



Punter Southall  
CONSULTING ACTUARIES

# The UK pensions environment



## 1. Introduction

The current UK pensions system's foundations were built in the early 20<sup>th</sup> century. Old age provision from the State began in the early 1900s, and gradually occupational provision began to appear. Both State and occupational pensions underwent several changes during the 20<sup>th</sup> century, resulting in the current system of three tiers:

- Tier 1: State benefits at the same basic level for all individuals who contribute
- Tier 2: An additional level of State benefits, based on earnings within certain limits
- Tier 3: Private pensions funded by individuals and/or employers.

A summary of each of these areas will be provided, although most of this section will focus on the third tier, and in particular defined benefit (DB) occupational schemes, since that is where the impact of any solvency funding regime will be felt.

## 2. Tiers 1 and 2

First tier pension provision consists of the Basic State Pension (BSP), which is a flat rate pension payable from State Pension Age (SPA), currently age 60 for women and age 65 for men. The maximum payable in the 2007/8 tax year is £87.30 per week, although this is dependent on an individual having made the required number of years of National Insurance (NI) contributions. It increases annually at the higher of 2.5% or RPI, although this will change to National Average Earnings (NAE) some time from 2012. It is funded on a pay-as-you-go basis through workers' NI contributions.

In addition there is a means-tested benefit called the Pension Credit, in order to ensure a minimum income level for all pensioners. It is funded through taxes.

It should be noted that SPA for women will increase from 60 to 65 between 2010 and 2020. In addition, a further increase in SPA to age 68 is planned for both men and women, beginning with a gradual rise from 65 to 66 over two years from 2024, a further rise to 67 over two years from 2034 and a final rise to 68 over two years from 2044.

Second tier pension provision consists of an earnings-related State scheme. The current scheme is the State Second Pension (S2P), which has been in force since 2002. Its predecessors were the State Earnings Related Pension Scheme (SERPS), in force from 1978 to 2002, and the Graduated Retirement Benefit (GRB), in force from 1961 to 1975.

Benefit accrual under S2P is complicated, but broadly there are three earnings bands and three corresponding accrual rates, which are designed to provide a larger pension (as a proportion of earnings) to lower income individuals. As with the BSP, S2P is funded on a pay-as-you-go basis using NI contributions.

Some benefits under S2P can be replaced with benefits in a private pension scheme. This is done by "contracting-out" of S2P. Both employers and employees pay lower NI contributions and the Government pays a rebate into the chosen private pension arrangement. This arrangement must then provide benefits that replace those S2P benefits foregone.

It is proposed that S2P will move to a flat-rate benefit. This will be a gradual process although it is intended that it will be fully flat-rate by 2030.

### 3. Tier 3

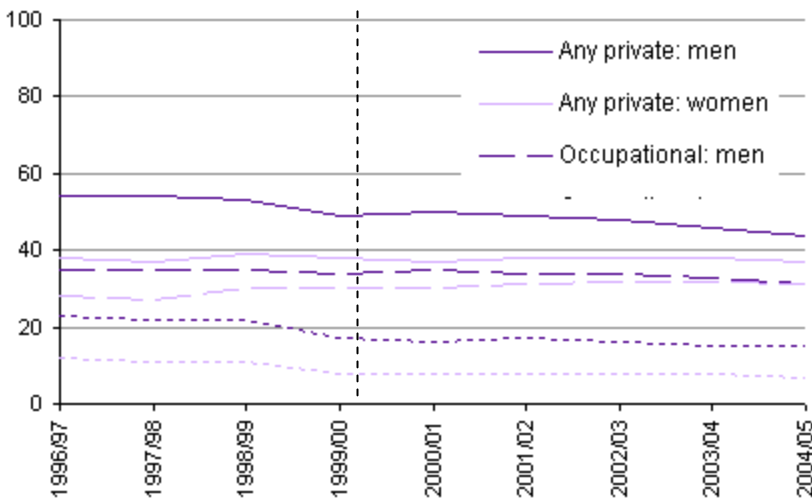
Third tier pension provision consists of all voluntary pension arrangements that are funded by employers and/or individuals (second pillar provision). These fall into two categories, both discussed in more detail below: occupational pension schemes and individual pension arrangements.

Chart 1 below shows the percentage of people of working age who are members of a private pension scheme, together with the proportion that are members of occupational schemes.

