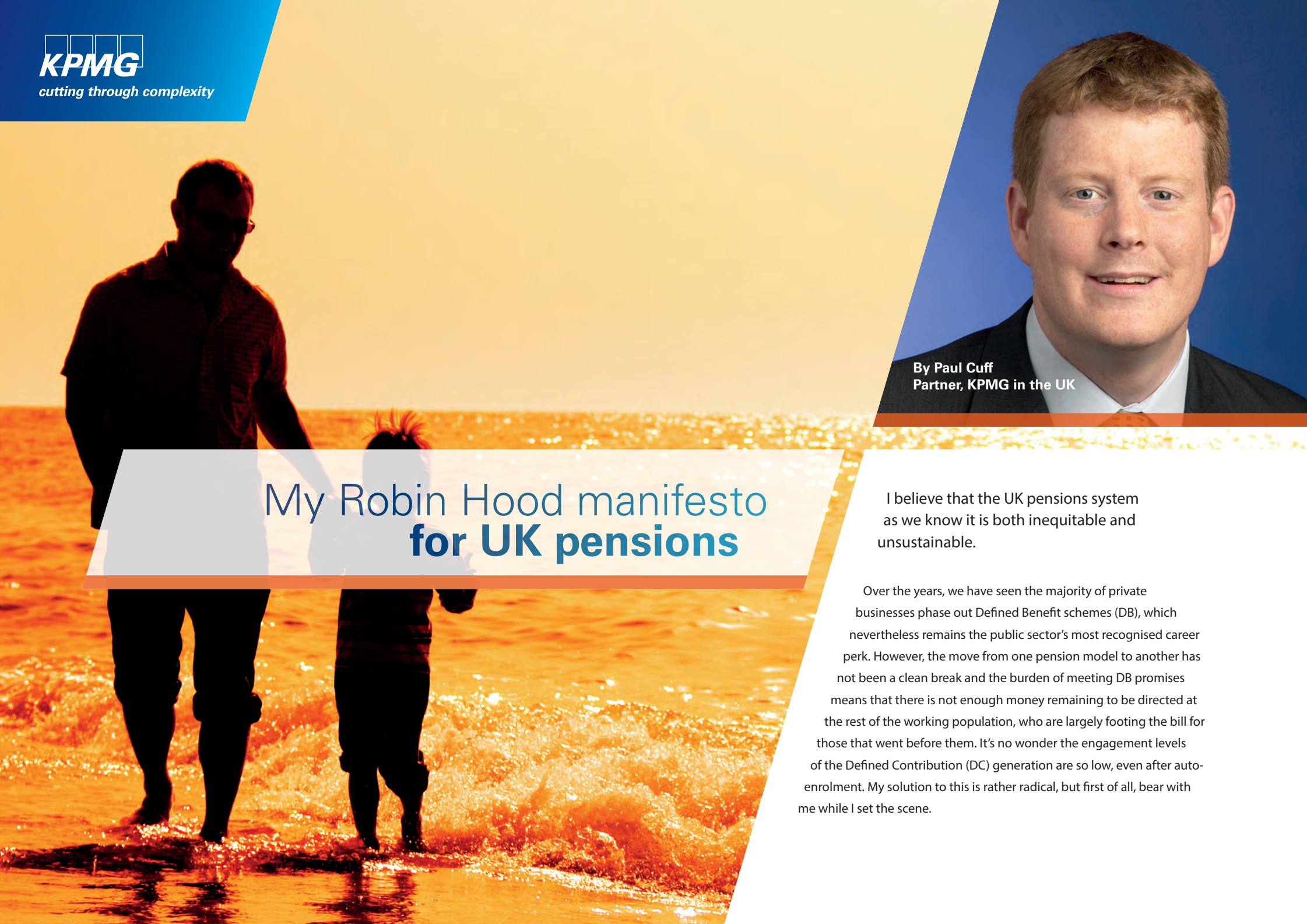
KPMG
cutting through complexity



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My Robin Hood manifesto **for UK pensions**

I believe that the UK pensions system as we know it is both inequitable and unsustainable.

Over the years, we have seen the majority of private businesses phase out Defined Benefit schemes (DB), which nevertheless remains the public sector's most recognised career perk. However, the move from one pension model to another has not been a clean break and the burden of meeting DB promises means that there is not enough money remaining to be directed at the rest of the working population, who are largely footing the bill for those that went before them. It's no wonder the engagement levels of the Defined Contribution (DC) generation are so low, even after auto-enrolment. My solution to this is rather radical, but first of all, bear with me while I set the scene.

