



# **THE MANAGEMENT OF PENSION SCHEME LIABILITIES BY UK PLC**

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**A SURVEY PUBLISHED BY PENSION REVIEW ASSOCIATES**

## Introduction

Research suggests that private sector Defined Benefit (DB) pension arrangements have a combined deficit of £200bn. IAS19, if unchanged, will increase that deficit by a further £25bn. Consequently there has been a massive increase in the number of organisations looking to reduce their pension liabilities and their cash commitment to DB pension schemes.

During May and June 2010, Pension Review Associates undertook a research study *The Management of Pension Scheme Liabilities in UK PLC*, in order to explore the perceived level of risk that DB arrangements represent for businesses and the risk management strategies that are being deployed.

The aim of the research is to help inform any organisation reviewing its DB pension arrangements and to mitigate threats posed by the arrangements to the future wellbeing of their organisations.

This report highlights the key findings of the survey, which was undertaken amongst a broad range of UK businesses, together with experiential analysis of the results.

## Research methodology

The research was conducted online and a questionnaire was distributed via the CBI and FD Centre targeted at those businesses with DB pension arrangements.

The questionnaire addressed the following key areas:

- **The perceived risk of DB arrangements**
- **Risk management of DB arrangements**
- **Internal resource capability in dealing with changes to DB arrangements**
- **Concerns relating to the closure of DB arrangements to new entrants and future accrual, as well as severing the link to final pensionable salary**
- **The Impact of IAS 19, NEST and auto-enrolment/re-enrolment**

The respondents represent a broad spectrum of UK businesses of varying sizes, including FTSE 100 plcs. They cover a wide range of activities, including: Accountancy, Business Services, Communications, Distribution, Financial Services, Manufacturing, Pharmaceuticals, Retail and Utilities. In total, the respondents account for more than 300,000 UK employees.

## Executive summary

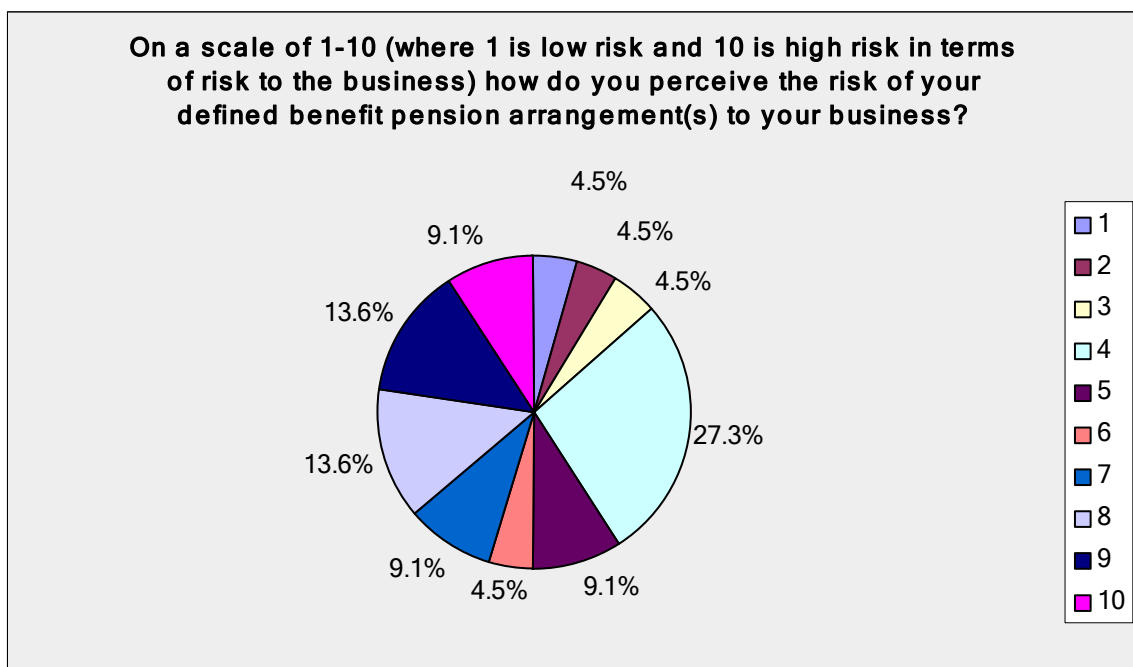
- Nearly half of respondents (45.4%) indicated that their DB pension arrangements represented a significant risk to their business
- Circa one in ten (9.1%) ranked DB pensions as the highest risk to their organisation
- 1 in 5 respondents reported that they were concerned about the liabilities associated with their DB arrangements and felt that they did not know the true risk to their business
- Almost 60% of respondents did not feel fully confident that they had done all that they could to mitigate the risk of their DB pension arrangements
- More than 40% of respondents have yet to decide on a definite course of action to manage the risk of their DB arrangements to the wellbeing of their organisations
- Nearly half of respondents did not know how long such a project would take to close their DB pension arrangement(s) to future accrual
- Around one in five respondents indicated that they were not satisfied that they had the necessary internal resources to close DB pension arrangements to new entrants/future accrual
- Half of the respondents felt that IAS 19 would have a significant or very significant impact on their organisation.
- Employee Relations was seen as the biggest concern of closing a DB scheme or severing the link to final pensionable salary

