ASSOCIATION OF ACA CONSULTING ACTUARIES

UK Pension Trends Survey Report…2

Trends in: Scheme provision, contributions and scheme deficits

pension trends survey: scheme reviews at record levels as costs bite

The Association of Consulting Actuaries (ACA) latest *Pension Trends Survey 2005* was conducted in January and February this year. Over 390 firms, with scheme assets exceeding £131 billion and over 2.8 million members, responded to a wide range of topical pension questions.

The first report, focused on firms' views on current public pension policies, *the 2004 Pensions Act* and responses to ideas posed by the Pensions Commission in its initial report. That report was published in April 2005 and is available from the ACA (see contact details on back page).

This second report confirms the high level of defined benefit scheme closures to new entrants reported in previous surveys and the extent to which mixed and defined contribution schemes are filling the gap. It looks at why firms offer pension schemes and the number that are trying to reduce pension spending and liabilities in the near and longer-term. It reports a very high level of scheme reviews, suggesting change in design is both high priority and under active consideration at many firms.

The report concludes by examining the levels of contributions into all types of schemes. A key finding is increasing contribution rates across all types of arrangements, most particularly defined benefit. In respect of defined benefit schemes, bands of ongoing funding levels are identified as are the periods over which deficits are expected to be removed.

the key findings

defined benefit closures continue as many firms look to reduce pension costs

68% of defined benefit schemes are closed to new entrants, with 10% closed to new accruals. 43% of firms are looking to reduce current spending on pensions.

employee welfare – not competition for staff - is the main driver behind offering a pension scheme

firms of all sizes say 'it is their responsibility as a good employer' to offer a pension scheme that makes adequate arrangements for employees in retirement.

high level of scheme reviews means rapid changes in provision

94% of firms will have reviewed their pension arrangements over a two-year period. Of these, around a half are currently under review or will be so during the next 12 months.

pension contributions rise across all types of schemes

defined benefit contributions have risen rapidly to help reduce scheme deficits. And as more defined contribution schemes are opened, contribution levels also seem to be rising.

defined benefit deficits are being addressed

89% of defined benefit schemes are in deficit, with the average ongoing funding being 85% of liabilities. Aside from increases in regular contributions, over a quarter of firms have made significant lump sum contributions. Most firms expect deficits will be removed within 15 years.

pension scheme design: changes afoot to control longer-term costs

Close to seven out of ten defined benefit schemes are closed to new entrants of which one in ten are also closed to new accruals. The transformation in provision over a number of years, but which has accelerated in the last 5 years since the stock market fall of 2000, has meant a rapidly changing picture of provision. These changes have to some degree been hidden by the scale of ongoing defined benefit provision, covering many millions of people, but much of which is now (aside from public sector schemes) closed to new entrants. It will take a number of years for the scale of the changes that have and are taking place to register, and the big concern must be the extent to which those now outside of open defined benefit arrangements are 'under-pensioned' compared to their predecessors.

Whilst the vast majority (93%) of defined benefit schemes remain contracted out of the State scheme, only 17% of defined contribution schemes are contracted out. Figure 2 (below) also reports a significant trend over the last 5 years for schemes to contract some or all of their members back into the State scheme, no doubt due to both changes in scheme structure as well as the current rebate terms.

Whilst defined benefit schemes still dominate in terms of the assets held by schemes, 52% of firms running such arrangements report that they have closed off this type of scheme to new entrants in the last 5 years. Whilst a few have set up mixed or career average schemes, the most common change has been to move more employees into defined contribution schemes or into flexible benefits arrangements with wider benefit options. 12% of schemes have also contracted some or all of their staff back into the State Second Pension.

Figure 1: Type of pension arrangements that firms offer and total value of scheme assets

Type of pension scheme	Percentage of firms with such schemes	% Closed to new entrants	% Closed to new entrants and new accruals	Total Asset Values (£bn)
Defined benefit scheme	71%	58%	10%	£119.1
Defined contribution	39%	5%	2%	£5.8
Mixed DB / DC	14%			£5.4
Group Personal Pension	16%			NK
Stakeholder	22%			NK
Industry-wide	2%			£0.9
All Schemes				**£131.2**

Figure 2: Changes in pension arrangements over last 5 years

Closed defined benefit scheme to new entrants	52%
Closed defined benefit scheme to future accruals	9%
Moved more employees into defined contribution schemes	18%
Set up a mixed defined benefit / defined contribution scheme	7%
Set up a career average scheme	5%
Reduced percentage of employees covered by firm's scheme	9%
Placed one or more schemes in wind-up	7%
Moved to more flexible benefits package with wider benefits option	15%
Introduced access to group benefits largely paid for by employees	1%
Contracted some or all of members back into State Second Pension	12%

The extent of the change in forward pension provision can be gleaned by the very high level of firms reviewing arrangements. Over a 2-year period, 94% of firms will have reviewed their pension plans, with close to half currently doing this or set to do so in the next 12 months.

