total of 9%.

[4] *A closed DB scheme is one which new employees cannot join but existing members can still build up rights.*

Figure 3. Expected changes to closed private sector DB schemes



Base: 67 respondents with closed DB schemes

Almost 600,000 people stand to be affected by these changes. There are 197,000 people in closed schemes who are planning to move these members to DC or hybrid pension provision and with total assets of over £15 billion, these represent some very large pension schemes. 377,000 people are members of schemes who plan to retain DB provision but work to reduce the costs or risks. These also include very large schemes, with assets of £63 billion.

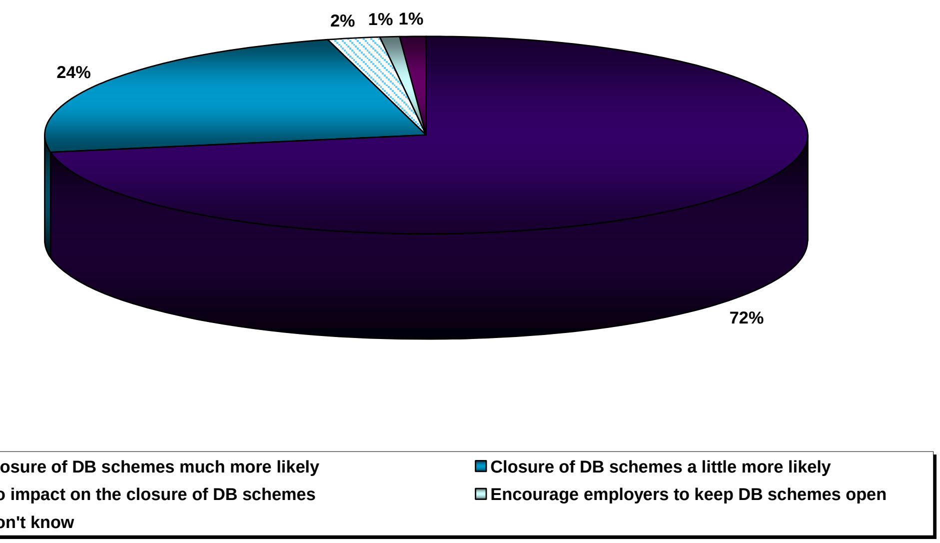
Taking all responses for existing members of both open schemes and schemes closed to new members, 25% of DB schemes are planning to close to future accrual as a result of the economic crisis.

General perceptions of DB and DC pension provision

Respondents to the survey were asked for their opinion on the effect the economic crisis will have more generally on UK pension provision. It is clear from the results that most schemes believe that DB pension provision will be severely affected.

Almost three-quarters (72%) of respondents believe that the economic crisis will make the closure of DB schemes currently open to new employees much more likely. A further 24% believe that it is a little more likely that DB schemes will be closed. Just 2% believe that employers would be encouraged to keep their scheme open (for example because the benefit will be more highly valued by employees) whilst just 1% believed that the crisis would have no impact on UK pension provision.

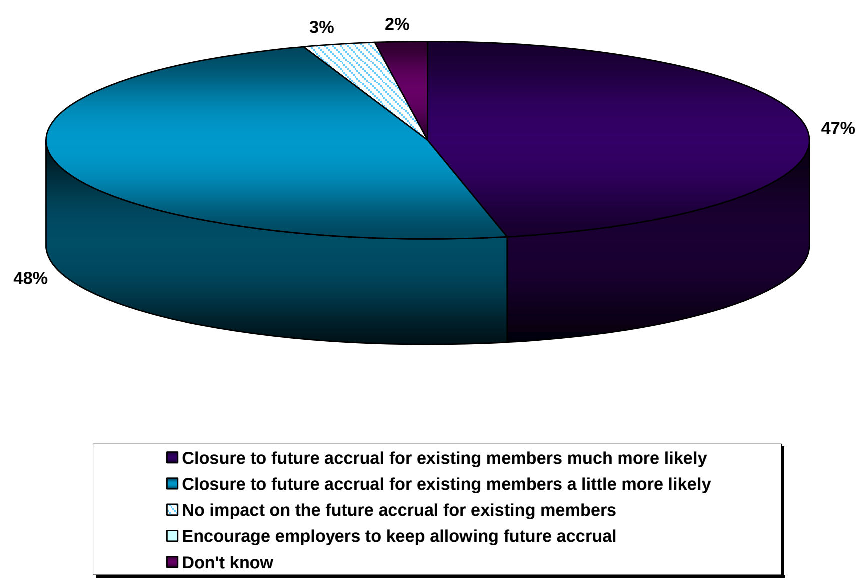
Figure 4. Effect of economic crisis on schemes open to new members