**Chart 1 Working age membership of private pension schemes**

**Great Britain**

Percentages



1. Males aged 16 to 64, females aged 16 to 59.
2. Employer-sponsored or personal pension. Data from 1999/2000 onwards are not comparable with earlier data because of the implementation of improvements in government surveys relating to pensions from that date.

Source: Family Resources Survey, Department for Work and Pensions and ONS

### 3.1 Occupational pension schemes

The table below provides some summary statistics in relation to the UK occupational pensions industry:

**Table 1**

Estimated number of defined benefit pension schemes <sup>1</sup>	7,750
% of employees actively participating in a defined benefit scheme <sup>2</sup> (This excludes deferred memberships)	19% (2004); 32% (1995)
Assets of defined benefit schemes <sup>3</sup>	£841bn
Assets of all private schemes as % of GDP (2005) <sup>4</sup>	71%
Pension assets as % of all financial assets (2004) <sup>5</sup>	51%
Estimated IAS19 deficits for all defined benefit schemes at 31 March 2006 <sup>6</sup>	£104bn
% of working age people expecting occupational pensions to provide main source of post-retirement income <sup>7</sup>	40%

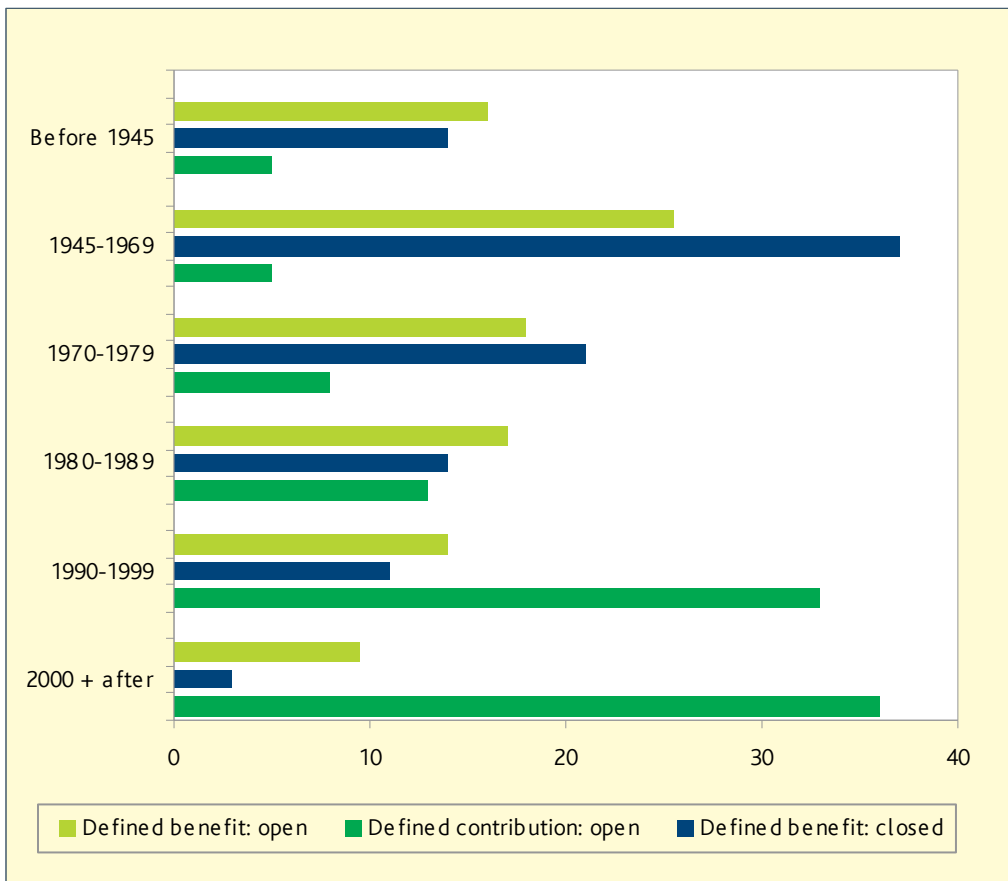
*Sources:*

- 1. The Pensions Regulator and PPF's Purple Book, updated for the PPF 7800*
- 2. The Pensions Commission: updated first report analysis*
- 3. The Pensions Regulator and PPF's Purple Book, updated for the PPF 7800*
- 4. OECD*
- 5. ONS: Pension Trends 2005*
- 6. The Pensions Regulator and PPF's Purple Book*
- 7. ONS: Pension Trends 2005*