## The findings in detail

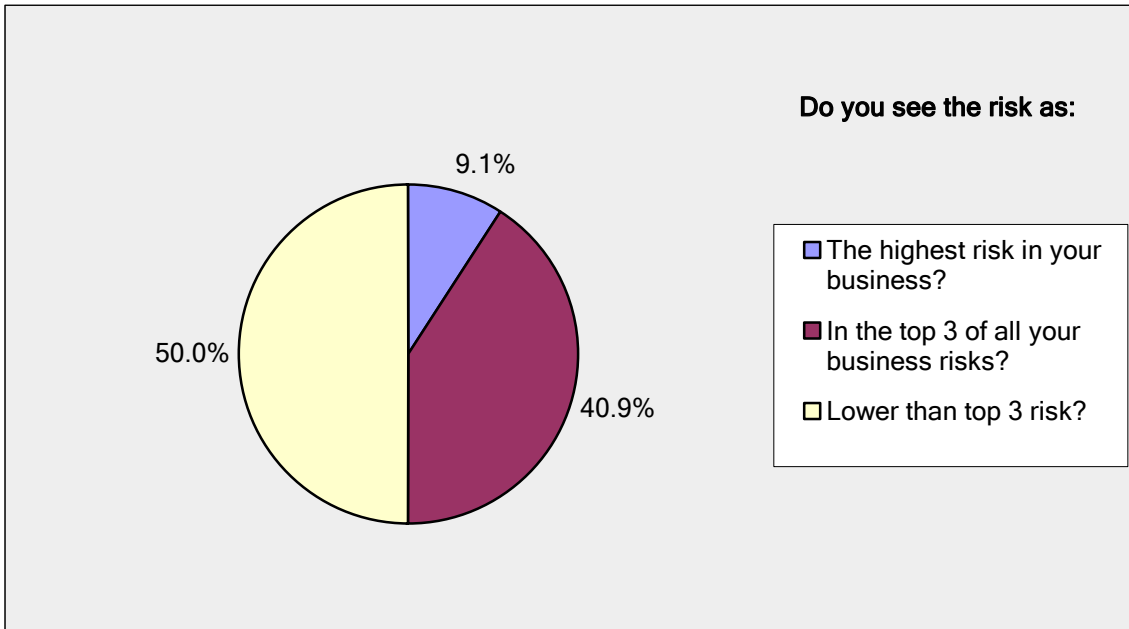
### THE PERCEIVED RISK OF DB ARRANGEMENTS

An overwhelming majority of respondents continue to view their DB pension arrangements as a risk to the organisation.

Nearly half of respondents (45.4%) indicated that their DB pension arrangements represented a significant (= a rating of 7 or more) risk to their business. Another 40.9% of respondents indicated that their DB pension arrangements represented some risk to their business (= a rating of between 4 and 6), whilst only 13.5% indicated that their pension arrangements represented a minor (= rating of 3 or less) risk.



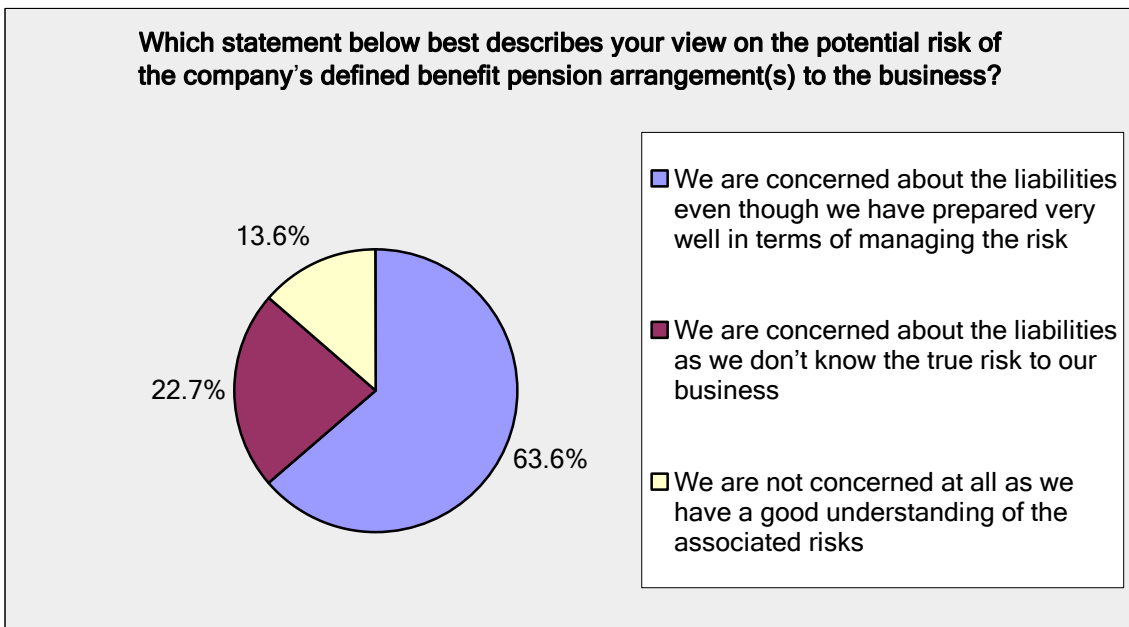
Nearly one in ten (9.1%) ranked DB pensions as the highest risk to their organisation, with 50% of respondents ranking it in the top 3 of all business risks.