Base: 97 respondents

Respondents also believe that the crisis will have a significant effect on members of closed schemes. 46% believe it will make closure of schemes to future accrual much more likely and 48% believe that this is a little more likely. Only 3% of schemes felt that the crisis would have no impact for existing members of closed schemes.

Figure 5. Effect of economic crisis on schemes closed to new members but open to future accrual



Base: 94 respondents

In addition to the effect of the economic crisis on DB pension provision, respondents were also asked if they thought the crisis would bring about any changes to the design of DC pensions.

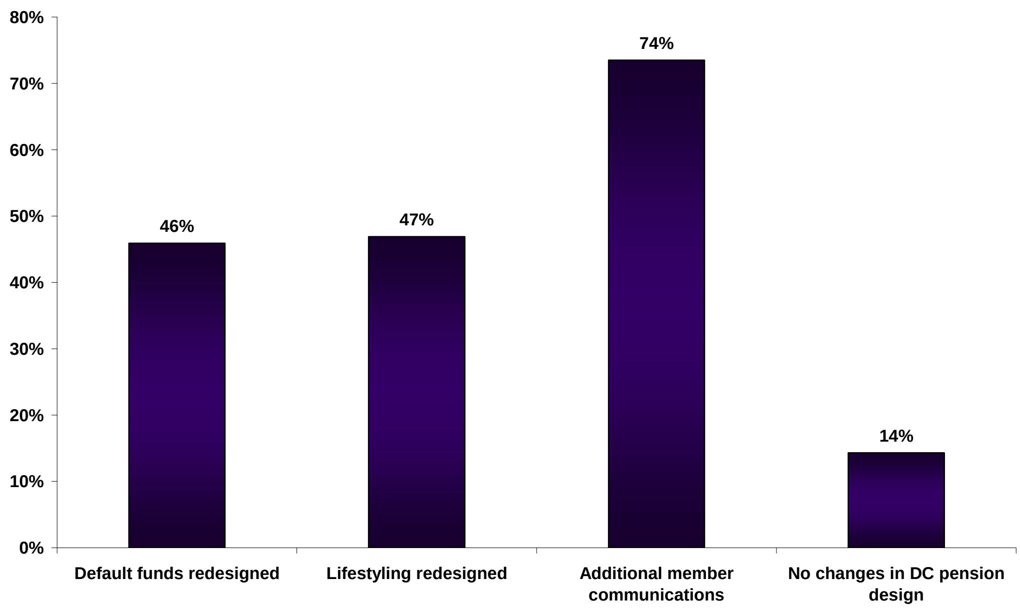
- In light of market falls and falling fund values, 73% of respondents felt that there will now be additional member communications to ensure a better understanding of the long-term nature of pensions investing.

- 45% thought that default funds would be redesigned so as to reduce volatility and increase protection from sudden drops in the stock market such as were seen in the last year.

- 46% of respondents felt that lifestyle funds, ie funds which switch to safer investments as the member nears retirement, would be redesigned to ensure that people are protected from very severe falls at key switching points.

- The number of respondents who felt that there would be no impact on the design of DC pensions was just 14%.