3.1.1 History

Occupational provision really became popular during the 1950s and 1960s, reflecting increasing prosperity and longevity, with pensions becoming a common part of compensation packages, as well as being an increasingly important tool for trade unions. Many schemes, particularly DB schemes, have their origins in the 1950s or even earlier:

Chart 2 Foundation dates of private sector occupational pension schemes



Source: the Pensions Regulator and PPF's Purple Book and ONS

Pension provision was originally thought to be easily affordable, and the regulatory environment as well as economic circumstances contributed to the popularity of DB schemes (and indeed at one time almost all schemes were DB). Higher marginal tax rates made pension provision a very tax-effective way of paying staff and pension schemes also enabled companies to smooth profits over the economic cycle. DB schemes were popular with management as a means of remunerating more senior staff, and also gained popularity for the workforce as a whole with rising inflation in the 1960s and 1970s. In addition, DB schemes offered the only means of contracting out until 1987.

Initially there were few requirements as to the minimum level of benefits to be provided by DB schemes, for example any member leaving employment with the sponsor would lose all entitlement, and there was no requirement to increase benefits once in payment to protect against inflation. Successive layers of legislation have increased the generosity of benefits provided by DB schemes (see below), with obvious cost implications for employers.

However, DB schemes are declining in popularity and defined contribution (DC) schemes are now becoming increasingly common. An occupational DC scheme is one that is operated under trust, in contrast to contract-based DC schemes as mentioned below (which in fact are relatively new).

### 3.1.2 Operation

Occupational pension schemes are set up by an employer and almost always operated under trust, primarily to benefit from tax concessions but also to ensure that assets are kept separate from the sponsoring employer. Occupational schemes can be either DB or DC, and trustees have a high level of fiduciary duty.

Benefits in a DB scheme are generally based on an individual's length of service and salary on retirement (i.e. benefits are generally "final salary" in nature). A typical benefit might be a pension of  $1/60^{\text{th}}$  of salary on retirement for each year of service. Normally part of this pension can be exchanged, or commuted, for a tax free cash lump sum. However in some schemes, typically current or former public sector schemes, a lower pension accrual rate is offered (e.g.  $1/80^{\text{th}}$ ) but a cash lump sum of  $3/80^{\text{th}}$  is accrued alongside pension, rather than being provided by commutation. Minimum requirements exist for certain areas of benefit, particularly for contracted-out schemes. For example, pensions for early leavers must now be revalued in line with price inflation between leaving and retirement, and in final salary schemes where a member dies in retirement, the member's spouse must be offered a pension of at least 50% of the member's pension. There is also a requirement to provide indexation to pensions in payment.

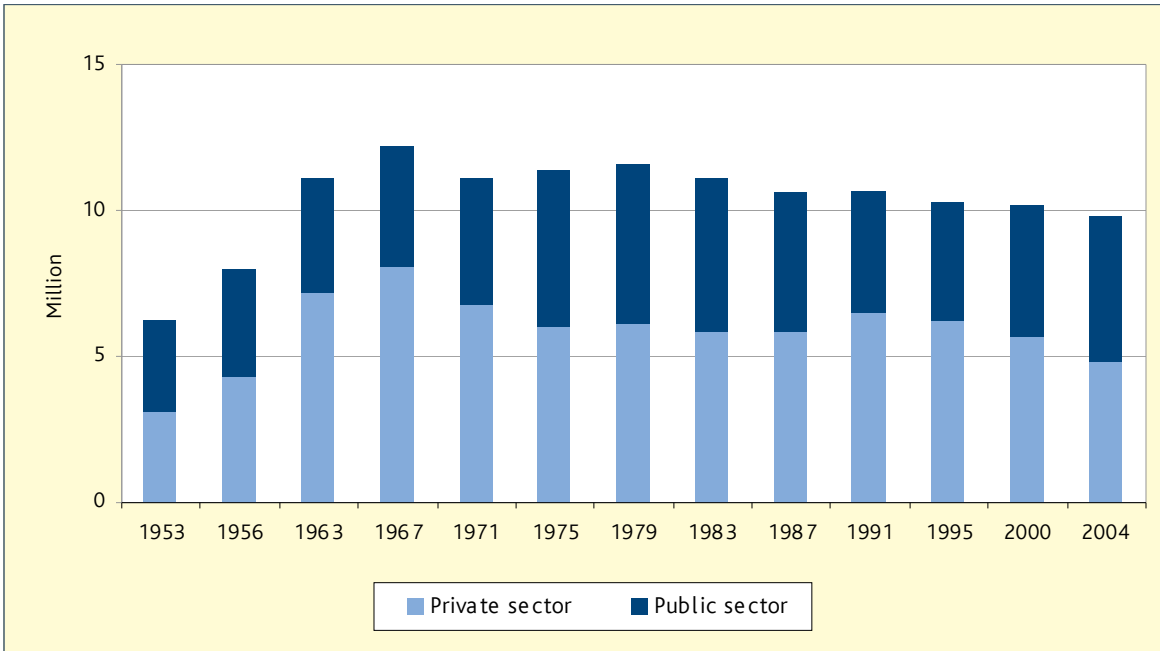
Occupational schemes can further be classed as either private sector schemes (those where the sponsoring employer is a private sector company) or public sector schemes (those where the sponsoring employer is a government institution or other public sector body such as the armed forces or NHS). DB and DC schemes exist in both sectors.

