

Back to the drawing board: The economic crisis and its implications for pension provision in the United Kingdom

An update

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Introduction

In June this year, we published our paper *Back to the drawing board: The economic crisis and its implications for pension provision in the United Kingdom*.¹ We argued that the economic crisis had highlighted not only weaknesses in financial markets and regulation but also in existing pension systems in many countries. The paper presented and discussed the myriad channels through which the crisis had affected the British pension system. We found that all aspects of the system had been hit, predicted a number of trends over the short to medium term and argued that the crisis had probably accelerated the shift towards a new pensions landscape in the future. We concluded that the challenges were so substantial that bold policy action would be required but that the developments also posed genuine opportunities to establish a more efficient, equitable and sustainable structure.

Since then half a year has passed, during which the world economy appears to have stabilised and the worst of the recession now seems to be over. However, there also remain deep worries that economies could slip back into recession, in particular, if the consumer fails to recover and once the substantial fiscal and monetary stimuli begin to be withdrawn.

It seems an opportune time to return to the issue, revisit some of our predictions and to assess whether our conclusions drawn earlier this year - when circumstances and sentiment were admittedly very bleak - remain valid in the light of an optically more upbeat economic environment now.

Recent developments

The state of the economy

As predicted, the UK economy remained very weak over the last six months and will, in line with experiences elsewhere, see a sharp contraction year on year (the fact that the UK appears to be emerging from the recession more slowly than other major countries has little relevance in the context of pensions). The weakness reflects to a large extent the continued fall in private consumption, which has been contracting on a quarter-on-quarter basis since the 2nd quarter of 2008. There are a number of reasons why private consumption has been falling, including the increase in unemployment itself, households' deteriorating confidence in labour market prospects but also potentially the drop in net financial wealth. In addition, precautionary savings appear to remain relatively strong.²

In line with experiences from previous recessions, it is younger workers that have been hit hardest by the crisis. Since our original report, the youth unemployment rate continued to rise, reaching the highest ever recorded rate of 18% in July to

¹ *Back to the drawing board: The economic crisis and its implications for pension provision in the United Kingdom*, Eich and Swarup, June 2009.

² *Inflation Report November 2009*, Bank of England, 2009.

September (compared with 11.9% in the same period in 2007).³ Unless countering measures are undertaken, there is the risk that an entire cohort could start their working lives with a broken employment record, making it difficult for them to build up adequate pension entitlements or other forms of long-term savings.⁴

The decline of defined-benefit pension schemes continues...

Over the last six months, there have also been a number of high profile closures of private sector defined benefit pension schemes, including Morrison's, Barclays, BP, Whitbread, and more recently, announcements from Tate & Lyle and Vodafone among others that they are considering closing their schemes to new accruals. In a similar vein, the Royal Bank of Scotland announced in August that future pensionable salary increases would be capped at 2% or the rate of inflation, whichever is lower.

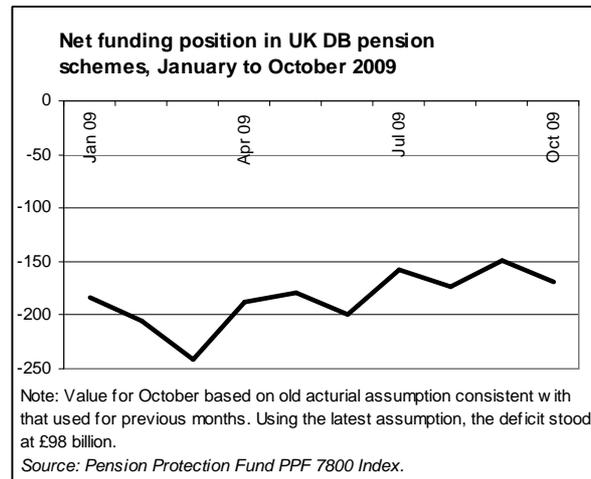
This is a trend we highlighted in our earlier paper and there is little reason to believe that it will come to a halt or even be reversed in the months and years to come.⁵ If anything, actual developments have been even more dramatic than we anticipated. There are a number of factors driving this trend, of which the net funding position (in other words the value of assets minus the value of liabilities) is only one. As can be seen from the chart, the net funding position of the PPF7800 Index recovered slightly between June and October but remains firmly negative. The improvement was due to a rebound in the value of assets, which in October was 8½% higher than in June and 13% higher than at the beginning of the year (and hence increased by more than the value of liabilities). However, it is interesting to note that the improvement in the funding position has generally been anaemic and a significant gap still remains. This is largely because the increase in asset valuations from rising equities and fixed income valuations has been largely offset by gains in liabilities caused by falling yields.

