Increased Pension Costs Due To Government Action

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Introduction

(1) Many countries are finding that their company pension schemes are becoming steadily more complicated and more expensive. A major factor in the UK has been Government action which in recent years has had a significant effect - both direct and indirect - on employers' pension costs. The main reasons for this are discussed in this paper as the UK experience may have some parallels in other countries.

(2) The pace of pensions legislative changes in the UK has been quite breathtaking in the last few years, with every year since 1984 having at least one Act of Parliament with a significant effect on company pension schemes. Apart from a desire to provide individuals with more choice and control regarding their pension arrangements, there would appear to be three main threads underlying these changes:

(i) greater protection for members of company pension schemes;
(ii) the transfer of some future pension costs from the State to the private sector; and
(iii) the restriction of tax advantages available to pension schemes.

These three aspects are considered in more detail below.

UK Pension Schemes

(3) **Company Schemes**. Before considering the changes that have taken place, a brief summary of the UK statutory framework for pension schemes may be helpful.

(i) Constitution. A pension scheme must usually be established as a legal trust, separate from the sponsoring employer.

(ii) Types of Scheme. Schemes operate on defined benefit or defined contribution (money purchase) lines (or a mixture of the two), but defined benefit schemes predominate. Most schemes are pre-funded with the funding objective for defined benefit schemes usually being to have sufficient assets to meet the capital cost of accrued liabilities.

(iii) Approval: Formal approval must be obtained from the Authorities (i.e. the Superannuation Funds Office of the Inland Revenue) if the scheme is to enjoy the considerable tax advantages available. These tax advantages include tax relief on both the employer's and the employee's contributions, and on the fund's investment income and capital gains. In order to obtain approval, the scheme must comply with the limits imposed by the Inland Revenue on the maximum benefits payable and contributions receivable.

(4) **The State Scheme**. Since 1978 the State earnings-related pension scheme (SERPS), which operates on a pay-as-you-go basis, has provided earnings-related pensions for all employees, whether members of a company pension scheme or not, in addition to the basic flat rate pension. The level of SERPS reflects the employee's average revalued relevant earnings throughout his career: relevant earnings are those falling between the Lower Earnings Limit (LEL) for National Insurance contribution purposes (currently £2,236 per annum) and the Upper Earnings Limit (UEL) (currently £16,900 per annum); these earnings limits are about 20% and about 150% of national average earnings, respectively. Revaluation of an employee's relevant earnings each year is in line with the change in the index of national average earnings. The target level of pension is now 20% of average revalued relevant earnings (compared with the original target level of 25%) for someone with a full career in SERPS and, once in payment, the State grants increases each year in line with price inflation.

(5) **Contracting-Out**. It is possible for company pension schemes to contract out of SERPS by providing part of the cost of the SERPS pension - known as the guaranteed minimum pension or GMP - in return for paying lower National Insurance contributions. This National Insurance rebate is reviewed every 5 years and currently amounts to 5.8% of relevant earnings (split 2.0% employee, 3.8% employer); it is designed to represent the accruing cost to the pension scheme of providing the GMP. As SERPS matures and the average accrual rate for GMPs decreases, the contracting-out rebate can be expected to decline steadily to an ultimate level of perhaps 3.5% of relevant earnings. The level of earnings-related pension paid by the State is the calculated level of SERPS (which will be the same whether or not the person was a member of a contracted-out pension scheme and includes the inflation-linked increases) less any GMP payable. When a member leaves a contracted-out pension scheme early, it is necessary for the scheme to revalue the GMP during the period until it comes into payment at State pension age in one of three ways; this corresponds broadly to the annual revaluation of the relevant earnings for SERPS calculation purposes.

Member Protection

(6) Improved protection for pension scheme members falls under three headings:

(i) early leavers
(ii) equality
(iii) disclosure

(7) **Early Leavers**. Early leavers have traditionally done relatively badly from final salary pension schemes. In fact before 1975 there was no legal requirement to provide any pension benefits for early leavers, other than a refund of their own contributions. Because the plight of early leavers has never been a high priority either for employers or for those representing members' interests, it has been left to the Government to provide a positive lead by way of legislation.