Private sector DB schemes are almost always funded, since funding is a requirement for maximising tax exemptions. A very small proportion of arrangements are unfunded – generally only those used to provide additional benefits for senior executives over and above the levels permissible within the favourable tax regime.

Some public sector DB schemes are unfunded or only notionally funded, in contrast to those in the private sector which are always funded.

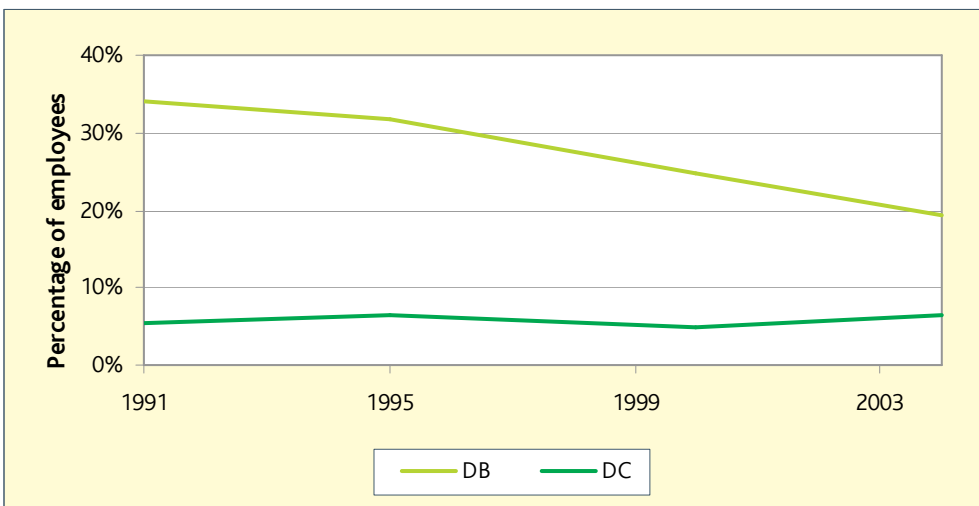
Chart 3 shows the number of active members of occupational pension schemes in the UK, split between private sector schemes and public sector schemes. Chart 4 shows the split, by proportion, of private sector membership between DB and DC schemes.

Chart 3 Active members of occupational pension schemes in the UK



Note: Numbers for 2000 and 2004 split between private and public sectors are not strictly comparable with numbers for earlier years. Members of schemes run by organisations such as the BBC are excluded from the public sector in 2000 and 2004 but included in 1995. No adjustment has been made in 2000 and 2004 for private sector employees who are members of schemes in the public sector (because their private sector employer participates in a public sector scheme such as a local authority scheme).  
Source: Pensions Commission first report