³ Labour Market Statistics November 2009 Statistical Bulletin, ONS, November 2009.

⁴ The Work Foundation has argued that a key priority for government should be to reduce the potential adverse consequences of youth unemployment. See *The Road to Recovery: Getting Britain back to work*, The Work Foundation, November 2009.

⁵ In its latest annual survey, the National Association of Pension Funds finds that more than half of the currently open DB pensions plan to close for new members, while less than two thirds of currently open DB pension schemes intend to remain open to existing members. See *Government action needed as recession impacts pensions*, National Association of Pension Funds' Annual Survey 2009, NAPF, 2009.

The true gap is even larger given that the PPF 7800 Index is based only on the capped liabilities that would need to be paid by the Pension Protection Fund (PPF) rather than the full liabilities of the underlying DB schemes. The Pensions Regulator requires corporate sponsors of DB pension schemes to close these gaps over time - this will require sustained special contributions and the exponential trend over recent years is likely to continue.



Further news that defined-benefit pension schemes continue to struggle came in November, when the PPF revealed that its own deficit had increased from around £520m in March 2008 to £1.2bn in March 2009.⁶ According to the PPF the main reason behind this development was the rising number and value of pension schemes claiming on the PPF. The rising deficit has further intensified the debate whether the PPF's structure is sustainable in an economic downturn - an issue already touched upon in our original report.

...while the value of assets in defined-contribution schemes follows the stock market

In our original paper we reported that the value of assets in British defined-contribution pension schemes had dropped from £550bn in October 2007 to £380bn in March 2009. According to Aon Consulting, asset values started to climb over the summer, reaching £520bn in early October (the highest level since mid 2008) before falling back again to £490bn at the end of the month.⁷ These fluctuations mainly reflect the ups and downs of the international equity markets, which recovered strongly over the year. However, question marks remain whether this recovery can be sustained as the economic fundamentals remain weak.

⁶ The Annual Report and Accounts 2008/09, The Pension Protection Fund, November 2009.

⁷ DC pensions drop £18bn in one month, Aon News Release, November 2009.

The rebound in equity prices has been reinforced by the recent resurgence in house prices, likely reducing the pressure to reform as home owners once again begin to feel that they have the financial assets to enjoy a good quality of life in retirement. While sponsors and members of DB and DC pension schemes alike may now have some important breathing space, none of this deals with the underlying issues in the provision of pensions in the UK identified in this note and our earlier work.

The focus on near-term issues has meant that the Bank of England has kept its headline interest rate at a record low of 0.5% and extended its programme of quantitative easing in recent months. Coupled with the fiscal stimulus from the government, this has succeeded in keeping yields at record lows. While the injection of money has arguably had some success in stemming the tide of deleveraging that typified the financial crisis, the fiscal stimulus in combination with structural changes in the economy has come at the cost of huge increases in public debt and there is still little sign of a recovery in the true engine of the economy – the consumer, who is still deeply indebted. In the meanwhile, the low yields continue to haunt DB pension schemes and their sponsors, resulting in higher perceived liabilities, as well as those DC members coming up to retirement, many of whom are finding annuity rates at record lows. For these, a near-term crisis has only been replaced by an even larger long-term one, where the answers are far from clear.

The state of the public finances remains deeply worrying, jeopardising the government's ability to implement its pension policies

In our original paper we argued that the crisis had not only impacted adversely on the funding position of DB and DC pension schemes but also shocked the public finances, with the UK running one of the largest structural fiscal deficits (at close to 10% of GDP) in the developed world. The picture has remained more or less unchanged as can be seen by comparing HM Treasury's 2009 Budget and 2009 Pre-Budget Report.⁸ Whatever the exact numbers might be, it is undeniable that the crisis has left any future government in a weakened position to deliver more generous state pensions. As such, it is probable that the next government will restore the promised link of the basic state pension to earnings growth at the latest possible date, which on current Labour and Conservative plans

would be 2015.⁹ If this were indeed to happen, then the implementation of government policy would come nearly ten years after the policy recommendations were made by the Pensions Commission. In any case, as economic fortunes have changed dramatically since then, it is debatable whether these are still the appropriate policy actions.

