

Funding pensions: Out of pocket

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The true cost of Britain's corporate pension schemes



WHEN Gordon Brown, the chancellor of the exchequer, raised employer national-insurance contributions by £4 billion (\$7 billion) a year in his 2002 budget, British business cried foul. But on October 31st, David Norgrove, chairman of the Pensions Regulator, set out proposals that will involve a cash call double that amount to get rid of company pension-fund shortfalls over the next ten years, and there was no great fuss. Instead, the stockmarket was galvanised by a takeover spree by foreign bidders for some big British firms.

A sanguine interpretation of this week's events is that prescient markets had already taken on board the scale of action needed to address pension-fund deficits. More likely, however, they have not woken up to the full impact of the regulator's proposals. That would be par for the course. There is a long, worrying history of government meddling in company pensions whose full impact is only appreciated years after the event. The failure to grasp the impact of new measures arises from the complexity of arrangements for funding private defined-benefit (DB) pensions, which are linked to final salary and years of service. This has grown enormously in the past year, as a new insurance and regulatory framework for company pensions has been constructed. The groundwork was completed in April when the Pension Protection Fund (PPF) started and the Pensions Regulator became a force in the land, replacing OPRA, its feeble predecessor.

The PPF, supported by compulsory levies on company schemes, provides compensation for members of underfunded DB pension plans whose sponsoring employers go bust. From the outset, the government has sought to avoid the financial problems afflicting America's 30-year-old company pension-insurance system. At the latest count, the Pension Benefit Guaranty Corporation (PBGC) had a record deficit of \$23 billion on its books, which many believe will require a government bail-out. One distinctive feature of the British approach is that the PPF

will rapidly make the levy mainly risk-based. Its charges will take into account both the funding of pension schemes and the risk that their companies may become insolvent. Another is that the regulator has been armed with powers to counter moral hazard—the temptation for companies to behave more riskily towards their pension funds once there is an insurance safety-net.

But these policies will prove ineffective as long as Britain's private DB plans remain perilously under-funded. The PPF does not provide full compensation: working-age members get 10% less in their prospective pension, which is also capped at a mere £25,000 a year; and indexation arrangements for pensions in payment are restricted. As a result, the benefits guaranteed by the PPF are worth some 30% less than the full value that would be secured through a buyout from an insurance company if a scheme had enough money, estimates Nigel Bodie of Watson Wyatt, an actuarial consultancy. Even so, the PPF revealed in July that the total deficit in company pensions under its valuation rules is £134 billion. That estimate is broadly equivalent to the £130 billion deficit that companies are registering under the FRS17 accounting standard, according to new figures this week from the regulator. That gap has emerged in the past few years because falling stockmarkets, rising longevity and declining interest rates have together battered pension-scheme finances. The deficit has proved stubbornly difficult to shift, despite the recent recovery in stockmarkets.

On October 31st the regulator served notice, in effect, that companies must get rid of these deficits within ten years. It is saying that the trustees of schemes and sponsoring employers must now, in general, draw up recovery plans to eliminate their deficits by around 2015; otherwise it is likely to intervene. It argues that this is a reasonable timetable, since over a ten-year period the financial health of firms is more likely to deteriorate than to improve. The regulator's plan is out for consultation, but its broad thrust is unlikely to change very much. Business regards the funding stipulations as onerous. In 2004 employers pumped £25 billion—equivalent to 2.2% of GDP—into pension funds, more than double the amount in 2001 (see chart on previous page). Around a third of this—almost £8 billion—was comprised of special contributions to reduce deficits. According to Mr Bodie, the regulator's proposals will require companies to stump up about a further £8 billion a year.

Estimates for the regulator by PWC, an accountancy firm, demonstrate the potential burden. These show that for 65% of companies, the cost of paying off their FRS17 shortfall would amount to less than 25% of their free cash flow (profits plus depreciation). But for 15% of firms, it would absorb 25-100%; and for 20% of companies, it would exceed the free cash that they can generate. Furthermore, companies are also facing another financial strain, the payments they must make for pension insurance. Within a few weeks, the PPF will reveal the total bill that it will charge private DB schemes next year—the final building-block in the new structure for company pensions. The levy is likely to be double the government's original estimate of £300m a year, says Raj Mody of Hewitt, a human-resources consultancy.

Even with such a boost to its resources, there are doubts about whether the PPF will prove viable in the long run without recourse to the taxpayer. In America the PBGC has been overwhelmed by huge claims from foundering industries such as steel and airlines. "It's become painfully clear that policy towards pensions has become industrial policy," says Olivia Mitchell, executive director of the Pension Research Council. When this happens, she says, "the system ceases to be insurance and becomes bail-out".

The immediate danger is that firms may conclude that the load on them is too much to bear. "If you push too hard, employers will give up," says Robin Ellison, chairman

of the National Association of Pension Funds. Already about 70% of DB schemes are closed to new employees. The NAPF is now expecting a second wave of closures, in which firms would stop the future accrual of pension benefits for existing members of DB schemes. Alternatively, they might make accrual less generous, so that each year of future service builds up less benefit. With so many schemes already closed to new employees, the traditional company pension is a dying species. The worry about the regulator's approach is that if business decides the pressure is excessive it can and will advance that date with the undertaker.