Figure 6. Changes to the design of DC pensions as a result of the crisis



Base: 98 respondents

Help for pension schemes from Government and the Pensions Regulator

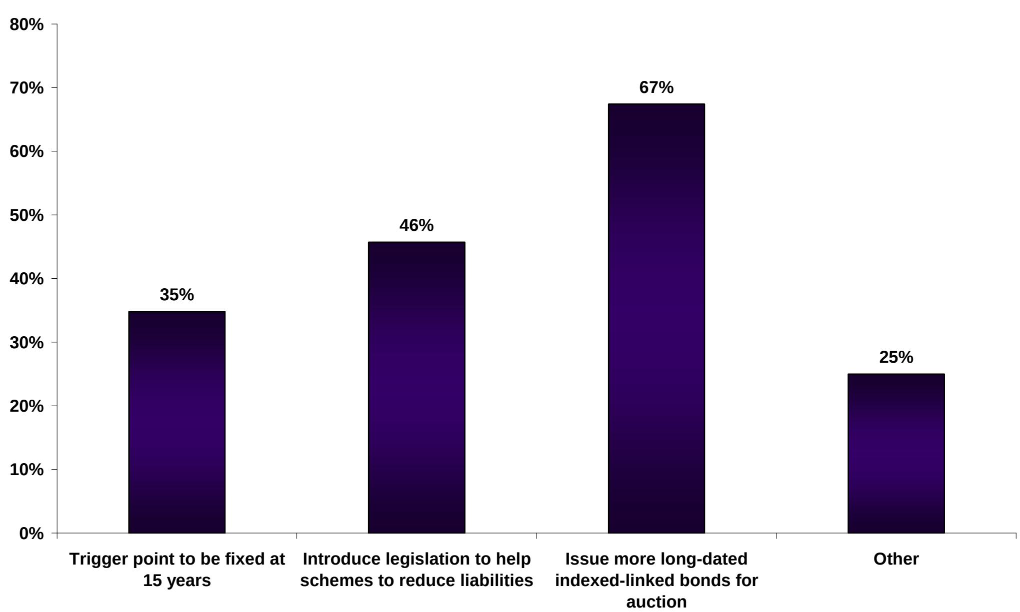
Finally, respondents were asked to suggest potential steps which the Government and/or the Pensions Regulator should take to help pension schemes deal with the additional constraints imposed by the current harsh economic conditions.

- 67% of schemes would like to see the Government issuing more long-dated gilts for auction. This would assist pension schemes by alleviating pressure on their balance sheets and companies would have greater access to debt finance at short and medium durations with less "crowding out" by government borrowing.

- 46% thought that legislation could be introduced which would help schemes to reduce liabilities. One such measure would be to make it easier for schemes to increase the normal retirement age for both past and future rights.

- 35% felt that the trigger point, ie the point which would cause tPR to consider more closely the terms of the recovery plan, should be raised from 10 years to 15 years. This would give a clear signal from the Pensions Regulator that they are allowing schemes more time to achieve their Statutory Funding Objective.

Figure 7. Steps the Government / tPR can take to help pension schemes



Base: 93 respondents

Suggestions from the 25% of respondents who suggested other alternatives included:

- A moratorium on new pensions regulation and legislation which poses new costs and administration burdens on schemes.
- Longer recovery periods to help scheme sponsors recover their funding positions and a return to the use of more long-term, stable assumptions.
- Making it easier to introduce risk-sharing arrangements as alternatives to pure DB or DC.
- Changing the rules on the recovery by scheme sponsors of 'trapped' surpluses.
- Stronger regulation on corporate activity that weakens pension security.
- Making it explicit that the Government is the guarantor of last resort for the PPF.
- Facilitating (through the introduction of appropriate legislation, for example) consolidation of small pension schemes to enable them to meet the challenges of operating in today's environment.

3. The employee perspective

Since the beginning of 2008, the NAPF has been conducting a Workplace Pension Survey to assess the confidence of scheme members and non-members in workplace pensions as a form of retirement saving compared to other savings options.

The survey of over 1,100 working age people[5] is conducted biannually. However, due to the extreme market conditions in the period since the last survey, it was repeated in December 2008 to assess the impact on employee confidence of the economic downturn.