Respondents were asked to consider the liabilities associated with DB arrangements in order to provide context to the more general issue of the risks posed by their organisations' existing arrangements.

More than 86% of respondents indicated concerns about the liabilities associated with their DB pension arrangements. Over 60% were concerned, even though they felt that they were very well prepared in terms of managing the risk.

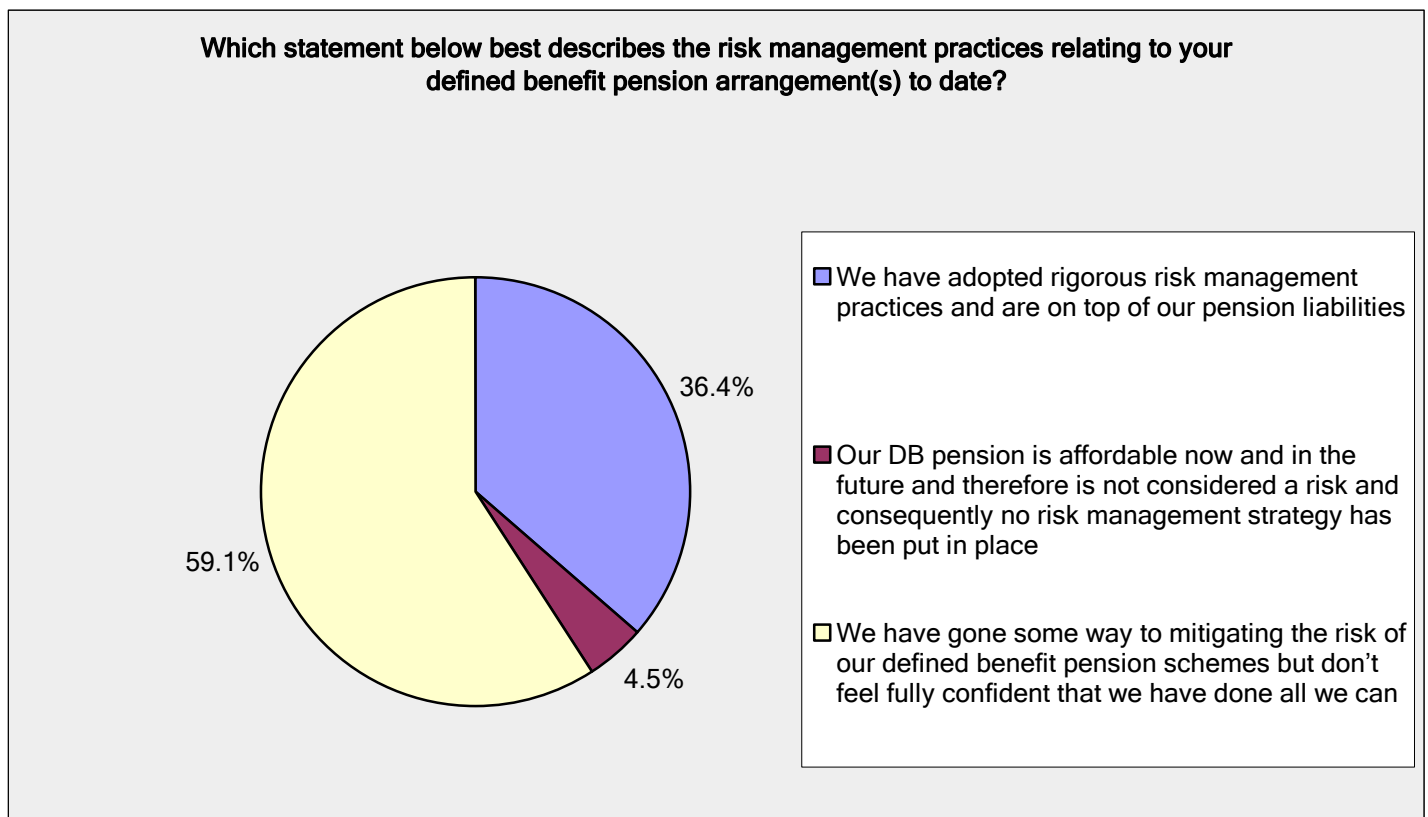
A worrying finding is the fact that more than 1 in 5 respondents reported that they were concerned and felt that they did not know the true risk to their business.



## RISK MANAGEMENT OF DB ARRANGEMENTS

Respondents were asked to describe those risk management practices that they had put in place relating to their DB arrangement(s).

36.4% of respondents stated that they had adopted rigorous risk management practices and were on top of their pension liabilities. However, almost 60% of respondents felt that although they had taken some action to mitigate the risk, they did not feel fully confident that they had done all that they could.