Figure 3: Number of firms reviewing their pension arrangements

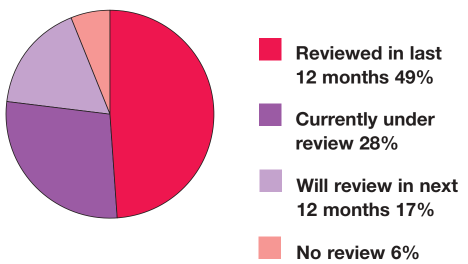


Figure 4 (below) summarises the spread of arrangements respondents run reported by size of firms and the maturity of schemes. Whereas firms employing up to 250 employees are in the main dominated by defined contribution arrangements, 17% still offer both defined benefit and defined contribution. In contrast, only 1% of firms with over 1000 employees only offer defined contribution, with 62% offering both defined benefit schemes (albeit many closed to new entrants) and defined contribution. Over a third of these larger firms still only offer a defined benefit scheme.

Only a third of defined benefit members are active scheme members, underscoring the maturity of such schemes, whereas 83% of defined contribution members are active, indicating the recent establishment of many such arrangements.

The reasons why firms provide pension arrangements are firmly welfare oriented. An analysis of these answers by size of firm produced no variation in the responses. This means that for all sizes of firms **'competition for staff' figures as only the third most important reason for providing a pension arrangement.** This is important for public policymakers to appreciate, as it suggests that changes, for example, in promoting pensions through job advertisements are likely to have limited success. It would appear that there would be more benefit in appealing to firms as 'good employers' to take particular actions, or promoting the idea that to improve pension arrangements is more likely to encourage greater loyalty, reducing staff turnover rates.

Figure 4: Size of firms responding to survey

Employees:	0-250	251-999	1000+
Defined benefit scheme only	1%	29%	37%
Defined benefit + contribution	17%	57%	62%
Defined contribution only	82%	14%	1%
Total sample of firms	21%	23%	56%

What is the distribution of membership of schemes?

	Active	Deferred	Pensioners
Defined benefit	33%	38%	29%
Defined contribution	83%	14%	3%
All schemes	34%	37%	29%

(Scheme average)

Figure 5: Reasons why firms provide employees with pension arrangements (in ranked order)

1.	We consider it is our responsibility as a good employer to make adequate arrangements for our employees retirement
2.	The scheme helps us to build our image as a caring employer, motivating and encouraging loyalty from employees
3.	The scheme helps us to compete in the labour market for skilled staff
4.	The scheme enables us to retire employees on reasonable pensions in an orderly way to suit our business
5.	The scheme has been in existence for many years and could not easily be discontinued
6.	We were required to introduce a scheme under the Stakeholder rules

controlling pension spend: the battle to control costs

43% of firms are trying to reduce current spending on pensions. A slightly higher number, 47%, are trying to reduce the cost of providing pensions that will be earned by employees in the future. The vast majority of these are running some sort of defined benefit scheme. Whilst many have closed such arrangements, the costs of the scheme have still risen in order to address deficits (see page 5).

24% of firms, perhaps a slightly lower figure than might be expected, have a target of what they would like to spend each year on pensions expressed as a percentage of payroll. Of those that do, 75% are looking to a payroll cost of 15% or less. However, expressed another way, this means a sizeable number of firms are prepared to contribute, over the long-term, to arrangements that would provide good pension benefits, particularly over and above an improved State pension. Contribution levels of, say, 10% by the employer plus 5% by the employee (or 15% + 5%) are encouraging. However, what is probably a pre-requisite is that those firms paying much more to recover defined benefit deficits, will need to have time to put these matters right first.