Employee confidence in pensions

Between February and September 2008, overall confidence[6] in workplace pensions versus other forms of saving for retirement improved markedly, rising from +3% in February to +22% in September – the height of the stock market turmoil. In September, the only groups displaying a negative confidence in pensions were those choosing not to join a pension scheme and those with no access to a scheme (eg because they work for a very small employer or had not been with their employer long enough to join the scheme). Also in September, women displayed a positive net confidence in pensions for the first time.

However, after the turmoil in the fourth quarter of 2008, employee sentiment reverted back to February levels. For all employees, the index was +1% and the only groups in positive territory were men and pension scheme members. Declining confidence has, not surprisingly, been most acute amongst older workers. Confidence amongst those aged 35-44, 45-54, and 55-64 had fallen by 32%, 19% and 33% respectively, compared to a fall of 7% for workers aged 25-34.

Confidence gains made in the middle two quarters of 2008 were effectively lost in the final quarter.

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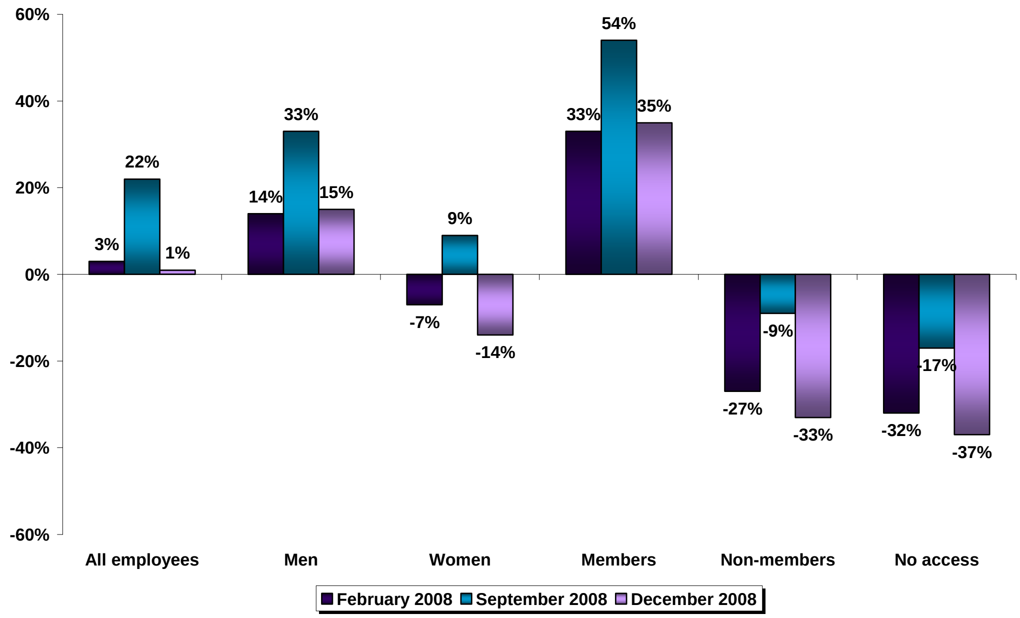
[5] The Workplace Pension Survey is conducted by TNS Global. The respondent numbers were 1,154 (February 2008), 1,198 (September 2008) and 1,156 (December 2008).

[6] Confidence is measured by reference to an index, which is the net percentage of those that are confident minus those that are not confident.

Figure 8. Confidence in pensions February – December 2008



Base: 1,154 (February 2008), 1,198 (September 2008) and 1,156 (December 2008)