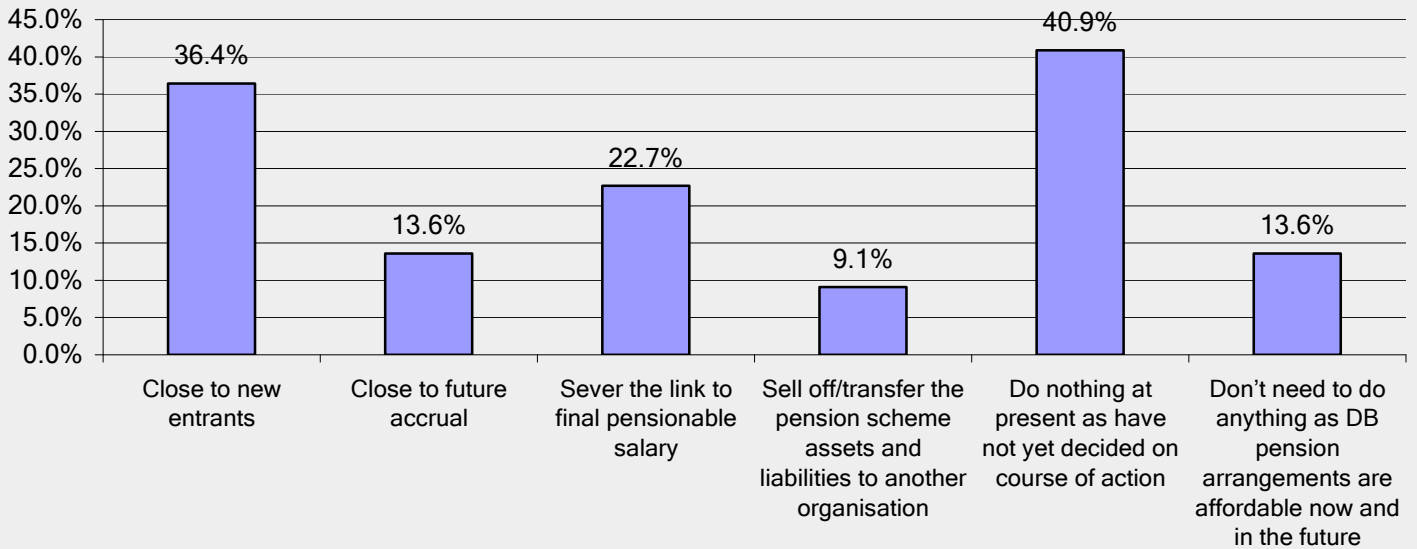


Respondents are planning a range of actions that include one, or more, of the following:

- Closing their scheme(s) to new entrants,
- Closing their schemes to future accrual,
- Severing the link to final pensionable salary
- Sell off/transfer the pension scheme assets and liabilities to another organisation

Only 13.6% of respondents are proposing no action. More than 40% of respondents have yet to decide on a definite course of action.

**What plans do you have for your defined benefit pension arrangement(s)?**

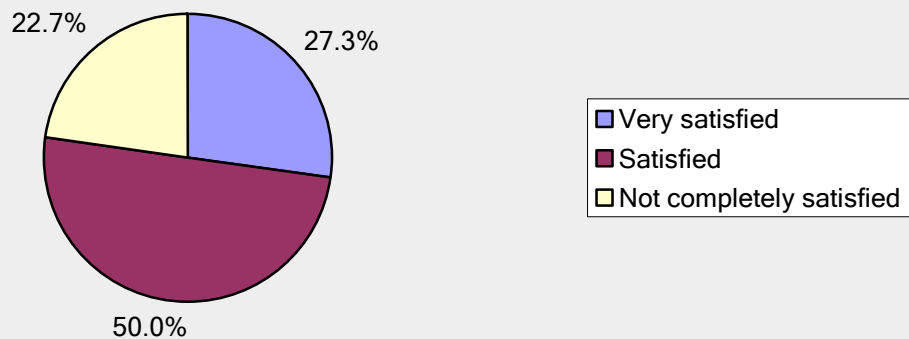


**INTERNAL RESOURCE CAPABILITY**

Respondents were asked to consider the adequacy of their internal resources if they were to close/are closing their DB pension arrangements to new entrants/future accrual

More than 20% of respondents indicated that they were not satisfied that they had the necessary internal resources.