Promising the moon

Today, employers continue to honour a promise that many struggle to keep. In the heyday of DB, life expectancy was significantly less than what it is now; a pension would perhaps have to last for ten to fifteen years. However, this does not match today's average life expectancy (around 88 years from someone retiring tomorrow) and all the while low long-term interest rates just drive the cost of pensions ever higher[1]. As this happens DB pensions continue to be inflation linked – even as wages fall behind inflation, DB pension schemes increase year on year.

You could say a promise is a promise, but what many people do not fully realise that maintaining the legacy of DB has unwittingly sealed the fate of subsequent generations' pension plans and not in a positive way.

Who takes the risk?

Not only are employer reward contributions significantly less in DC schemes, but they also come at personal risk for the employee (as many have experienced as a consequence of the financial crisis). For DB scheme holders this is not an issue to worry about; the risk is entirely borne on the employer (and taxpayer), regardless of what external market conditions might prevail.

The difference is stark

In order for future generations (in DC) to be able to retire at 68, they will need to contribute far more to their own pension funds to achieve the same level of pension entitlement that DB scheme holders have. According to my research, a DC employer contribution rate of 39.9 percent is required to match the level of benefits expected from a DB scheme for a male member of average age (45 years)[2].

This is a far cry from the average DC employer contribution (6.1 percent; 2013)[3]; and with only 2.9 percent (2013) going into the pot from your average Joe's earnings[4], it is clear that there is a vast difference between what the DC workforce of today can expect in the future, compared to the DB generation that went before them.

So, let's get employers to pay more into DC, right?

Before we address this question, let's consider the amount of cash being paid into pension arrangements in the UK today. The amount being spent by employers on private DB occupational pension schemes during 2013 was around £42 billion[5]. This is over nine times the amount spent on private sector DC occupational schemes, group personal pensions and group stakeholder schemes (circa £4.5 billion)[6].

Over nine times as much money being spent on a group of people only accounting for 30 percent of the private sector working population![7]

Over nine times as much money is being spent on a group accounting for only 30% of the private sector population

[1] Based on the latest actuarial tables and projection models.
[2] See Section 4) of Appendix; based on annuity rates, November 2014
[3] Occupational Pension Scheme Survey 2013, p1 – http://www.ons.gov.uk/ons/dcp171778_377737.pdf
[4] Ibid
[5] Please see table 1) of Appendix.
[6] Occupational Pension Scheme Survey 2013, p25, table 3 – http://www.ons.gov.uk/ons/dcp171778_377737.pdf
[7] Please see section 3) of Appendix.

We need a rebalancing of what we have already

So, one answer is to increase DC contribution rates. But in this fragile economic recovery that is not an option for many employers, and certainly it is not an option for employers paying large amounts to DB schemes. My view is this: the large DB contributions are directly restricting the ability of employers to pay higher contributions to DC plans.

A systemic inter-generational subsidy

This has unintentionally created a systemic inter-generational subsidy, where younger generations of taxpayers are not only having to be a whole lot more responsible for their own retirement but are meanwhile effectively paying for previous generations' DB pension schemes at the expense of their own long term savings.

Sadly, this is just one of many injustices younger workers face today; including belated retirement, large amounts of student debt, restricted access to the housing ladder and the weight of a depressed economic climate on their shoulders.

A small compromise

A middle ground is needed; a system which should facilitate the taking of risk, but within a system that protects people against bad times by holding back something in good times. However, even with such a system, it would still take generations to bring about a fairer distribution if pensions built up are not revisited, even if the economy booms.

We need a rebalancing of what we have already. This isn't as controversial as it sounds; what I would propose are relatively small changes, such as slowly lessening inflation increases on annual pension payments.

I believe that this is the most palatable element of cost that can be removed from the current structure; but would still make a massive difference to future generations who are already experiencing a far lower standard of living than their predecessors and only a very small difference to pensioners.

Here's one way we might do this: give today's pensioners a five-year notice period of a one-off zero pension increase in year six, but then resume increases again for year seven. In tandem, all non-pensioners would be notified that they would also receive a nil pension increase in the sixth year after they retire.

Knowing now that in six year's time your pension will be flat for a year gives plenty of time for people to plan. It will make very little difference to DB members. But if you give the "savings" this generates in the DB schemes to those in DC, it could be quite a game-changer for the generation coming through.

An instant boost

My calculations show that this could reduce the level of UK DB liabilities by £45 billion. If schemes were then mandated to disinvest an amount equal to this from their assets and pay it into a centralised fund, it could be distributed equally amongst the 17.2 million[8] private sector employees either in a DC arrangement or in no arrangement.

This would lead to an instant boost of around £2,600[9] to all DC members' pension savings. Given that the average DC pension pot at retirement in 2013 was £25,000[10], I am sure that this ten percent (plus) boost would be extremely welcomed and could even lead to greater engagement in retirement planning.