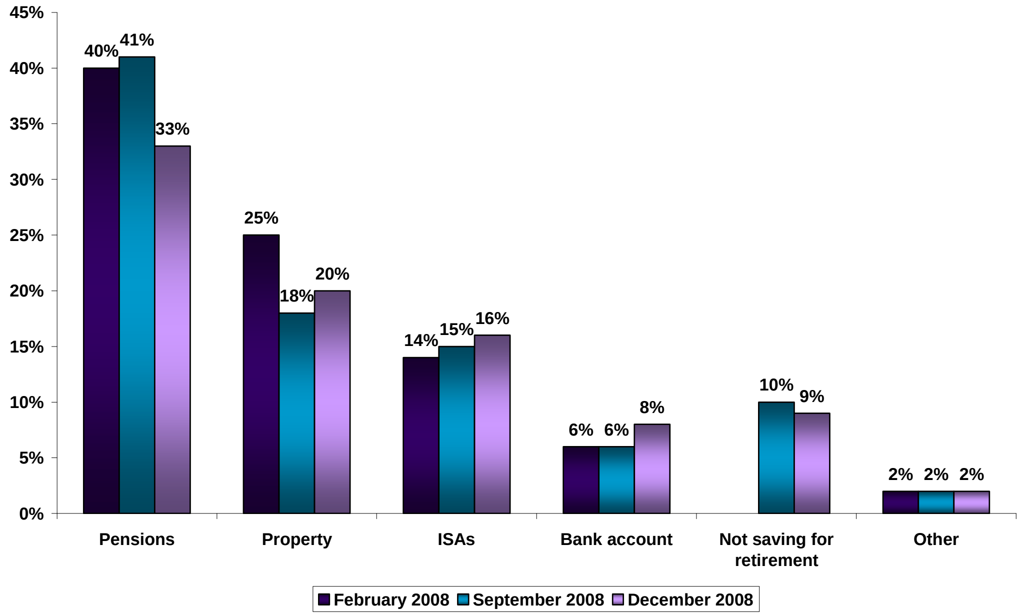
NAPF research has shown that the most frequently cited reason for people not joining a pension scheme when one is available is affordability. Part of this rationale includes an element of confidence that it is worth making a sacrifice of immediate income for income in retirement.

What is the best way to save?

Respondents were also asked for their views on what they considered to be the best way to save for retirement from a range of options including pensions, property and ISAs.

Whilst pensions have consistently topped consumers' preferences as the best way to save for retirement, the last 12 months has seen a decline in favourability. The responses show that the number of employees believing pensions to be the best way to save for retirement dipped from 40% to 33% between February and December 2008. There was a similar decline in support for pensions as the best way to save for retirement across all categories of respondents, with the decline being particularly marked amongst scheme members, where a fall of 10% was recorded over the last quarter of 2008.

Figure 9. Best way to save for retirement



Base: 1,154 (February 2008), 1,198 (September 2008) and 1,156 (December 2008)