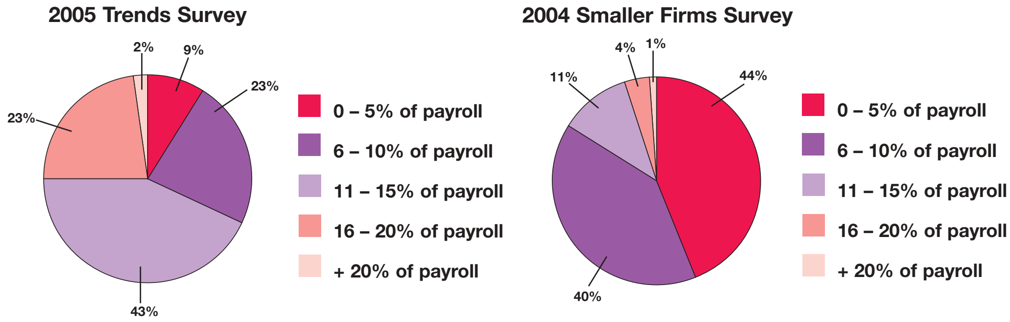
The number of smaller schemes, employing 250 or fewer employees, prepared to set pension cost targets is also included in Figure 6, drawn from the ACA's *2004 Pension Scheme trends in Smaller Firms Survey*. This shows quite clearly the greater difficulty in persuading smaller employers to afford employer contributions of over 5 or 10% of payroll.

pension contributions: up they go all round

Average combined employer and employee contributions into defined benefit schemes are now 22% of earnings, up from 15.8% just 3 years ago. This 39% increase over the period has been split between employers and employees. Whilst employees have on average contributed an extra 1.2% of earnings to pensions, employers have on average added 5% (an increase of 43% over the period). These increases, almost without exception, will have been made not to enhance benefits, but to fund benefits at a time when deficits are widespread amongst schemes due to lower investment returns, higher benefit costs through legislation and faster-than-expected improvements in longevity.

Over the four-year period, the survey found there has also been an improvement of overall contributions, albeit much smaller, into defined contribution arrangements. With combined contributions now averaging 10% into both occupational defined contribution and Group Personal Pensions, there is perhaps some evidence that as larger firms switch their pensions to defined contribution, they are doing so at higher levels of contributions than hitherto. This is an encouraging trend, in contribution terms, if it persists into the future.

Figure 6: Target pension costs, by bands of employer contribution:



The spread of contribution levels between types of arrangements is still quite different. Predictably, the spread of defined contribution arrangements is much broader, with many more schemes receiving much higher levels of both employer and employee contributions. A half of defined benefit schemes receive employer contributions in excess of 15% of earnings, whereas no occupational defined contribution or Group Personal Pensions, reporting to the survey, receive contributions at this level. Still 30% of Stakeholder schemes report no employer contribution being paid.

Employees in membership of defined benefit schemes are also, generally, paying higher contributions into schemes. 42% are now contributing in excess of 6% of earnings, compared to 10% of employees in membership of defined contribution schemes.

Figure 7: Average of contributions paid into pension schemes (as a percentage of earnings).

Average employer contributions into:	2002	2003	2004	2005	Long-term expectation
Defined benefit schemes	11.5%	13.1%	15.1%	16.5%	14.8%
Defined contribution schemes	5.1%	5.2%	5.8%	5.9%	
Group Personal Pension	5.6%	5.6%	5.8%	6.1%	
Stakeholder (where contribution made)	5.0%	5.2%	4.3%	4.5%	

Average employee contributions into:	2002	2003	2004	2005	Long-term expectation
Defined benefit schemes	4.3%	4.5%	4.9%	5.5%	6%
Defined contribution schemes	3.4%	3.5%	4.0%	4.1%	
Group Personal Pension	3.6%	3.8%	3.6%	3.8%	
Stakeholder	3.3%	3.5%	3.7%	3.8%	

Average combined employer and employee contributions into:	2002	2003	2004	2005	Long-term expectation
Defined benefit schemes	15.8%	17.6%	20.0%	22.0%	20.8%
Defined contribution schemes	8.5%	8.7%	9.8%	10.0%	
Group Personal Pension	9.2%	9.4%	9.4%	9.9%	
Stakeholder (where contribution made)	8.3%	8.7%	8.0%	8.3%	

(Figures from ACA 2003 and 2005 Pension Trends Surveys)

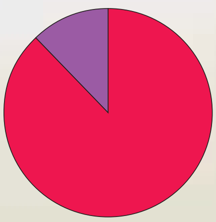
scheme deficits: employers and members respond

The extent of deficits in defined benefit pension schemes has been much reported since the stock market adjustment of 2000. Deficits have been compounded by evidence of much faster improvements in longevity than were reasonably predicted some years ago. Enforced improvements in scheme benefits due to Government measures, reductions in tax relief and greater regulatory burdens have also contributed significantly to deficits, which - on the basis of this survey's results - can be estimated at over £130 billion on an ongoing basis.