(8) There has been a steady improvement in the protection of early leavers' pension rights and the position now reached is that, for defined benefit schemes, the accrued pension at exit for those with at least 2 years' qualifying service must be preserved and granted a minimum level of increase during its deferment period: the GMP component (for contracted-out pension schemes) must be revalued as explained in paragraph (5); and any excess over the GMP must be revalued by 5% per annum during the deferment period, or in line with the increase in prices if less. Strictly speaking, this second component of revaluation is only in respect of that part of the excess pension deemed to have accrued since 1984 but, in due course, this formula will apply to the whole of the excess pension.

(9) A report published in February 1989 by the Occupational Pensions Board (the OPB) (a Government body set up to supervise some areas of occupational pensions and to report on specific remits from the Government) recommended that the above revaluation formula should apply to the whole of the non-GMP pension. The Government announced in November 1989 that legislation is to be introduced to implement this recommendation.

(10) Interestingly, with one exception (discussed in paragraph (22)), there is no statutory requirement for most company pension schemes to grant regular increases to pensions that have come into payment, although individual scheme rules will often provide for such increases. However, the OPB has reported that, as a matter of good practice, schemes should be urged to grant increases to non-GMP pensions in payment in line with increases in prices up to a maximum of 5% a year. For schemes that do not guarantee increases of this level, the OPB recommends that pensioners should have the option of exchanging their pension for a lower pension with such a guarantee. The

Government's response (in November 1989) to this proposal appears to be that this should be left merely as a matter of scheme design. However, the Government has also proposed that, upon the winding-up of a pension scheme, pension increases should be granted both to pensions in payment and during deferment in line with increases in prices up to a maximum of 5% a year. Moreover, where the scheme's assets are insufficient to cover such liabilities, the Government has proposed that any shortfall should become a debt due to the scheme by the employer. This is a controversial proposal giving rise to a number of anomalies and it remains to be seen whether there will be a change of heart on the Government's part before the legislation is introduced.

(11) The cost of the increased protection already granted to early leavers will have varied from scheme to scheme. In some cases the additional cost resulting from the legislative changes will have been minimal, but in other cases the increase in accruing pension costs could easily exceed 3% of payroll, depending on the particular circumstances of the scheme.

(12) Early leavers now have the right to take a transfer value in respect of their accrued pension rights to another pension arrangement. The legislation and accompanying actuarial professional guidelines prescribe how the minimum level of these transfer payments should be assessed and, in some cases, this may have resulted in an increase in the level of individual transfer payments and hence an increase in pension scheme costs.

(13) **Equality**. Since November 1986, the Sex Discrimination Act 1986 has made it unlawful to discriminate against either men or women in relation to their retirement date i.e. the age at which they must cease working (which is not the same as the age at which their pension commences). No change has been announced in the State pension ages of 65 (men) and 60 (women) and it is permissible for pension schemes to have retirement ages for pension purposes which vary according to sex. Nevertheless there is evidence that many pension schemes are being affected indirectly by the Sex Discrimination Act by introducing a common pension age for men and women. It is usual, but not universal, for there to be a net reduction in the average pension age for such schemes which has therefore increased their cost of pension provision.

(14) The Social Security Act 1989 introduces a number of measures required by the Second EEC Directive on Social Security. The principle of equal treatment underlying the Act is that, in any employment-related scheme, one sex should not be treated less favourably than the other on the basis of sex. The Act does not take effect until 1993 and there are a number of exemptions including, most importantly, permitted differences in pension ages and in survivors' benefits. However, it is clear that the changes will result in increased costs for many schemes particularly as the legislation

applies to indirect as well as direct discrimination. Thus, for example, pension schemes which do not at present admit part-timers may find themselves obliged to admit them in future if they tend to be of one sex (as is often the case), with resulting increased costs.