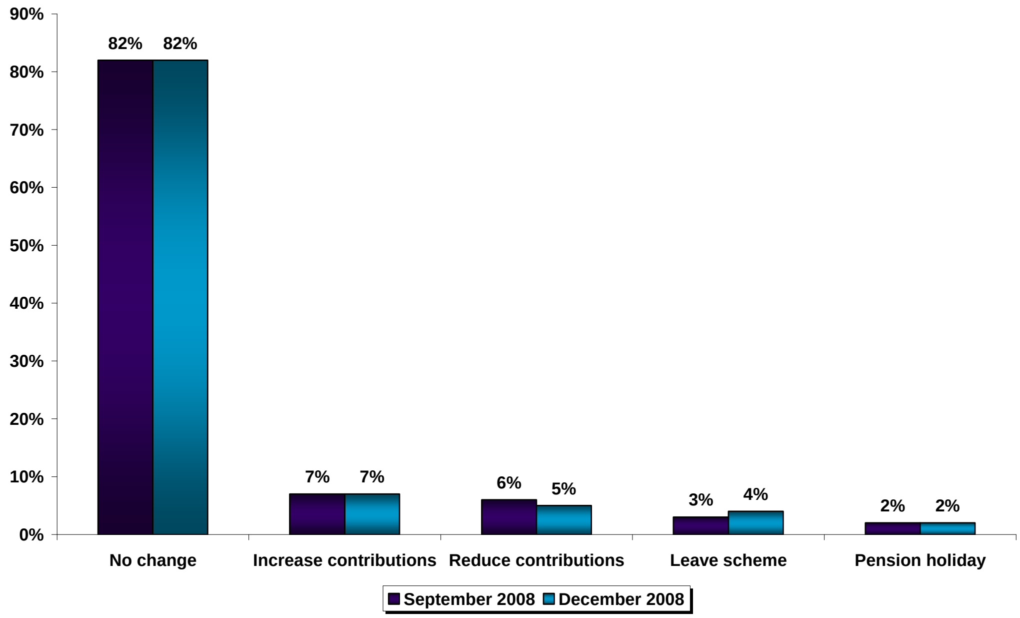
Changes to pension saving

In light of the current economic climate, growing unemployment and increasing cost pressures, there is a concern that employees might seek to scale back their expenditure by ceasing to save in a pension. To gauge the extent to which this might happen, we asked pension scheme members what they intend to do over the next year in terms of their own pension arrangements.

Encouragingly, despite the economic turmoil, fall in confidence and negative publicity on pensions, 82% of pension scheme members say they will make no change to their current pension arrangements. A further 7% say they will increase their contributions. These figures have remained stable over the last four months.

However, 11% of scheme members say they will cut back on pension saving by reducing contributions (5%), taking a pension holiday (2%) or leaving their scheme (4%). The youngest respondents in the survey (those aged 16-24) were most likely to say they would make changes to their pension arrangement, and were also most likely to say they would reduce their contributions, leave their scheme or take a contributions holiday.

Figure 10. Employee changes to pension as a result of the economic crisis



Base: 1,154 (February 2008), 1,198 (September 2008) and 1,156 (December 2008)

4. An action plan for Government, regulators and the industry

Our surveys show that the pressures on workplace pension schemes are considerable. These pressures will ultimately be felt by pension scheme members, many of whom are likely to face the closure of their scheme over the short to medium term.

The Government has acknowledged the extraordinary pressure under which schemes are currently operating. It says it supports good workplace pension provision and that it is keen to help scheme sponsors. Speaking at a recent conference, Pensions Minister Lord McKenzie of Luton said:

> *"…We must therefore take steps to relieve some of the financial strain on employers at this time, as well as increasing consumers' understanding of their pensions…*
>
> *These times **are** exceptional. So we want to support the pensions industry and those employers who currently provide pensions – pushing down on costs and driving out unnecessary burdens…"*

We agree.

With the industry's support, the Government is already doing much that is helpful. It has frozen the administration levies schemes must pay towards the Pension Protection Fund (PPF) and the Pensions Regulator; from this April, the ceiling on revaluing pensions in deferment has been reduced from 5% to 2.5% per year for future leavers; the government is consulting on changing legislation on s75 where, on any corporate restructuring, any deficiency becomes a debt on the employer; and it is also consulting on easing the conditions under which a scheme surplus can be returned to the employer. These are all helpful measures that have been welcomed by the NAPF.

However, as Lord McKenzie has made clear, these are exceptional times. If the predictions of those running schemes reported in this survey come true, we are likely to see a very rapid shift in UK pension provision. Some of our largest schemes covering many thousands of members are likely to close, thus bringing to an end the period of relative stability we have witnessed over the last two or three years.

These exceptional times call for exceptional measures and new thinking that goes to the heart of maintaining strong workplace pension provision in the UK. We have seen the Government take bold action in relation to the banking sector and to underwrite loans to small businesses, to both support the viability of these companies and to revitalise liquidity in the credit markets, for example. Similar action is now needed for the UK's pension schemes.

Action Plan

The NAPF Action Plan sets out steps the Government, the Pensions Regulator and industry can take together to support the long-term future of pension provision in the UK and which eases the cost of liabilities on scheme sponsors, helps schemes funding positions, and tackles and builds scheme member confidence.

Enhancing scheme member security

One consequence of the economic crisis is likely to be much higher calls on the Pension Protection Fund as more employers with insolvent schemes cease trading. Already we have seen victims of the credit crunch such as Lehman Brothers, Woolworth, and Nortel enter the PPF assessment. The architects of the PPF did not envisage the economic conditions which we are now experiencing when they set the levy basis or their predictions of the numbers of people needing PPF support.

It would be unjust to expect existing DB schemes, already struggling with deficits and weakening employer covenants to meet the additional costs of a larger than expected demand on the PPF.