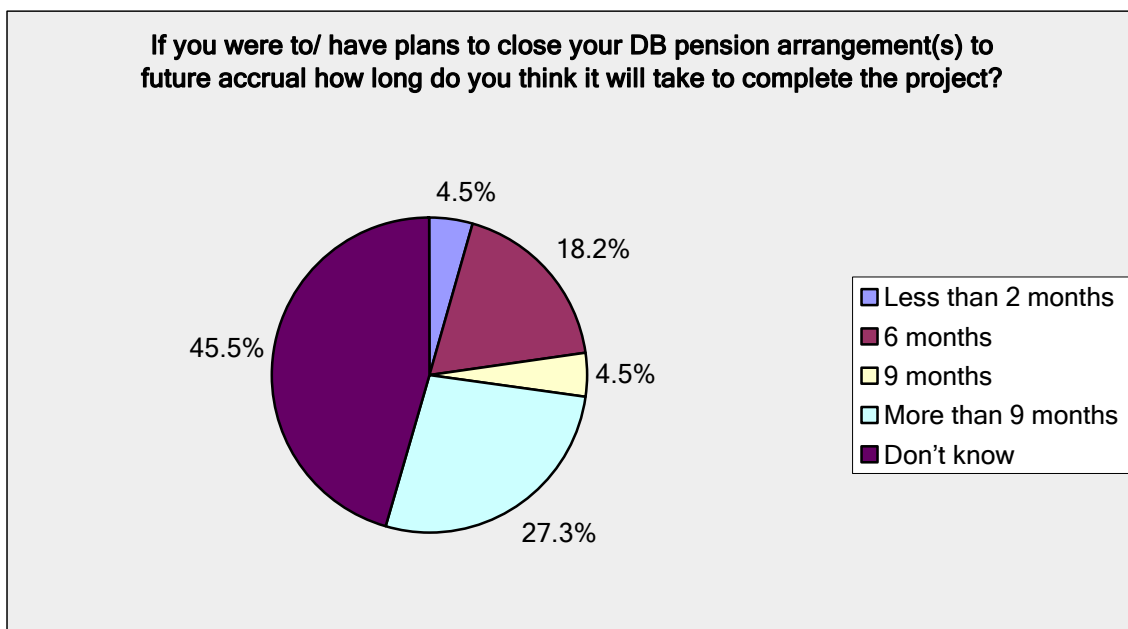
**If you were to close/are closing your DB pension arrangements to new entrants/future accrual how satisfied are you that your internal resources are sufficient to manage this process effectively?**



For those respondents who had plans to close their DB pension arrangement(s) to future accrual, they were asked how long they thought it would take to complete the project.

Surprisingly more than 45% of respondents did not know how long such a project would take. This did not seem consistent with the fact that more than 75% of respondents had reported they were satisfied or very satisfied they had sufficient internal resources for a project of this type.

Equally surprising was the fact that 4.5% of respondents believed that this could be accomplished in less than 2 months. Compliance with Occupational and Personal Pension Schemes (Consultation by Employers and Miscellaneous Amendment) Regulations 2006 alone would require a 60-day consultation period.



***CONCERNS RELATING TO THE CLOSURE OF DB ARRANGEMENTS/SEVERING LINKS TO FINAL PENSIONABLE SALARY***

Respondents were provided with a list of concerns that they had to rank in terms of the level of concern they represented.

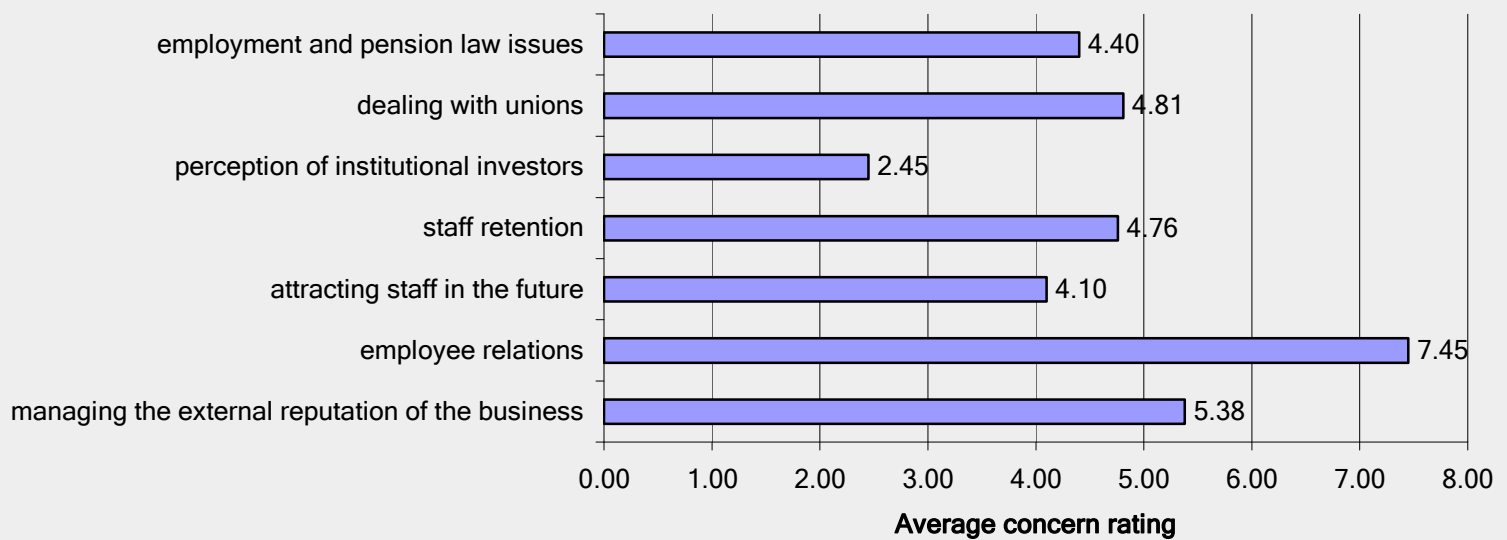
Employee Relations had the highest average rating (7.45), with the second biggest concern being managing the external reputation of the business (5.38).