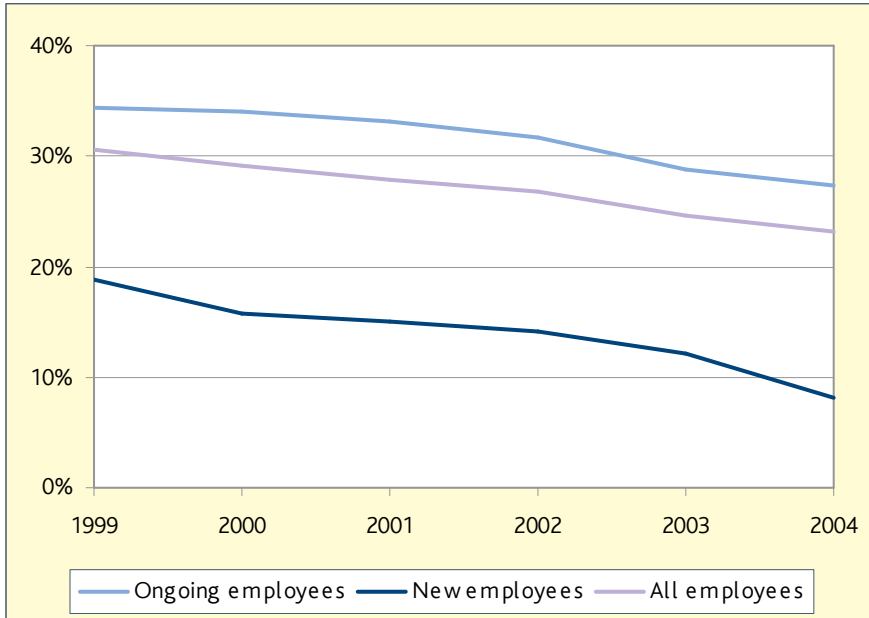
Chart 4 Estimated proportion of private sector employees participating in occupational pension schemes



Note: Definition of public and private sector employees may vary between sources.  
Source: Pensions Commission first report

The distribution of pension scheme sizes in the UK is very skewed, with only a handful of very large schemes and over 50% of schemes with less than 100 members. This is shown in the table below:

**Chart 5 Pension scheme membership**



Source: *The Pensions Regulator and PPF's Purple Book*

Schemes are required to carry out formal funding checks on a triennial basis. In order to calculate the value of the liabilities (i.e. technical provisions), an estimate is made of all future pension payments arising from entitlements accrued to date, and these amounts are discounted at a suitable rate, making allowance for mortality and other demographic assumptions, in order to arrive at a present value. Any shortfall of assets against technical provisions will be converted into contributions payable by the sponsoring employer (in addition to the cost of further accrual). All accrued and guaranteed benefits must be allowed for, and discretionary increases may or may not be taken into account.

In the event that the valuation identifies an excess of scheme assets compared to technical provisions, this excess may be offset against future contributions required by the employer to cover the cost of benefits accruing, or alternatively may be held as a buffer against future adverse experience. Conversion into additional benefits for members is also possible, but this is now rare, and a refund to the employer is also legally possible, but difficult to achieve in practice due to the conditions attached.

As well as comparing assets with technical provisions, this assessment will also involve calculating the cost of new benefit accrual (where relevant).

The requirements relating to formal valuations have changed significantly recently with the advent of Scheme Funding, which is described further below.

### 3.2 Individual pension arrangements

Individual pension arrangements are a relatively new phenomenon in the UK. A limited form of individual provision was made available in 1971 in the form of retirement annuity contracts. Popularity of individual arrangements increased in 1988 when personal pensions were introduced to replace retirement annuities. Popularity has increased further in recent years with the availability of stakeholder pensions in 2001. These made individual arrangements available to a much wider range of people; previously they had only been available for the self-employed or those who were not in an occupational scheme.

Individual arrangements work on a money purchase, or DC, basis. Contributions are paid during the working lifetime and the accumulated value is exchanged on retirement for a guaranteed income for life. Some of the fund may also be taken as a tax-free lump sum. Contributions can be paid by an employer as well as by the individual. Some employers set up group personal pensions (or variants on these), whereby each individual has his or her own plan which belongs to a group contract set up with an insurance company. These are known as "contract-based DC schemes" and operate on a different basis to occupational defined contribution schemes.

### 3.3 The trust framework

Each occupational pension scheme has its own trust deed and rules and it must be operated in accordance with these. There will be a board of trustees consisting of anything from two trustees upwards. A scheme's trustees are responsible for holding the scheme's assets, as well as ensuring that the scheme is properly run, that members' benefits are secure, and must act in the members' best interests. Trustees must also comply with both trust law and pensions law.

Scheme assets will be held in a range of investments, the most common being equities and government or corporate bonds. However, other asset classes are also used, particularly for DB schemes, for example property and cash. The last few years have also seen increased use of investment classes such as hedge funds, private equity, commodities and other "alternative" investments, partly as a result of a move to more liability-driven investment which in turn is designed to help reduce volatility in funding levels.

For contract-based schemes (i.e. individual pension arrangements set up as direct contracts with an insurance provider), the trust framework is not relevant.