This survey found 89% of defined benefit schemes reporting to the survey are in deficit, with an average funding level of 85% (on an on going funding basis as a percentage of liabilities). This average funding level compares with the 80% level reported to the ACA last year by smaller firms running defined benefit schemes.

88% of firms say their Scheme Actuary has recommended increases in contributions as a result of the deficits found at the last actuarial assessment.

Figure 9: Have Scheme Actuaries recommended an increase in contributions at the last actuarial assessment?



As reported earlier, firms have responded to scheme deficits by increasing contribution rates. Whilst 40% have only increased contributions by up to 3% of earnings, 40% have increased contributions by upwards of 5% of earnings.

Figure 10: Change in employer defined benefit contribution rates

Employer contribution rate increases	Percentage of firms
+10% of earnings	18%
+5% - 10%	22%
+3% - 5%	20%
0 – 3%	40%

Figure 8: Current range of employer contributions

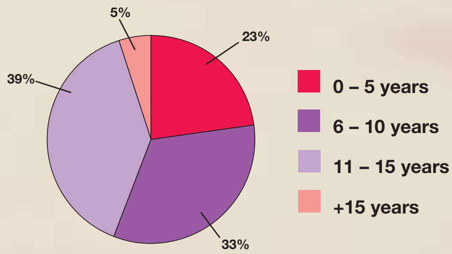
Contribution as % of earnings	Defined Benefit	Defined Contribution	GPP	Stakeholder
0%	-	-	-	30%
Up to 3%	1%	4%	4%	11%
Over 3 – 6%	1%	48%	41%	28%
Over 6 – 9%	7%	26%	44%	21%
Over 9 – 12%	11%	18%	11%	7%
Over 12 – 15%	30%	4%	-	3%
Over 15 – 18%	20%	-	-	-
Over 18%	30%	-	-	-

Current range of employee contributions

Contribution as % of earnings	Defined Benefit	Defined Contribution	GPP	Stakeholder
0%	5%	5%	-	5%
Up to 2%	2%	4%	5%	5%
Over 2 – 4%	15%	42%	53%	61%
Over 4 – 6%	36%	39%	37%	26%
Over 6 – 8%	38%	6%	5%	3%
Over 8%	4%	4%	-	-

Alternatively, 23% of firms have made fixed monthly amounts and 27% have paid significant lump sums to reduce deficits. A marked and consistent recovery in equity markets would improve the deficit position of many schemes (but is not anticipated), but otherwise firms are looking to recover deficits over a period of up to 15 years, with 10 and 15 years the most often quoted timescales.

Figure 11: Period over which firms say scheme deficits are expected to be removed?



Members of defined benefit schemes are also contributing more to safeguard their benefits. 44% of firms report increases (or future increases), with the majority falling in the range up to 2% of earnings. A third, however, represent increases above this amount.

Figure 12: Change in employee contribution rates into defined benefit schemes

Employee contribution rate increases	Percentage of firms
+2% of earnings	33%
+1% - 2%	58%
0 – 1%	9%

Changes in normal retirement age (NRA) are another way schemes can look to reduce their forward liabilities. Presently 75% of schemes have an NRA of 65, with 25% having an NRA between 60 – 65. Of these, over half have an NRA of age 60. Some 15% of firms are looking to change their retirement age, with the vast majority presently being in the band with an NRA below age 65.

Changes in accrual rates are a further way of reducing scheme costs into the future. Some 10% of defined benefit schemes have made changes, with the most common being a reduction from an accrual rate of 1/60th of final salary for each year of scheme membership to 1/80th of final salary per year of membership.

conclusions and concerns: legislative worries head list

This second report of the *2005 ACA Pension Trends Survey* has focused on changes in the shape of provision that are being introduced at speed across firms as defined benefit arrangements are closed to new entrants and, in some cases, new accruals. There are encouraging signs that as this process advances, average contribution rates into defined contribution schemes are rising, albeit not to the levels that would generate the same levels of pension being paid by defined benefit schemes.