Dealing with trade unions (4.81) was understandably a concern as was staff retention (4.76).



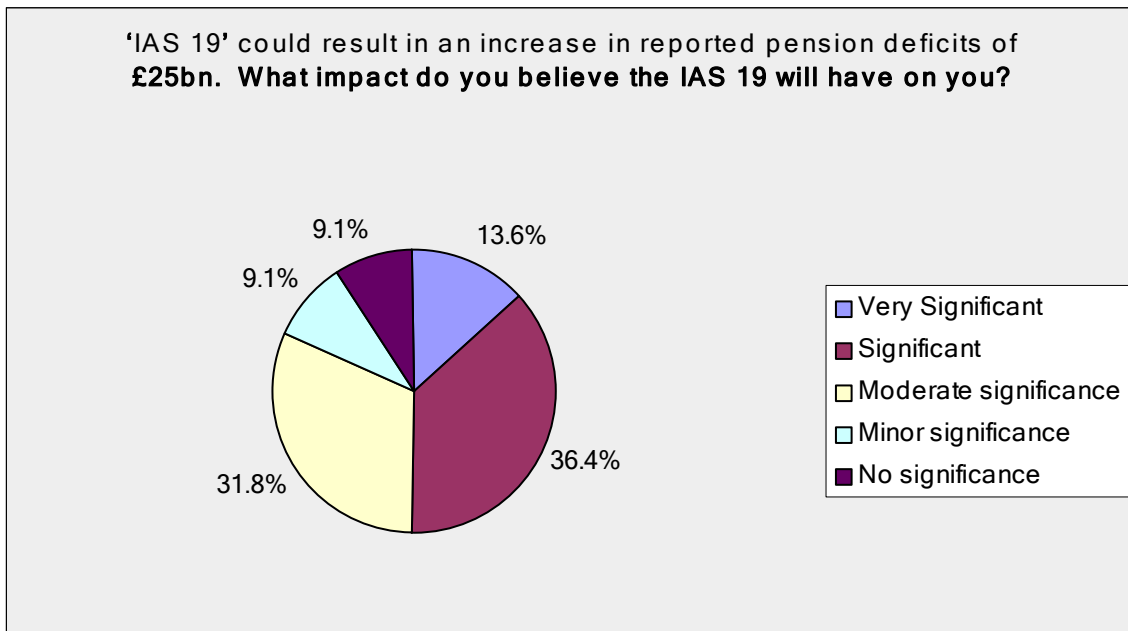
The fact that the perception of institutional shareholders was ranked lowest (2.45) was not surprising. All of these actions (closure to new entrants, closure to future accrual and severing the link to final pensionable salary) would reduce future risks and liabilities and closure to future accrual might well deliver a significant 'curtailment gain'.

**If you were to close/are closing your DB pension arrangement(s) to new entrants/future accrual or were to sever/are severing the link to final pensionable salary what would you perceive to be your biggest concerns on a scale of 1(smallest) - 10(biggest)**



### **THE IMPACT OF IAS 19, NEST AND AUTO-ENROLMENT**

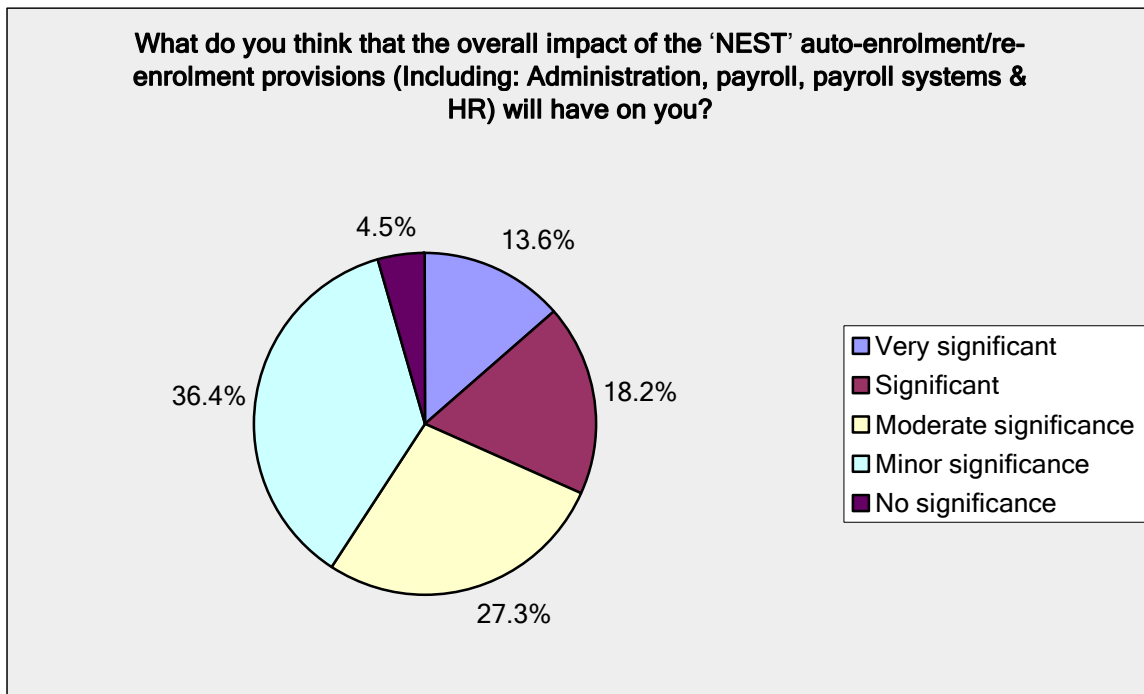
Half of the respondents felt that IAS 19 would have a significant or very significant impact on their organisation. A further 31.8% felt that the impact would be of moderate significance. Less than 10% of respondents reported that IAS 19 would have no significant impact on their organisation.