### 3.4 Tax treatment of tier 3 pensions

The tax treatment for private pensions in the UK is of the "exempt, exempt, taxed" regime. Until April 2006, this was applied differently to individual arrangements and to occupational arrangements, but the Finance Act 2004 introduced significant changes to the tax system and brought the tax treatment of both into line.

Since April 2006, employee contributions to a private pension arrangement receive tax relief at an individual's marginal rate. There is no overall limit on contributions, but there is a limit on the amount that can receive tax relief. Employer contributions are paid gross and normally receive full corporation tax relief. Investment returns on accumulated funds are not subject to tax. On retirement, up to 25% of the value of an individual's pension can be taken tax-free as a lump sum (meaning that the final "taxed" element of the regime is only a partial taxation), but the remainder must be taken as income and is taxed at an individual's marginal rate. There is no overall limit on the amount of benefits that can be taken, but anything above a certain limit (£1.6m in value for the 2007/8 tax year) is subject to additional taxation.

### 3.5 The regulatory environment

The regulatory environment within which occupational pensions operate has seen numerous developments over the last two decades:

- Legislation has been introduced to protect, or "preserve" benefits for early leavers, and the benefits preserved have gradually increased. Starting in 1975, schemes were obliged to preserve the pension accrued for any member leaving with more than five years' service, but this was reduced to two years with effect from 1988. In 1986, schemes were also required to provide indexation on the benefits accrued after 1984; in 1991 this was extended to all benefits.
- Additional legislation has also created requirements for pensions to be indexed in payment at minimum levels, and for spouses' pensions.
- A raft of new requirements was introduced by the Pensions Act 1995 in response to the Maxwell scandal in which the assets of an occupational pension scheme were misappropriated by the employer. This involved increased requirements to disclose information, requirements on timescales for certain tasks, a new Minimum Funding Regime (MFR), as well as certain requirements for benefits. Guaranteed increases in payment and spouses' pensions were required for pensions earned after 6 April 1997. A new pensions watchdog, called the Occupational Pensions Regulatory Authority (OPRA) was established, charged with monitoring schemes' compliance with legislation and best practice.
- In 1997 the Government withdrew the ability of pension schemes to claim advance corporation tax dividend credits.
- The Pensions Commission was established in 2002 in order to review the UK private pensions system and long term savings.
- The Pensions Act 2004 introduced further significant changes, in particular the new Scheme Funding regime to replace the MFR (see below). A new Pensions Regulator was introduced to replace OPRA, and was given statutory powers to investigate schemes deemed to be at risk. A pensions safety net was established, called the Pension Protection Fund (see below) in order to provide benefits to members where the sponsoring employer for an underfunded scheme has become insolvent. At least one third of a scheme's trustees must be member-nominated, and trustees are required to have sufficient knowledge and understanding of pensions matters in order to be able to carry out their duties effectively. New requirements for good governance and internal controls were also introduced.
- The Finance Act 2004 came about in part to simplify the tax regime for pensions, and replaced the existing eight regimes with one simplified regime, effective from April 2006.
- In December 2000, the UK's Accounting Standards Board introduced FRS17 to replace the existing method of accounting for pensions costs in company accounts. FRS17 requires companies to measure assets and liabilities at fair value, and to recognise the pension scheme deficit on the balance sheet. Liabilities must be assessed using a corporate bond discount rate, and operating and financing costs must be recognised in the appropriate period. This is in contrast to the previous standard, SSAP24, where the profit and loss account was the main focus, and where pension costs needed to be recognised on a "systematic and rational basis", and the actuary had reasonable freedom over the method and assumptions to be used. In 2006, the International Accounting Standards Board issued a revised version of the international accounting standard IAS19 which covers pension costs. This is very similar to FRS17.

### 3.6 Scheme funding

The new Scheme Funding framework requires technical provisions to be calculated prudently and on a scheme-specific basis, so there is no prescription as to any of the financial or demographic assumptions.

Schemes are also required to assess the value of the liabilities on a “buy-out” basis. This gives an indication of the cost of securing all benefits with an insurance company. The assumptions used will typically be more conservative than those used for the scheme’s own funding basis, mainly because the insurer’s pricing reflects the fact that there is no longer any employer covenant, so it is required to hold additional solvency capital. It must also cover its expenses and profit and this is reflected in its pricing assumptions. It should be noted, however, that for an ongoing employer intending to continue to operate its pension scheme, this figure has no direct relevance to the cost of providing benefits through the scheme.

