

## The decline of Defined Benefit pensions

In a presentation this week, Lindsay Tomlinson, the Chairman of the National Association of Pension Funds observed that of all the problems afflicting voluntary occupational pension schemes, only one was exogenous or outside of our influence and control – longevity. All of the rest are self-inflicted wounds, internal to the pension system<sup>1</sup>. Recently, in a paper published in Philosophical Transactions of the Royal Society (2009), Adair Turner challenged the idea that the developed world in general faces a crisis and observed that “Most countries in the rich developed world face an important but quite manageable challenge of pension system redesign.”

Though the reality is that pensions, broadly as we knew them, were and are sustainable, and affordable, we are continuously assailed by ‘forecasts’ and ‘analyses’ that see only penury and immiseration ahead. The media are active accomplices in this; bad ‘news’ apparently still sells newspapers. Treating these commentators as Cassandra is long overdue.

We are collectively living longer, but the rate of growth in life expectancy is far lower than the growth we have seen in total productive output. With the exception of occasional years of recession, we are experiencing ever higher standards of living at all ages. Life expectancy has increased by about 0.3% annually over the last century, but gross domestic product has increased at more than 2% annually by even the most conservative estimates.

The increase in male life expectancy from 81.7 years in 1995 to 82.6 years in 2010 is at first sight cause for concern. However, one recent trend has been for men and women to retire from the labour force at later ages – men now retire at 64.5 years. In 1995 men expected to spend 18.7 years in retirement, but now this is just 17.6 years. Pension provision has actually become less onerous in this regard.

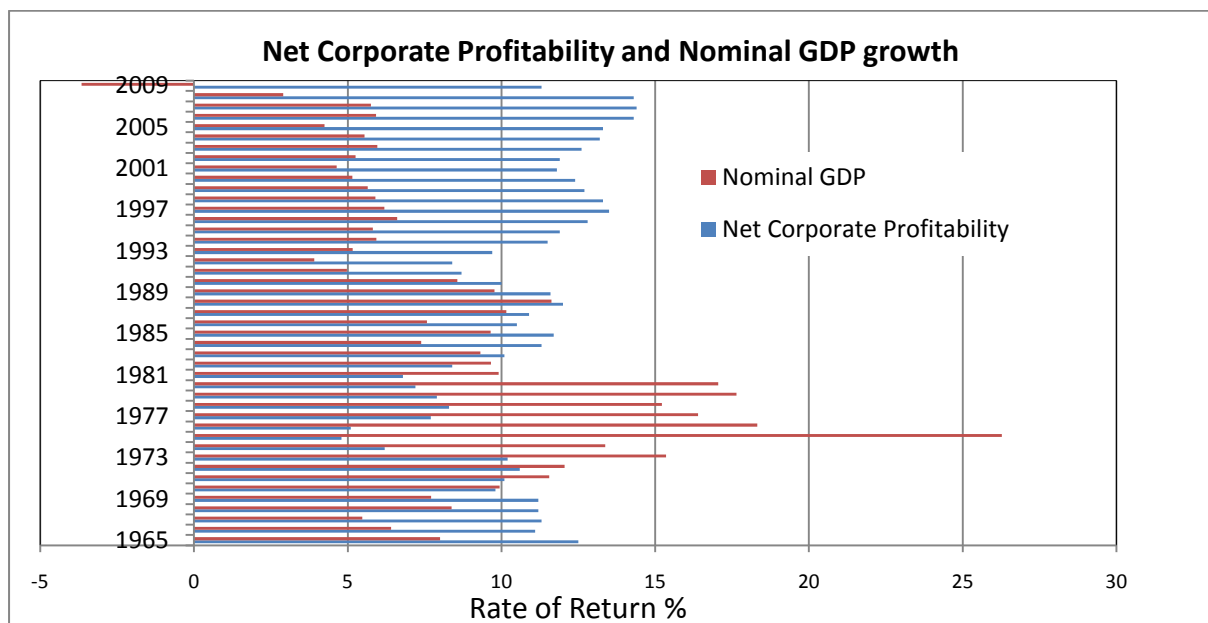


Chart 1: Net Corporate Profitability (PNFCs) and Nominal GDP Growth – Source ONS

<sup>1</sup> Self-inflicted declines ending in extinction have been well-known throughout history – Easter Island is perhaps the best known.

