



## The future of corporate pensions

### Introduction

The global financial crisis has sparked fresh debate about the future of UK pensions. Since the collapse of Lehman Brothers in September 2008, many pension schemes have once again swung from surplus to deficit. According to recent research from Pension Capital Strategies, private-sector UK pension schemes had a funding level of 98% in October 2008, under the standard accounting measure used in company reports, but this had fallen to 79% a year later. Strong performance in equity markets since March 2009 has not been sufficient to fill the gap—if anything, those gains are being more than offset by falling bond spreads and increasing liabilities.

Concerns about the volatility of equity and bond markets have been compounded by rising longevity and uncertainty over inflation and interest rates. This is encouraging many companies to reassess the risks associated with their pension schemes—and evaluate their effectiveness as a recruitment and retention tool.

Even before the crisis, a gradual shift of investment risk from employer to employee had been underway for a number of years. In 2000, there were only seven companies in the FTSE 100 that had closed their defined benefit or final salary schemes (where the benefits the member receives are linked to their earnings) to new entrants. Today, the tables have turned entirely and there are only three—Tesco, Cadbury and Diageo—that still run a defined benefit scheme that is open to new members.

More recently, a growing number of companies have taken this trend one step further with the closure of defined benefit schemes to future accrual. In recent months, Vodafone, Barclays, Whitbread and Fujitsu have all closed schemes to existing employees. Following the precedent set by these high-profile companies, it seems inevitable that more will follow.



Yet despite this shift, companies recognise that pensions remain an essential employee benefit, and a valuable source of competitive differentiation. A generous, well-run pension scheme can serve as a powerful recruitment and retention tool at a time when loyalty is in increasingly scarce supply. Moreover, most companies recognise that they have a duty to educate and empower employees to ensure that they make adequate preparations for retirement. This responsibility goes beyond the provision of financial benefits; it also encompasses advice and guidance to ensure that employees make the right decisions.

This research, which was conducted by the Economist Intelligence Unit and sponsored by Buck Consultants, examines corporate perceptions of a changing pension environment in the UK. While companies are keen to minimise their defined benefit liabilities, they still feel an obligation to at least offer a basic level of retirement provision and guidance.

With an increasing number of companies changing the model of their pension provision, and with the impact of the financial crisis still weighing heavily on scheme funding and risk, what decisions are companies taking, and how do they view the importance of their pension scheme in the context of other priorities?

#### **Key findings from our research include the following:**

- Pension scheme deficits are seen as the biggest challenge facing companies this year. The number of UK companies operating a defined benefit scheme is shrinking constantly, and the majority of respondents expect such a scheme to disappear altogether within the next ten years.
- Limited appetite remains for transferring liabilities to an insurer, but this is likely to be a growing trend post-recession.
- Companies see pension schemes as an important competitive differentiator, yet they worry about the inadequacy of defined contribution plans.
- Most employers expect to maintain their contributions to defined benefit and defined contribution schemes at a steady level, despite the forthcoming introduction of personal accounts.
- As employees are increasingly responsible for investment decisions, employers must put in place a robust framework to provide guidance and advice on these issues.

**Three-quarters of respondents expect that defined benefit pensions will have disappeared within a decade.** UK companies have been reducing their commitment to defined benefit schemes for a number of years, but the financial crisis has accelerated the demise of the final salary benefit. In our survey, 20% of respondents say they still offer a defined benefit pension scheme that is open to new employees, but three-quarters of all respondents predict that defined benefit schemes will no longer exist by 2019. There is no doubt that companies find defined benefit schemes a burden—41% of those surveyed say that dealing with increasing deficits will be the biggest challenge in the coming year in terms of managing their pension schemes.

Already, more UK employees are enrolled in money purchase schemes (also known as defined contribution, where the amount an employee receives when they retire depends on how much they and their employer pays in) than defined benefit schemes, according to official statistics. The emphasis is now shifting from the cancellation of schemes for new members to the closure for future accrual. Just 8% of companies in our survey say that they expect to close their defined benefit scheme to new members in the next three years, whereas 18% say that they plan to close their scheme to future accrual. This reflects broader trends in the market. Already this year, there has been a wave of companies announcing the



closure of their defined benefit schemes to future accrual. Faced with uncertainty over the scale of future liabilities and a volatile market environment, it seems inevitable that many more companies will follow this lead over the next few years.