(15) On a point of detail, contracted-out pension schemes are now obliged to grant GMPs to widowers (as well as to widows) on the death of a member or pensioner with title to a GMP. This element of compulsory widowers' pensions for contracted-out schemes has often resulted in the full introduction of widowers' pensions on the same basis as widows' pensions, at a typical ongoing cost of up to 1% of payroll.

(16) **Disclosure**. In the past, the extent to which pension schemes were obliged to keep their members informed was minimal and, for some schemes, it was not even necessary to have audited scheme accounts. However, pension schemes are now obliged to disclose a significant amount of information to their members, following the disclosure regulations introduced in 1986. In most respects this disclosure legislation was just formalising the existing practice of many "good" schemes, but for some schemes the increase in administration required must have come as quite an expensive and time-consuming shock. For example, schemes are now required to provide benefit statements to their members on request (within certain limits) which has resulted in a number of schemes deciding to introduce a computerised record keeping system to cope with the possible demand.

Transfer of Costs from the State to the Private Sector

(17) The majority of developed countries are expecting a steady decline in the demographic ratio of active population to retired population with consequential problems in pensions financing, and the UK is no exception. The UK Government's solution to this problem (introduced in the Social Security Act 1986 and taking effect from April 1988) has been to cut back on the scale of pension benefits payable from the State Scheme (as explained in paragraph (4)), and to transfer a greater part of the emerging cost of State benefits to the private sector. The resulting impact on company pension schemes is discussed in the following paragraphs.

(18) **Reduction in SERPS**. A reduction in the target level of SERPS benefits payable from the State Scheme implies either a reduction in the total income that the individual may anticipate after retirement, or a compensating increase in the pension benefits payable from company schemes (or both). The latter will, of course, increase the cost of those schemes and this has occurred, for example, in cases where company schemes define a target level of pension inclusive of whatever the State Scheme provides.

(19) **Reduction in Basic State Pension**. A more subtle way in which company pension scheme costs are increasing arises from the Government's practice regarding increases to the basic flat-rate pension. The LEL (referred to in paragraph (4)) is based on the level of the basic State pension. This must, by law, be increased each year at least in line with the increase in prices. Before 1980 the statutory minimum increase each year was in line with the increase in prices or earnings, whichever gave the higher figure. In practice, the level of basic State pension remained fairly steady at about 25% of national average earnings in the years to 1980. Since then, however, real increases in average earnings have resulted in the basic State pension declining steadily to about 20% of national average earnings. The benefit design of many company pension schemes is based on earnings in excess of 1 or 1.5 times the LEL, in order that the scheme benefits should integrate with the basic State pension. There is thus a gearing effect on the pensionable earnings for such integrated schemes and pensionable earnings are therefore increasing at a faster rate than gross earnings. The result is an increase in the accruing pension costs when expressed as a percentage of gross earnings.

(20) **Increased Contracting-Out**. The main way for the State to transfer future pension costs to private sector schemes is to encourage more contracting-out. The Government's intentions are quite clear in this regard because the 5.8% contracting-out rebate (referred to in paragraph (5)) has deliberately been made attractive by incorporating an explicit margin of 0.4% of relevant earnings; and, furthermore, the Government is paying an additional incentive rebate of 2% of relevant earnings (referred to in many quarters as "the 2% bribe") for newly contracted-out schemes until 1993. Most contracted-out pension schemes - and newly contracted-out schemes in particular - therefore have a temporary financial advantage which actually reduces their costs. This advantage may not be quite as significant as it first appears, however, because younger pension scheme members are showing a greater tendency to opt out of their company schemes (as they are now allowed to do) with the result that the average age - and hence the average cost of providing accruing GMPs for scheme members - is increasing.

