In this Pensions Perspective, I examine the range of reasons why employers may need to change the design of their pension arrangements, illustrated by real-life case studies. This will help you consider the strength of your own company's business case for change. I believe that, for many companies, the business case is compelling and change is not only necessary but long overdue – it is time to grasp that nettle!

Companies in the news

Shell recently became the last FTSE 100 company to announce the closure of its final salary pension scheme to new recruits, although most companies did this more than 5 years ago. Unite accused Shell of "moral bankruptcy" when it subsequently announced annual profits of £18 billion. Unilever has been aiming to achieve something which is more significant and potentially emotive. Its proposals would change the benefits provided to its scheme’s existing members for their future service. This is a much more common action for companies to be taking, with the NAPF in its 2011 annual survey finding that almost 25% of final salary schemes are now closed to future accrual. Ironically, Unilever's plans are mild compared to what has happened for most of this 25%, which has been to switch members from final salary to a defined contribution (DC) scale for their future service.

Unilever is proposing to retain a defined benefit (DB) approach, so the company would continue to carry the risks of poor investment performance and faster than expected improvements in life expectancy. The main change would be to switch future accrual to a career average rather than a final salary basis, something which seems likely to affect Unilever’s high-flying executives far more than a factory worker. Nevertheless, rather like similar proposals to move to a career average basis within the public sector, this led to a series of strikes and apparent bad feeling amongst the pension scheme's membership, before agreement with the unions on improved proposals was finally reached.

So what is all the fuss about? It is useful to start with a recap on what...
employers can and cannot do from a legal perspective.

What change is legally possible?

Employers can only propose changes to their current pension provision for future service. They need to formally consult with employees on their proposals over a period of at least 60 days, before making a final decision and implementing any changes.

Even in the unusual case where members’ contracts explicitly refer to membership of a final salary scheme, it is possible to change this – albeit here the consultation is more complex and must run for at least 90 days. Usually the scheme’s trustee board need to sign a deed of amendment which implements the changes.

Things to watch out for from the company perspective are:

• a trust deed and rules which prevent certain changes (although this is relatively unusual, in the extreme it could mean that no changes are possible to future service accruals)
• a trustee board which, if egged-on by over-zealous advisers, can demand extra contributions, investment de-risking or security in return for signing the deed of amendment
• if the intention is to cease final salary accrual, whether this could trigger what is called a section 75 buy-out debt on the employer.

Pension benefits already earned cannot be changed and the company must finance what is typically a large deficit in respect of past service liabilities.

One area where changes made for future service can have a knock-on impact on past service liabilities is the link to future salary increases. If final salary accrual is stopped, the link between what a member has earned for past service and their future salary increases is usually broken. The reserve previously held for the salary link over and above the rate of deferred revaluation is then released. That reduces a scheme’s deficit, typically by something in the range 5%–15% of the employees’ past service liabilities.

So are Unite right? If a member has been earning a particular level of final salary pension since he joined an employer 20 years ago, can it ever be right for that employer to seek to amend the terms of the pension for his future service? I think it depends on why the employer wants to make the change, so let us look at the range of reasons.

It’s all about cutting costs, isn’t it?

This may have been true for many of the companies who were first to stop DB pension accrual. However, for those making changes more recently, the driver for change has often not been the level of cost but the uncertainty.

Take a look at a real-life example of how the employer’s share of the cost of a traditional 1/60ths final salary pension has increased over time, as this will help explain why companies have become so concerned about this uncertainty.

Case Study – uncertain times

• Members of a traditional 1/60ths final salary scheme have always contributed 5% of pensionable salary, with the employer meeting the balance of the cost – at the time of the 2003 funding valuation, this was estimated to be about 10% of pensionable salary
• 3 triennial valuations later in 2012, the contributions needed to finance each year’s accrual of pension have increased from 15% to 25% of pensionable salary, as a result of lower anticipated returns from equities, reductions in gilt yields used to match the liabilities and increased life expectancy.
• The company has not sought to push up the members’ contribution rate, so its own costs have doubled from 10% to 20% of pensionable salary in less than 10 years.
• Even if members are asked to pay more, there is still uncertainty over whether the new overall rate of 25% will prove sufficient to meet the eventual cost - the company remains “on-the-hook” for any shortfall.
• In addition, poorer than anticipated investment performance from the scheme’s assets has led to a burgeoning past service deficit between 2003 and 2012, requiring a much higher level of deficit contributions.