The efforts by firms to correct defined benefit scheme deficits and to safeguard pensions are also worthy of mention. Whilst the Government has acted to safeguard pensions where firms are insolvent (but largely passed these costs onto schemes and their sponsoring firms), corporate UK has also responded by increasing employer (and employee contributions), making other regular or sizeable one-off contributions with a view to setting right deficits over a period up to 15 years. Actions to increase normal retirement ages, especially where they are below age-65, and to reduce accrual levels are also being undertaken.

What is now needed is braver action by Government. The *2004 Pensions Act*, as our first report concluded, has been a grave disappointment. It is expected to add to scheme costs without providing any significant simplification measures to help firms and schemes address rising costs. Measures such as auto-enrolment (where new employees are automatically enroled into the firm's scheme unless they positively 'opt out') are unlikely to take off so long as firms believe parallel measures to reduce increases in costs from Government are unchecked.

What is concerning for the future is that firms are most fearful of the impact of legislation on benefits and funding costs. This runs ahead of worries about investment markets, the increasing burden on management time due to greater scheme complexity and further pension reforms. To help employers provide occupational pensions, the 'unfinished' agenda for Government is to:

- **Enact genuine pension simplification.** Aside from a major reduction in pension regulation so the administration and costs of running schemes of all types is significantly reduced, the rushed and generally chaotic way in which pension legislation and regulation is progressed must be addressed by Whitehall and Parliament. Procedures and timescales need to be more disciplined and, importantly, Regulatory Impact Assessments need to be conducted or checked by independent organisations of Government ahead of measures being fixed upon.

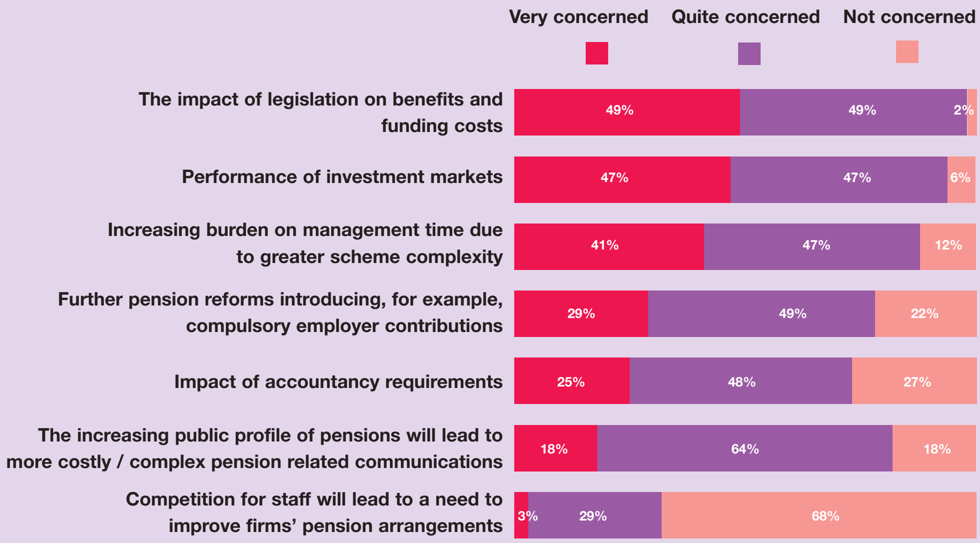
- **In order to control long term scheme costs, employers should have the option to change scheme rules retrospectively (subject to regulatory approval)** to avoid increases in cost due to unforeseen longer life expectancy, for example by raising normal retirement age. Schemes in deficit should also be able to suspend Limited Price Indexation until they remove their deficit.

- **The Government should provide a better incentive to encourage the development of good second-tier private pensions**, particularly where employers continue to or decide to sponsor schemes that meet a certain standard.

- **The Government's encouragement of private pension provision should be above a higher consolidated Basic State Pension and be by way of tax relief**, with longer-term saving attracting a higher rate of relief than shorter-term savings products.

This represents an important targeted agenda for action by the new Government to begin the recovery of the occupational pensions sector.

Figure 13: What issues are most likely to have an influence on pension thinking in the longer term? (in ranked order)



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