(21) **GMP Formula**. With the reduction in the target SERPS pension from 25% to 20% of revalued relevant earnings, there is a corresponding reduction in the accrual rate of GMPs accruing after April 1988. This has two effects on the costs of contracted-out schemes. First, the balance of any scheme pension from the scheme (over and above the GMP) will be correspondingly higher in future, assuming no change in the scheme's pension benefit formula. Because the State Scheme meets the cost of inflation-proofing the GMP component (as explained in paragraph (5)), scheme pension increases will normally be restricted to the excess pension over the GMP. Assuming no change in the level of such increases, there will be an increase in costs because scheme pension increases will be payable on a larger proportion of the total scheme pension.

(22) The second factor is that the company scheme is now required to meet the cost of increases on the post April 1988 component of GMP (up to a maximum of 3% a year), thus relieving the State of part of the liability to give inflation-proofed increases on GMPs. There is therefore a twofold increase in the pension increases payable by contracted-out company schemes, with a resulting increase in accruing pension costs of typically some 1% of payroll.

Tax Advantages

(23) As explained in paragraph (3)(iii), approved pension schemes enjoy considerable tax advantages. In some quarters there is the belief that these tax concessions provide pension schemes with too great an advantage compared with other methods of saving or investment. Recent Government decisions have resulted in a noticeable trimming of some of these tax advantages.

(24) In 1987 the Government tightened up many of the limits on maximum benefits that approved pension schemes could provide. These did not increase the benefit costs of company schemes (and will have actually reduced them in some cases where the new limits were biting) but did have the effect of increasing the administrative complexity of schemes. In 1989 there was a further tightening up of the benefit limits. In some respects these 1989 limits represent a simplification (unlike the 1987 limits) but there is one important change which will have a direct effect on company pension costs.

(25) Any new employee must now have a limit on his pensionable pay from an approved pension scheme of £60,000 a year (a figure to be increased each year in line with the change in prices, not earnings). Although such a limit may be relevant for less than 1% of the working population at the present time, this percentage will steadily increase in future because of the limit's link to prices. Certain other countries (including the United States, France and Norway) already have such a ceiling on pensionable pay. If companies wish to retain their present target pension packages for their more senior staff in future, this will be possible, but only by providing topping-up benefits from unapproved schemes without the same tax advantages, and hence at an increased cost.

Conclusions

(26) This paper identifies the main areas where Government action in the UK in recent years has resulted in an increase in company pension costs. What the paper may not convey adequately is the sheer weight of new pensions legislation and its horrendous complexity which is imposing additional burdens on all those involved with company

pension schemes. The Government's latest proposals (announced in November 1989) continue this well established trend.

(27) Little mention has been made of the new found freedom of employees to opt out of their company pension schemes and to make their own pension arrangements, either by purchasing a "personal pension" (an individual money purchase arrangement) from an insurance company or, by default, relying on SERPS. Evidence to date suggests that perhaps only 1% of current members may have opted out of their company scheme, but around 10% of potential new scheme members appear to be deciding not to join their company scheme. In due course this could have a significant impact on company scheme membership and hence on employer pension costs. The apparent short-sightedness of many employees could actually be reducing a company's pension costs in the short term, but there will be a price to be paid eventually when people appreciate the impact on their pensions.

(28) Company pension schemes are also, for the first time, in the position of having to "sell themselves" against the competition. This may be no bad thing but it is resulting in further costs for communication exercises etc. Furthermore, in order to improve their competitiveness against the perceived threat of personal pensions, many schemes have recently introduced improvements for their members, either by way of higher benefits or by reductions in the level of member contributions. Such changes might have been introduced in any event but the result has been a further increase in company pension costs.

(29) A saving feature is that many of these changes imposed by the Government (which, as explained in the paper, can be quite expensive for many company schemes) have been introduced at a time when the economic outlook for pension scheme financing in the UK has been improving steadily and the investment performance of most funds has been considerably above expectations. Any increase in company pension costs has therefore usually been absorbed in a relatively painless way. This may not be so in future and we await, with interest, any further proposals.