The wider boost in getting people engaged in thinking about pensions, and taking responsibility, would be huge. If you said today "in one year's time, all DC pots will receive a windfall of £2,600", just imagine how many young people with no pension arrangements at all would wake up and pay attention. It would have much more impact even than auto-enrolment.

[8] Please see Appendix section 7.
[9] Ibid.
[10] The Pensions Regulator website, in Key Findings section.

Are we letting companies off the hook?

This cash injection to DC pots would not result in companies and their shareholders lining their pockets, however. The pension scheme deficits companies need to meet would still be the same the day after my proposed change, because the money given to kick-start and top-up DC pots would come from the DB schemes. These schemes would be paying out an amount equal to the reduction in their liabilities; enabling a Robin Hood-like redistribution between members of DB schemes and the younger generation in DC schemes, with everyone else left neutral.

A lack of political appetite

Of course, in order to allow this to happen we would need the government to take a stand. But who would suggest it? History has shown us that reducing anything is a tricky game to play in politics. For this reason, it would be in everyone's best interests to take pensions out of the political party remit, especially when the matter is likely to affect the voter majority, who are older and therefore more likely to be in DB schemes themselves. Again, that's just not going to happen.

To make matters worse, the younger generations, the majority of whom will be in DC schemes, do not seem to be sufficiently engaged with this debate. This could partly be down to a general mistrust in the pensions system, but I think the bigger issue is a lack of communication from the top.

A widening gap

On the face of it, with the emergence of auto-enrolment for example, you could say the government is making an effort to encourage workers to think about saving for retirement. Regardless, this initiative will not solve the systemic inter-generational subsidy faced by the UK majority.

What I expect we will see from auto-enrolment however, is the average age of the DC active member decreasing (currently 45)[11]; and therefore a widening gap between the average ages of DB (currently 48)[12] and active DC members, signalling further polarisation of UK pension schemes.

Promises and pie crust…

With the majority of DB schemes closed to new joiners and with the average age of DC members decreasing through auto-enrolment, the age gap between the "haves" in DB schemes and "have nots" in DC schemes will only widen. How certain can we be that younger generations in DC arrangements, who generally have the poorest levels of pension provision, will be willing to continue supporting the wealthiest DB pensioners?

Indeed, without intervention it could very well be another 50 years down the line until the last generation of DB pension holders pass away. In my view, we cannot rule out the threat of social unrest.

…Are made to be broken

Changing current pension policies may seem like pie in the sky thinking, but in the future and as the government becomes less able in both justifying and upholding the cost of their promises[13], I believe something will have to give. Given that this will continue to affect the growing majority of UK employees, a middle ground must be sought sooner rather than later.

It would be in everyone's best interest to take pensions out of the political party remit.

[11] Annual Survey of Hours and Earnings 2013, p7, Figure 4 – http://www.ons.gov.uk/ons/dcp171778_335027.pdf
[12] Ibid.
[13] Read article: We must reform the Pension Protection Fund to avoid a black hole – http://www.kpmg.com/UK/en/IssuesAndInsights/ArticlesPublications/Pages/reform-the-ppf-to-avoid-a-pensions-black-hole.aspx

Appendices

1 The amount of money spent on DB Pensions versus DC Pensions

Based on high level KPMG analysis, the estimated amount spent on private sector DB occupational pension schemes during 2013 was c.£42bn, compared with c.£4.5bn spent on private sector DC occupational pension schemes, group personal pensions and group stakeholder schemes. This amounts to over nine times as much being spent on private sector DB pensions than private sector DC pensions (i.e. 42 billion divided by 4.5 billion).

	Data	Source	Page
A	Median UK Salary for a full time employee in the private sector - £25,480	2013 Annual Survey of Hours and Earnings UK	22
B	Number of active members in a private sector occupational DB pension scheme - 1,600,000	Occupational pension scheme survey 2013	Table 3, 25
C	Number of active members in a private sector occupational DC pension scheme - 1,200,000	Occupational pension scheme survey 2013	Table 3, 25
D	Number of active members in a GPP or stakeholder DC pension scheme - 1,700,000	2013 Annual Survey of Hours and Earnings UK – Summary of Pension Results	Table 3, 6
E	Average employer contribution rate (DB) - 15.40% p.a.	Occupational pension scheme survey 2013	1
F	Average employer contribution rate (DC) - 6.10% p.a.	Occupational pension scheme survey 2013	1
G	PPF Assets at 31 March 2013 - £1,118,500,000,000	Purple book 2013	Table 4.1, 34
H	Ratio of Technical Provisions to assets - 84.70%	Tranche 7 valuations (Orange book)	Table 2.1, 15
I	Ratio of Technical Provisions to Reference Liabilities - 81.20%	Tranche 7 valuations (Orange book)	Table 2.5, 24
J	Deficit reduction contributions as % of Reference Liabilities - 2.20%	Tranche 7 valuations (Orange book)	8

The total amount that an employer contributes to a DB scheme consists of future service contributions and deficit contributions.