The NAPF believes the Government should give a clear assurance that it will act as the guarantor of last resort for the PPF.

This would have the dual benefit of providing scheme members with the security that their benefits will be paid in the event that their scheme falls into the PPF. It would also provide much-needed security to levy payers and scheme sponsors that they will not face unlimited levy demands.

Building member confidence

A national agenda to rebuild consumer confidence backed by the Government and delivered by the experts will be essential to rebuilding employee confidence in pensions and saving for later life. This should be built around a pro-active and on-going campaign that gives working people easy access to no-nonsense help and information on pensions and retirement savings and which emphasizes the long-term nature of pensions against a back drop of short-term market falls. The NAPF is already playing its part via its PENSIONSFORCE service, providing information free at the point of use for employees via their employers, and we will continue to do so.

Improving scheme efficiencies

As the Pensions Commission reported, the cost of running pension schemes has increased significantly over the last few decades. These additional costs and complexities are particularly acute for smaller schemes.

The NAPF believes there is scope to improve the cost-effectiveness of pension schemes, including by facilitating and encouraging scheme consolidation where appropriate, to the benefit of scheme members:

- DB scheme members would gain if investment risks were reduced, returns are increased and/or scheme administration costs are reduced as schemes benefit from scale economies.

- DC members would benefit from larger pensions if the investment strategy is better and costs are less, as tends to be the case with larger schemes.

Government, regulators and the pensions industry must work together to mitigate the drags on pension provision.

Easing the pressures on scheme sponsors

The Government has already signalled its intention to issue record levels of gilts this year. The NAPF believes there are substantial gains to be had if issuance is skewed significantly towards long-dated debt, both fixed and indexed-linked. Pension funds will be able to obtain greater quantities of low-risk assets, thereby reducing risks for scheme sponsors, members and the Pension Protection Fund. Just as significantly, because liabilities are valued by reference to long bond yields, there will be a notable improvement in scheme funding levels which will be an important factor in helping to keep DB schemes open in the current economic downturn.

This action will achieve three highly desirable objectives:

1. Government will obtain access to funding at low rates of interest (lower than those available at shorter durations).

2. Institutions such as pension funds and insurance companies will benefit from greater availability of a strategic asset and reduced pressure on their balance sheets.

3. Companies will have greater access to debt finance at short and medium durations with less ‘crowding out’ by government borrowing.

Helping schemes manage their liabilities

The rising cost of scheme liabilities is placing further pressures on schemes. For example, it is estimated that around £9bn was added to pension scheme deficits as a result of rising life expectancy between 2006 and 2007 alone. Government should introduce legislation that helps scheme sponsors manage the costs of those liabilities, shares risks between the sponsor and scheme members and helps to ensure the longevity of DB schemes.

The NAPF has identified two measures that would help in this context:

- **Optional Indexation:** In respect of future pensioners, the requirement to index pensions in payment should be removed entirely. Therefore schemes would aim to target the funding level necessary to provide a pension not linked to inflation. However, schemes would be required to give scheme members the option to buy inflation proofing. This approach mirrors that already available to DC schemes.

- **Normal Retirement Ages:** Occupational pension schemes should be given the same flexibility as the state to manage longevity risk. Whereas currently schemes can only change retirement ages for future service, they should be given the flexibility to increase retirement ages for the whole of the period of a members' service. To protect scheme members, increases should be limited to future expected increases in longevity and workers close to retirement at the point the change is introduced should be excluded.

Helping schemes manage their deficits

According to the Pension Protection Fund, aggregate scheme deficits stood at £194.5 billion in January 2009. Making good these deficits has become more difficult in view of the severe financial pressure under which many employers are now operating.

The Pensions Regulator has acknowledged this and has helpfully said that trustees and employers should consider back loading deficit correcting contributions to help them through the downturn, for example. However, further assistance could be provided. NAPF believes the Regulator should allow trustees and employers, where appropriate, to agree recovery plans extending over 15 years before further investigation by the Regulator is automatically triggered.

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