The UK corporate sector is actually well-positioned to deliver pensions to its employees. The reported profitability of UK private non-financial corporations, net of depreciation and amortisation has averaged 12.7% annually since 1965. Adjusted for their riskiness, the variability from year to year of these corporate earnings, the long-term rate of return on capital employed is almost unchanged. It should be noted that these figures are reported after deduction of the present costs of pension provision, which are material and low-bias the results published. Chart 1 indicates that it is the periods of high inflation which may prove hazardous, rather than the low-inflation, low-return environment of recent times which has appeared so problematic.

The introduction of ‘market-consistent’ accounting has done more to destroy defined benefit provision by the private sector than almost any other regulation. It is fundamentally misconceived. When we wish to know if a company will be able to meet its future liabilities on time and in full, we need to ask what the company will earn and what the amount of its shareholders’ funds are today. These determine the security of the liability. We do not ask what yields prevail in markets, on gilts or AA corporate bonds. The use of ‘market-consistent’ discount rates for liabilities and market prices for assets adds insult to injury, introducing both bias and spurious volatility to pension scheme valuations.

The extent of this spurious volatility, which is rooted in the ‘animal spirits’ of financial markets, is quite remarkable. The volatility of broad equity market total return indices typically lies in a range between 15% and 20%, and bonds, though lower are still typically between 7% and 10%. By comparison, the volatility of aggregate corporate earnings is less than 2%. The lack of relationship between the FTSE ALL share index and corporate earnings is illustrated in Chart 2. Note that the relationship between FTSE returns and actual corporate earnings is negative and that the explanatory power is negligible.

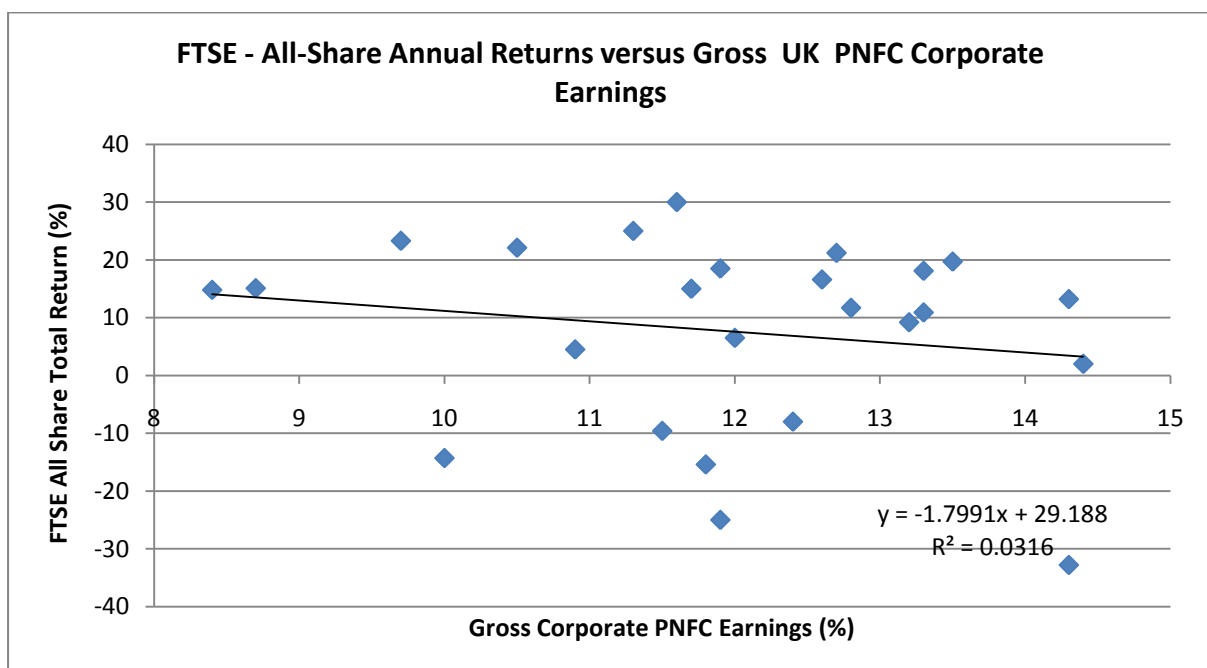


Chart 2: FTSE-All Share returns and Gross UK Corporate Earnings

It is clear that the UK corporate sector can, sustainably and affordably, offer defined benefit pensions to its employees. Its position as the balance of cost underwriter of such schemes is not predicated or dependent in any way on the performance of markets for financial assets. Introducing spurious dependence through misconceived accounting standards only serves to obscure this. In fact, the central economic argument which supports the provision of occupational pensions is precisely that employers in the state and private sectors can contract to deliver pensions<sup>2</sup>, claims on their future production directly to employees, without recourse to financial markets.