Given the lack of detail on how the deficit will be reduced, gilt yields will likely rise over the next 2-3 years. As noted in our previous paper, issuance is already going to be large over the coming year – coupled with worries over the size of the deficit and the need for a credible plan to tackle public finances; this does not bode well. The risk of a gilts crisis is growing albeit small – any rise in yields is likely to be gradual rather than violent at this stage. Ironically, the rise in yields has a positive effect on pension funds as it translates into a higher discount rate and lower liabilities. The problem is that such a situation would inevitably be accompanied by volatility on the asset side – large rises in yields could well lead to government austerity and growing worries over the sustainability of the current 'recovery'.

We also speculated that given the parlous state of the economy, the government might judge that the 2012 launch of its flagship Personal Accounts programme could present an unacceptable financial burden for businesses, many of which will still be reeling from the recession. In September the government acknowledged that its Personal Accounts programme would not become fully operational before 2016, a delay of 12 months from the initial timetable, while the Conservative Party has stressed repeatedly that it will review Personal Accounts should it win the election, not least because they are concerned that the introduction of Personal Accounts could actually lead to an overall reduction rather than increase in contributions.¹⁰ In December, the government pushed the timetable still further into the future, now expecting Personal Accounts to become fully operational only by 2017.¹¹ Developments over the last six months have therefore, if anything, increased the probability that Personal Accounts will be launched substantially later than originally planned (possibly

⁸ *Budget 2009 Building Britain's Future*, HM Treasury, April 2009 and *Pre-Budget Report 2009 Securing the recovery: growth and opportunity*, HM Treasury, December 2009.

⁹ Note though that given the state of the public finances, it is easily conceivable that this date could be pushed further into the future than is currently acknowledged by the two main political parties. Related, the Conservative Party has stated that it would consider bringing forward the increase in the state pension age to finance the earnings link.

¹⁰ *Encouraging a new culture of saving*, Theresa May, 13 October 2009.

¹¹ *Pre-Budget Report 2009 Securing the recovery: growth and opportunity*, HM Treasury, December 2009.

even beyond 2017) or might even not be launched at all in their currently planned structure.

An unchanged outlook and assessment

In June we concluded on a rather downbeat note, arguing that the crisis had impacted on all aspects of the British pension system and that it would leave a lasting legacy. Ultimately, bold policy action would be required to move British pensions onto an efficient, equitable and sustainable footing. Was this assessment influenced by the bleak economic circumstances at that point?

Even though there are signs that the worst of the recession is now over, we believe that our assessment remains valid, not least because developments over the last six months have more or less been in line with our predictions. The financial crisis and the recovery thereafter have obfuscated the far more slowly unfolding crisis in pension provision in the UK. The recovery in asset prices and the economic outlook is not mirrored by a recovery in the prospects for the UK pension system going forward.

Defined-benefit pension schemes continue to struggle and are closing down at a rapid rate. While the rise in the value of assets in defined-contribution schemes is obviously to be welcomed, it also illustrates the inherent volatility and the burden of the future risk placed on the individual. Meanwhile the government is quietly pushing back the date at which it plans to implement fully its flagship pension policies.

Meanwhile, the public finance outlook is as bleak as before, with the UK facing one of the largest structural deficits in the developed world. With a general election less than six months away, it is not surprising that the two main political parties have not yet declared fully how they intend to address this challenge. It seems likely that government spending will have to be slashed and taxes increased, with the fiscal tightening required to bring the public finances back on a sustainable path in the wake of the crisis depressing disposable income growth for years to come.

However, dealing with the legacy of the current crisis will not be good enough though as society also ought to prepare for the economic and fiscal consequences of population ageing. The post-war baby boomers are reaching state pension age now and the second, larger baby boom generation born in the 1960s will reach their retirement within the next 20 years, with government spending on health, pensions and long-term care all set to increase.

Last but not least, we see little evidence that individuals are starting to take planning for retirement

seriously, with the increase in precautionary savings better explained by concerns regarding short or medium-term employment prospects than a genuine shift to a new "savings culture". This is perhaps understandable in the midst of a recession. The probability that a large fraction of older people will be disappointed by their retirement income in the future thus remains high. With the government required to bring its public finances back under control, it will not be in a strong position to help out though it might have no choice but to offer solutions.

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