The future of NEST and auto-enrolment/re-enrolment is uncertain and currently under review by the Government. However respondents' views were sought on these two areas.

Nearly a third of respondents (31%) indicated that auto-enrolment would have a significant/very significant impact on administration, HR & payroll systems. 40% of respondents reported that there would be little/no significant impact.

Whilst we have no knowledge of our respondents HR and payroll systems, the typical experience is that many existing HR and payroll systems are generally not able to cope with auto-enrolment/re-enrolment.



## Analysis, Conclusions and Recommendations

1. With almost 60% of respondents not feeling fully confident that they have done all that they can to mitigate the risk of their DB pension arrangements and with more than 40% of respondents having yet to decide on a definite course of action to manage the risk, it highlights the need for UK plc to proactively manage the risks and future liabilities associated with their DB pension arrangements.

Some organisations have adopted an incremental approach that includes some/all of the following:

- Close the scheme to new entrants,
- Switch from final salary to CARE,
- Cap future pensionable pay increases,
- Close the scheme to future accrual, and,
- Sever the link to final pensionable salary.

However this approach has proven to be fundamentally flawed and a recipe for future employee relations problems. The incremental approach amounts to 'death by a thousand cuts', which will over time erode management's credibility and produce a de-motivated workforce. A cap on future pensionable pay increases, whilst lawful, is immoral. It represents the worst of all worlds. Closing an arrangement to future accrual gives members the benefit of 'statutory revaluation' and putting in place a good money purchase (DC) arrangement should enable most members to recoup the losses associated with future service.

2. It is critical to make sure you have the necessary resources to successfully effect major changes to occupational pension arrangements as they are both time consuming and resource hungry. This was evidenced by a fifth of respondents indicating they were not satisfied with their internal resources in terms of dealing with changes in their DB arrangements.

Validating member data, an essential step in the process, is a major exercise in its own right.

Moreover, the completion of the closure of an arrangement would be a 'listed change', as defined in the Occupational and Personal Pension Schemes (Consultation by Employers and Miscellaneous Amendment) Regulations 2006 and this alone would require a minimum consultation period of 60 days.

In addition, we have found many cases where individual members have a contractual right to membership of a DB pension scheme. In one particular case, although the scheme had been closed to future accrual, members retained a contractual right to benefits based on their final pensionable salary. It follows that any change might amount to a variation to their terms and conditions of employment, which could involve a (minimum) 90-day

consultation period. Any organisation proposing a listed change, or a contractual change, needs to ensure that employee representatives have an appropriate mandate.

Unless the employer is to be exposed to unnecessary litigation, 9 months is probably the absolute minimum for achieving such a change.

3. Internal and external communications are critical success factors in making any changes to DB arrangements. This was borne out by the fact that employee relations was the greatest concern amongst organisations regarding the closure of DB arrangements. Internal communications requires detailed planning and preparation. Very few members have even a superficial understanding of pensions. Many will not know the identity of their 'statutory employer' and a small, but significant, number will probably not know what scheme they are in.

Any communications issued should not prejudice the outcome of the consultation process. A 'low external profile' approach should be adopted.

Keeping the Trustee fully informed throughout the process is invaluable because, in all likelihood, at some point the sponsoring employer will want the Trustee to agree to a change in the Trust Deed and Rules.

Communication with any 'recognised' trade unions (TUs) is clearly important and any organisation with TUPE transferred staff needs to look at the status of any TU agreements, which will also have been protected by TUPE. The negative impact of a hostile reaction by TU's can be mitigated by effective internal communications. It is also helpful to identify what changes the TUs have made to pension provision for their own employees.

Finally, reaching agreement on the proposed changes with employee representatives is a real plus. Typically few, if any, members choose to vote with their feet. Providing the main drivers are the reduction of risk and future liabilities, rather than cost reduction, it should be possible to devise a very attractive defined contribution (DC) arrangement.