As these statistics have shown, the pension problem is not a problem in aggregate for the private sector. It is therefore surprising that the Pension Protection Fund should have concerns about multi-employer schemes, such as last-man standing arrangements.

The problem, of course, is that these aggregates cover a broad distribution of differing corporate performances. Some companies will fail and, of course, the sole risk faced by a pension beneficiary under a DB arrangement is sponsor insolvency. However, it is clear that the private sector is more than capable of pooling and managing such risks. Mutual indemnity insurance and even specialty commercial insurance vehicles would be viable. Incidentally, such arrangements would be far cheaper and much more efficient than the Pension Protection Fund.

The closure of DB pension schemes which has resulted from these accounting standards, and the mountains of regulation based upon them, has been entirely rational. This “de-risking” is, however, costly to society at large and to individual companies. For example, closure of a scheme to new members may limit the total future exposure of the sponsor, but it also increases the cost of provision of the residual pensions to existing members of the scheme.

It is disconcerting to see that the public sector is now the focus of attack of these “free-market” ideologues. The idea is prevalent that these unfunded schemes are devices for intergenerational theft. This is a simple miscomprehension of the economics. A pension is a claim on future production. However it is always current production which is divided among economically active and inactive individuals, since consumption goods cannot be stored. The award of an unfunded pension to a nurse lowers the need for higher taxation today. This raises the disposable income of all individuals, who are free to consume or invest this today. This raises current and future production, making these pensions all the more affordable. This is in fact a true ‘free-market’ solution, since the alternate of taxing and investing the raised funds, under state direction, would be prone to political intervention on a massive scale. The inefficiencies of this are obvious. Anyone doubting the scope for political intervention needs look no further than the National Lottery for examples of diversions from original purpose.

The trend to DC provision is pronounced. The reason obvious: under these arrangements the costs and risks to the corporate sponsor are limited to the initial contribution. All risks are borne by the

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<sup>2</sup> The risk game faced by the state or private sector when offering pensions, contracting on future production is simple. Risk is exogenous – a game against nature. The company is trying to maximise production given its resource constraints. An individual cannot contract in this manner on their own future production – precisely because they will be in non-productive retirement. The individual needs to make provisions, to save and to buy claims on this production in financial markets in the form of equities and gilts. The risk game here is complex. It is partly a game against nature but predominantly a game against others. Risk is much higher for the individual.

individual, whether capable or not. In fact, a DC arrangement is just a tax-advantaged savings scheme in the absence of a conversion mechanism to transform these financial assets into a retirement income. However, the most important point is that these individuals are entirely dependent upon the performance of financial markets. This is grossly inefficient. The scale of this inefficiency is stark: a two thirds final salary pension that may require contributions of 20% of salary would cost more than 30% in contributions under a DC arrangement.

Saving on the scale necessary to provide an adequate pension under these DC arrangements is without precedent in recent UK history. This is perhaps just as well as the cost in terms of income taxation revenue foregone would be measured in tens of billions.

The actual contributions that are being made – 9.6% DC versus 20.5% for DB – mean that pensioners will receive less than one third of the retirement income of DB pensioners. In this income region, the iniquities of displacement of means-tested benefits also come to prominence. Penury and poverty do become significant issues when pension provision is as inadequate as this. The advent of NEST will do little or nothing to alleviate this problem, and may even exacerbate it. It should be realised that any system which provides grossly inadequate pensions will prove unsustainable.

These issues and many more are considered in much greater length and detail in a recent paper entitled 'Don't stop thinking about tomorrow: The future of pensions'<sup>3</sup>. It seems appropriate to end with the same exhortation as that paper: "If it takes just a little while, Open your eyes and look at the day, You'll see things in a different way."

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<sup>3</sup> This report is freely available from [www.futureofpensions.org](http://www.futureofpensions.org)