Therefore, to estimate the total amount spent by employers on DB contributions in the private sector we need an estimate of the total amount of future service contributions and deficit contributions.

The total annual amount of future service contributions can be estimated by: A x B x E (assumes the median UK salary can be used as the average salary for all active DB members).

The total annual amount of deficit contributions can be estimated by: (G / H / I) x J (assumes we can ignore the impact of schemes in surplus on the figures quoted in the orange book).

The total amount that an employer contributes to a DC scheme consists of only future service contributions.

Therefore the total amount spent by employers on DC contributions in the private sector can be estimated by: A x (C + D) x F (assumes the median UK salary can be used as the average salary for all active DC members and that the average employer contribution rate for occupational DC schemes is also that of GPP and stakeholder DC schemes).

2 The average age of a member of a DB scheme Vs DC scheme

According to the Annual Survey of Hours and Earnings 2013 and KPMG analysis, the average age of a DB scheme active member was 48 and the average age of a DC scheme active member was 45.

It is expected that due to the effects of auto-enrolment, which started in October 2012, the average age of a DC active member is likely to decrease going forward producing a bigger gap between the average ages of DB and DC active members.

3 The number of people in DB/DC schemes

According to the Occupational Pension Scheme Survey 2013, the number of active members in a UK DB occupational pension scheme was 1.6m and the number of deferred members was 5.4m, a total membership entitled to DB benefits in the future of 7m.

The ONS estimates the total UK private sector working population as 24.2m. If we make the assumption that the 7m memberships above don't have any other pension arrangements then there are 17.2m people of working age either in a DC arrangement or in no arrangement.

Building on the answer from Q1 above, there is over 9 times as much money being spent on a group of people that makes up 30% of the private sector working population.

	Data	Source
A	Private sector working population - 24.2m	http://www.ons.gov.uk/ons/rel/pse/public-sector-employment/q2-2013/sty-public-section-employment.html
B	DB pension scheme population - 7.0m	Occupational pension scheme survey 2013, table 3 p.25 (both active and deferred population)

Proportion of the UK private sector working population in a DB scheme = B/A (excludes potential overlap between people who are both active and deferred members of a scheme).

4 The level of DC contributions required to match DB levels

	Data	Source
A	Assumed investment return - 4% p.a.	Estimate
B	Assumed salary Increases - 2.50% p.a.	Estimate
C	Assumed accrual rate - 1/60th	Estimate
D	DC employee contribution rate - 6.1% p.a.	See question 5
E	Average Age - 45	See question 2
F	Annuity - 37	L&G Annuity Calculator (for a male retiring at age 65 with a pension increasing at RPI, guaranteed for 5 years with an attaching 50% spouses pension for a spouse 3 years younger)

The level of DC contributions required to match DB levels was estimated by working out the contributions made to a DB scheme and subtracting the level of contributions made by employees in a DC scheme:
C x (((1+B)/(1+A))(65-E) x F) – D

5 The average DC contribution rates

According to the Occupational Pension Scheme Survey 2013, the average employer contribution rate was 6.1% and the average employee contribution rate was 2.9% for a DC private sector occupational pension scheme in 2013.

6 Average DB pension increases in payment

Table 18 from the Occupational Pension Scheme Survey 2013 gives the number of pensions in payment in a private sector DB scheme by increase paid.

The average pension increase in payment has been estimated by the sum product of the midpoint of the pension increases given in Table 18 and the number of pensions in payment.

According to the Occupational Pension Scheme Survey 2013 and KPMG analysis, the average pension increase in payment for a DB scheme in the UK was 3.3% in 2011, 3.2% in 2012 and 2.4% in 2013.

7 How much does one year's worth of inflation payments account for in relation to the total cost of DB pensions?

We have performed a high level analysis on an example scenario where all pensioners in receipt of a pension today are given 5 years notice of a one-off zero pension increase in year 6, pension increases resuming as normal from year 7. In additional to this, all non-pensioners are to be notified that they will also receive a nil pension increase in the 6th year after they retire.

Our analysis indicated that this one off exercise would immediately reduce total UK DB liabilities by c.£45bn. If schemes were then mandated to disinvest an amount equal to this from their assets and pay it into a centralised fund, it could be distributed equally amongst the 17.2m private sector employees either in a DC arrangement or in no arrangement. This would lead to an instant boost of c.£2,600 to everyone's pension savings and lead to greater engagement in retirement planning. Given the average DC pot at retirement in 2013 was £25,000 according to tPR, this over 10% pot boost would be extremely welcomed.

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