This example highlights a number of key points about pension change:

• In market sectors where companies operate on tight margins and labour is an important component of overall costs, the uncertainty in cost of final salary pensions has become unsustainable for employers.
• In many cases employers are insisting on cost certainty, not cost reduction. The alternatives which companies are introducing are not necessarily cheaper than continuing with the status quo.
• Companies often need to find significant extra resources to finance past service deficits. This sometimes means diverting resources away from funding future service.
• Eating humble pie, we pensions actuaries were slow to flag the increasing cost of final salary accrual, not least by consistently under-estimating the pace of improvements in life expectancy in the 1990s and early 2000s.
• Companies have often hesitated to make changes to their pension design, even when it had become clear that costs were increasing significantly. Therefore employees may have no previous experience of changes being made to their pension benefits.
In summary, the level and uncertainty of cost are key reasons why companies may need to make changes to their pension schemes. Such changes are surely not immoral if they are justified by the protection they give to the business (including to employees) against a potentially crippling financial burden.

Equity between the generations

Although Shell’s final salary scheme will not shut to new employees until next year, most such schemes were shut between 5 and 10 years ago. What companies chose to introduce for new employees at that time was typically a fairly standard DC arrangement. This means that, 5 to 10 years on from closure, there is now:

- a huge disparity between the value of the benefits provided to the two groups of members
- often more DC members than final salary members.

In theory the more recent recruits should have been provided with a higher salary or other benefits to compensate for their less generous pension benefits. In practice that has not happened, so there are colleagues doing the same job, with the same levels of compensation but with very different pension provision, depending on when they joined the company.

A growing reason for pension change is cost re-allocation, not cost saving, as employers look to establish a level playing field across different generations of recruits. That may mean spending less money on current final salary members for their future service (although not if past service deficit payments are included) but more on the current DC members. The case study given below illustrates this well.

Will new or planned legislation affect the pace of pension change?

In every case, impending legislative changes will speed up the necessity for companies to take action.

Case Study - a level playing field

- A company whose final salary scheme was shut to new employees in 2001, had (ten years later) twice as many members in the DC section as in the final salary section.

- However, the company’s future service contribution rate for the final salary section had increased to more than twice what it paid for DC members.

- The company had two main objectives – establishing a level playing field for all employees’ future service and achieving much greater certainty of pension cost.

- That led to a DC design with matching contributions, which was significantly more generous than the previous DC contributions scale but was unlikely to replicate the benefits which final salary members had enjoyed. This new design took some communicating to the final salary members!

- Key to that communication was being able to share, openly and honestly, the company’s objectives in tackling pension change, the historical development of its pension costs and the financial analysis which had led it to the proposed new design.

- Whilst obviously the unions did not welcome the change to the new DC contribution scale for the former final salary members, they did appreciate that overall their members were likely to be better off as a result of the changes. The Company had achieved its two main objectives, albeit at a slightly higher overall annual cost.
The Coalition Government has abolished the default retirement age of 65 and has plans to increase State pension age to 68 and beyond. This will make it more difficult for employers to part company with their employees when they reach age 65. This issue will be exacerbated by having employees with inadequate pensions who cannot afford to retire.

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Auto-enrolment (AE) is almost upon us, with the very largest employers needing to comply from 1 October 2012. The scale of its impact will depend critically on the current take-up rate for an employer’s pension arrangements. Already a few employers have launched pension consultations citing increased costs under AE as a key reason for change.

A significant legislative change that is expected in, perhaps, 3 years’ time is the end to contracting-out of the State Second Pension by DB schemes. This will affect all schemes whose members accrue benefits on a traditional final salary basis. A recent survey by the Association of Consulting Actuaries found that 20% of such schemes thought it would definitely bring an end to future accrual, while a further 40% thought it may well do so.

The last word

I hope that I have demonstrated why, for many companies, there is now a compelling business case to push ahead with pension change. Whilst there are always company-specific reasons why pension change may be a sensitive issue, there are tried and tested ways in which even financially strong employers can justifiably and successfully implement change, including the replacement of final salary benefits with a DC scale of contributions.

If you would like to know more about how to carry out a successful pensions consultation, then please read my Pensions Perspective entitled “Taking the sting out of final salary closure”.

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