In addition most schemes also carry out an assessment of the funding position on an IAS19 (or FRS17) accounting basis. Strictly this is not relevant for the operation of the pension scheme itself, since it is simply a requirement for the purposes of the sponsoring employer’s accounts. In practice, however, IAS19 positions are often also considered by employers when making financial decisions relating to the pension scheme, since the IAS19 liability is carried on a company’s balance sheet and in many cases is of significant size.

### 3.7 The Pension Protection Fund (PPF) and Financial Assistance Scheme (FAS)

The PPF commenced operation in April 2005 as a central scheme set up to rescue those pension schemes where the sponsoring employer becomes insolvent and the pension scheme is underfunded. The benefits payable from the PPF are broadly a pension from normal retirement age at 90% of scheme pension levels, up to a maximum of around £27,000 at age 65 (for the 2007/8 tax year), with higher levels for those already over normal retirement age when compensation starts to be paid. Benefits earned prior to April 1997 receive no indexation in payment, whilst those accrued on or after April 1997 are increased in payment at the lower of RPI and 2.5% p.a.

The PPF is funded partly through annual levies paid by DB schemes. These levies are expected to total £675m for 2007/8 and are determined on an annual basis in order to ensure that the PPF has sufficient assets. Some funding also arises as a result of assets transferred from those schemes that enter the PPF following insolvency of the sponsoring employer.

The Financial Assistance Scheme (FAS) was established by the Pensions Act 2004 in order to provide financial assistance to members of occupational pension schemes where the sponsoring employer had become insolvent and the scheme had gone into wind-up underfunded. It is estimated that 125,000 members, both pensioners and non-pensioners, have been affected in this way, although this should be compared to the number of members of occupational pension schemes currently receiving payments, estimated to be around 5.1 million).

The initial design provided help only to those who were within three years of retirement, and only within certain limits (payments would be around 80% of scheme benefits, with a maximum pension of £12,000 p.a.). However, recent changes mean that all members, regardless of age, will receive financial assistance of up to 80% of scheme benefits (which could be further increased to 90% in future), with the maximum pension increased to £26,000 p.a.

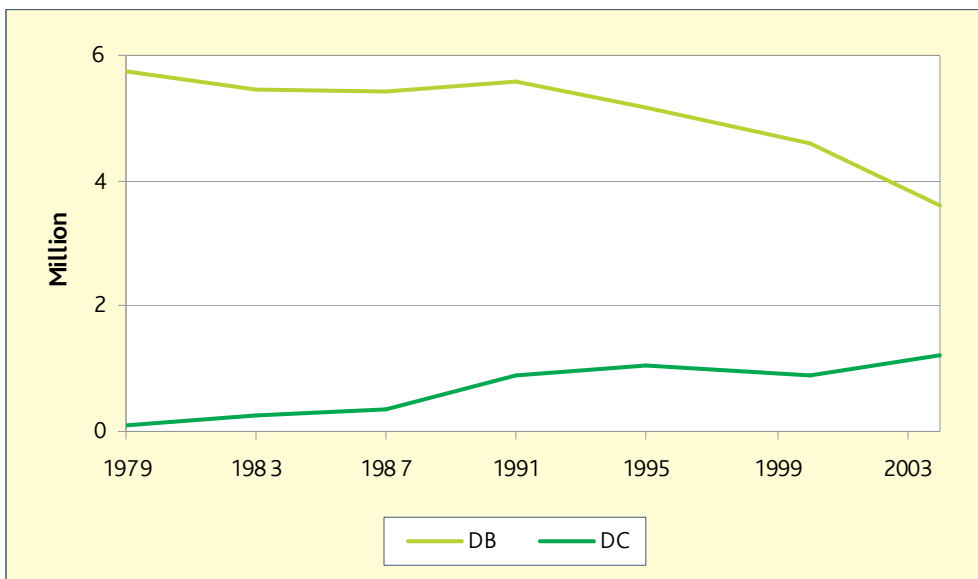
### 3.8 Current developments in the pensions industry

Changes in the pensions industry over the last decade or so have reduced the popularity of DB schemes. Running costs in relation to both external advisors and involvement of the sponsoring employer have risen significantly due to the increasing volume and complexity of pensions legislation, as well as more stringent governance requirements. The requirements of FRS17 and IAS19 to disclose pension scheme deficits on company balance sheets, and the inherent volatility in these figures, have been an issue for many companies and are a further factor contributing to the decline in DB arrangements.