## Appendix – the research questions and findings in detail

### QUESTION 1

On a scale of 1-10 (where 1 is low risk and 10 is high risk in terms of risk to the business) how do you perceive the risk of your defined benefit pension arrangement(s) to your business?	
Answer Options	Response Percent
1	4.5%
2	4.5%
3	4.5%
4	27.3%
5	9.1%
6	4.5%
7	9.1%
8	13.6%
9	13.6%
10	9.1%

### QUESTION 2

Do you see the risk as: (Please tick as appropriate)	
Answer Options	Response Percent
The highest risk in your business?	9.1%
In the top 3 of all your business risks?	40.9%
Lower than top 3 risk?	50.0%
Not sure	0.0%

### QUESTION 3

Which statement below best describes your view on the potential risk of the company's defined benefit pension arrangement(s) to the business? (Please tick as appropriate)	
Answer Options	Response Percent
We are concerned about the liabilities even though we have prepared very well in terms of managing the risk	63.6%
We are concerned about the liabilities as we don't know the true risk to our business	22.7%
We are not concerned at all as we have a good understanding of the associated risks	13.6%

#### QUESTION 4

<b>Which statement below best describes the risk management practices relating to your defined benefit pension arrangement(s) to date? (Please tick as appropriate)</b>	
<b>Answer Options</b>	<b>Response Percent</b>
We have adopted rigorous risk management practices and are on top of our pension liabilities	36.4%
Our DB pension is affordable now and in the future and therefore is not considered a risk and consequently no risk management strategy has been put in place	4.5%
We have gone some way to mitigating the risk of our defined benefit pension schemes but don't feel fully confident that we have done all we can	59.1%
We have not put any risk management framework in place and don't plan to	0.0%
We have not put any risk management framework in place but plan to in the next year	0.0%

#### QUESTION 5

<b>What plans do you have for your defined benefit pension arrangement(s)? (Please tick all that apply)</b>	
<b>Answer Options</b>	<b>Response Percent</b>
Close to new entrants	36.4%
Close to future accrual	13.6%
Sever the link to final pensionable salary	22.7%
Sell off/transfer the pension scheme assets and liabilities to another organisation	9.1%
Do nothing at present as have not yet decided on course of action	40.9%
Don't need to do anything as DB pension arrangements are affordable now and in the future	13.6%

#### QUESTION 6

<b>If you were to close/are closing your DB pension arrangements to new entrants/future accrual how satisfied are you that your internal resources are sufficient to manage this process effectively? (Please tick as appropriate)</b>	
<b>Answer Options</b>	<b>Response Percent</b>
Very satisfied	27.3%
Satisfied	50.0%
Not completely satisfied	22.7%
Not satisfied at all	0.0%

## QUESTION 7

If you have plans to close your DB pension arrangement(s) to future accrual how long do you think it will take to complete the project? (Please tick as)	
Answer Options	Response Percent
Less than 2 months	4.5%
2 months	0.0%
3 months	0.0%
6 months	18.2%
9 months	4.5%
More than 9 months	27.3%
Don't know	45.5%

## QUESTION 8

If you were to close/are closing your DB pension arrangement(s) to new entrants/future accrual or were to sever/are severing the link to final pensionable salary what would you perceive to be your biggest concerns on a scale of 1-10 (where 1 would be the smallest and 10 the biggest concern)?											
Answer Options	1	2	3	4	5	6	7	8	9	10	Rating Average
managing the external reputation of the business	2	3	2	1	2	1	3	5	2	0	5.38
employee relations	1	0	0	2	1	2	4	4	2	6	7.45
attracting staff in the future	4	3	2	2	2	6	1	0	1	0	4.10
staff retention	3	3	2	1	3	4	2	0	2	1	4.76
perception of institutional investors	7	7	3	0	1	0	2	0	0	0	2.45
dealing with unions	5	2	3	1	1	2	0	3	2	2	4.81
employment and pension law issues	1	4	5	2	3	0	2	1	1	1	4.40
none of the above	0	0	0	0	0	0	0	0	0	0	0.00
Other (please specify)											



## QUESTION 9

<b>'IAS 19' could result in an increase in reported pension deficits of £25bn. What impact do you believe the IAS 19 will have on you? (Please tick as</b>		
<b>Answer Options</b>	<b>Response Percent</b>	
Very Significant	13.6%	
Significant	36.4%	
Moderate significance	31.8%	
Minor significance	9.1%	
No significance	9.1%	

## QUESTION 10

<b>What do you think that the overall impact of the 'NEST' auto-enrolment/re-enrolment provisions (Including: Administration, payroll, payroll systems &amp; HR) will have on you? (Please tick as appropriate)</b>		
<b>Answer Options</b>	<b>Response Percent</b>	
Very significant	13.6%	
Significant	18.2%	
Moderate significance	27.3%	
Minor significance	36.4%	
No significance	4.5%	

## About Pension Review Associates

PRA is a wholly-owned subsidiary of Pension Review Advisors Limited (Company Number 6861679). Its registered office and correspondence address is at 2<sup>nd</sup> Floor, 145-157 St John Street, London, EC1V 4PY.

PRA specialises in helping private and public sector organisations to reduce the risks and future liabilities of their occupational pension arrangements. For more information about our services, please go to our website [www.pensionreviewassociates.com](http://www.pensionreviewassociates.com), or contact us at:

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