Contributions have had to increase to fund for the higher compulsory benefit levels (e.g. indexation and benefits for early leavers). The removal of the advance corporation tax credit for pension schemes had an impact on the returns expected on assets. The early 2000s saw significant falls in the equity markets, resulting in many schemes moving into deficit, and falling interest rates combined with increasing longevity have increased deficits further.

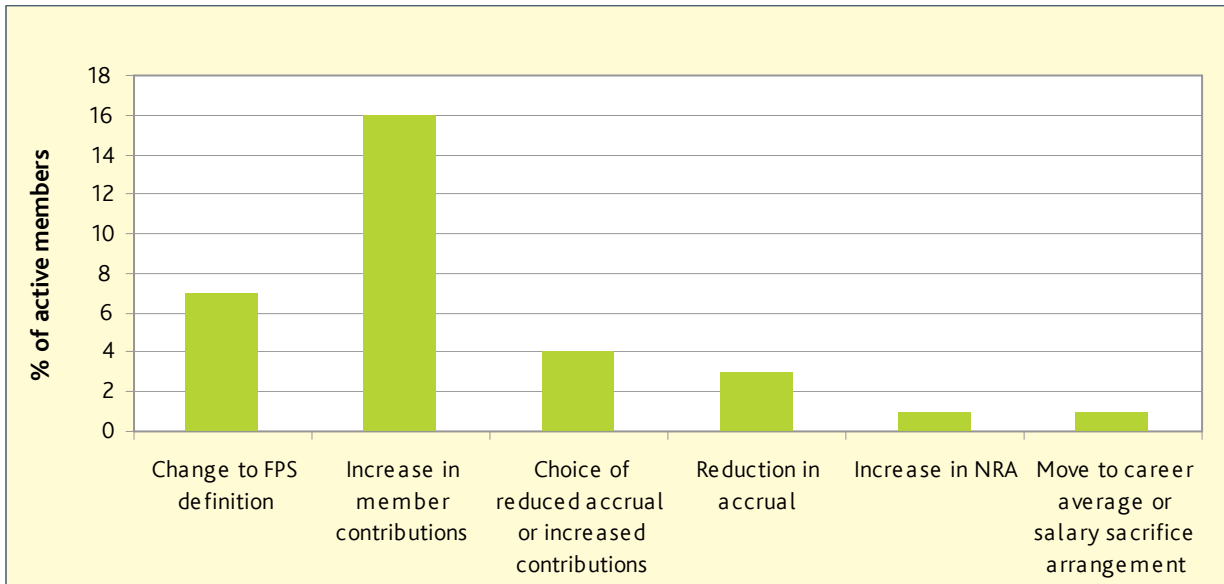
Many companies are now closing their DB schemes and setting up DC arrangements in their place, as shown in Chart 3 above. As an alternative to closing a DB scheme completely, some employers are choosing to keep existing employees in the DB scheme but put new hires into a DC scheme. Chart 6 illustrates the difference between the proportion of existing employees being a member of a DB scheme and the equivalent proportion of new hires. In some cases employers are making changes to DB schemes, for example reducing accrual rates or increasing member contribution rates, in order to keep them open (Chart 7).

**Chart 6 Participation rates in private sector salary-related schemes by employee status**



*Note: In this analysis a 'new' employee is defined as one that has worked in the same job in the organisation for less than one year. All data presented here has been revised and takes account of the new ASHE methodology which weights the data.  
Source: Pension Commission first report - analysis of Annual Survey of Hours and Earnings*

**Chart 7** Changes to DB schemes between 2004 and 2005, by percentage of total active employee membership of DB schemes



Source: *The Pensions Regulator and PPF's Purple Book*

Contributions to DC schemes are usually much lower than contributions to DB schemes, and furthermore virtually all risk is passed away from the employer and to the employee. There is some debate as to how effective these arrangements will be in the long term as a means of providing acceptable levels of pension provision. There has been discussion recently within the industry about "risk-sharing schemes", recognising the need for arrangements which spread the risk between employer and employees, rather than leaving it all with one party only (as DB and DC do).

In 2006, Chris Lewin and Ed Sweeney were asked to carry out an independent review of how the legislation surrounding pensions could be simplified, and in July 2007 they published their report, "deregulatory review of private pensions".

This set out suggestions for a number of measures designed to encourage risk-sharing schemes and to move away from the current regime of prescriptive legislation towards a more principles-based approach. This report has been considered by the Government which has now published its response which sets out some initial proposals for change.