**There remains limited appetite for transferring liabilities to an insurer, but this is likely to be a growing trend.** The bulk annuity buy-out market, which enables sponsors to transfer some or all of their liabilities to a third-party insurer, has endured its ups and downs over the past few years. In 2006, there was a flurry of activity as a series of new entrants came to market to compete with the traditional buy-out specialists, Prudential and Legal & General. Organisations such as Paternoster and Pension Insurance Corporation, backed by private equity capital, brought new competition and capacity to the market. But since then, the industry's fortunes have been mixed. Although some large deals have been signed, including Prudential's purchase of a pension annuity contract worth £1bn from Cable & Wireless, the market has been slow to take off, and has been hit hard by the financial crisis. Recent signs of a recovery include a deal agreed in December 2009 that will see Cadbury transfer £500m of assets to Pension Insurance Corporation, made up principally of assets to cover the pension liabilities, along with a premium for the pension insurance group.

Few companies among our survey respondents have carried out similar deals, despite the obvious appeal from a financial perspective of removing pension liabilities from the balance sheet. Just 7% say that they have transferred some of their liabilities to a third-party insurer in the past three years, while 6% have transferred all their liabilities. A growing proportion, however, see this as something they may consider in the future. Almost two-fifths say that they expect to transfer some of their liabilities in the next three years, while 10% plan to transfer the entire scheme. This suggests that, although the buy-out market has suffered as a result of the current crisis, it may well pick up again as confidence in insurers is regained and the country emerges from recession.

There are broader concerns, however, about the impact of transferring liabilities on corporate reputation. Almost one-fifth of companies would transfer their liabilities to an insurer but have not because they are afraid of the reputational damage they feel it would do to their brand. This implies that de-risking could leave them less financially stable, spooking their investors. But ridding themselves of changeable liability could offer them the stability they are seeking.

**Companies see pension schemes as an important competitive differentiator, yet they worry about the inadequacy of defined contribution plans.** Asked about the key reasons for providing a pension plan—whether defined benefit or contribution—respondents point to the need to stay competitive with other companies in their sector. This highlights the importance of a generous, well-run pension scheme as a source of differentiation and a tool for recruitment and retention. Companies also recognise that they have a duty to employees—the second most important reason for offering a plan is to fulfil the responsibility to provide for employees' retirement.

Yet there are concerns elsewhere in the survey that companies may be falling short of these objectives. It is interesting to note, for example, that there is very limited support for the achievement of a pension quality mark. Asked about the reasons for providing a pension, not a single respondent highlighted this as an objective. And asked what would influence them to shift from a basic personal accounts arrangement to one that would meet the quality mark, respondents point to financial support from government as the key factor, not reputation or the concerns of employees. However, given the government's budget deficit, financial support is unlikely to be forthcoming.



**Most employers expect to maintain their contributions at a steady level, despite the forthcoming introduction of personal accounts.** The average allocation to defined contribution plans among survey respondents is 9%, and almost two-thirds of respondents say that they will maintain employer contributions at the same level over the next three years. Smaller companies, in particular, are adamant that they will make no change to contributions, with three-quarters indicating that they will hold them steady.

Yet there are clouds on the horizon for employer contributions. The introduction of auto-enrolment in 2012 will require all employees to be enrolled in a personal pension scheme. Contributions must total 8% of the employee's salary, with 3% of this coming from the employer. Personal accounts are one possible pension vehicle, and will be the default in the event that an employer fails to offer any alternative scheme or arrangement to receive the new contributions. There are concerns that some employers will use the introduction of personal accounts as an excuse to reduce contributions to the statutory level. It is therefore heartening to see, for the time being at least, that companies have no plans to pull back from this commitment.

**Guidance for employees must improve alongside a changing pensions environment.** A shift from defined benefit to defined contribution requires a different approach to supporting employee decisions on pensions issues. Given that employees are increasingly responsible for investment decisions and the provision of adequate funds for retirement, companies must ensure that they put in place a robust framework for providing guidance and advice on an ongoing basis—not just when an employee first joins the company. The results highlight that employers feel a responsibility to educate their employees—something that may seem at odds with their actions to date, such as closing defined benefit schemes and the ongoing reduction of employer contributions.

A key issue seems to be that employers focus their efforts on the induction stage and, thereafter, engagement tails off. Asked about the services that their company provides to help employees make decisions about pensions, 63% provide information about the scheme as part of the induction process, but only one-quarter provide regular communication with employees about trends in pensions, and less than one-third provide one-to-one meetings with independent financial advisers. These trends are broadly the same across companies that run defined benefit schemes and those that run defined contribution.



## Conclusion

Market volatility, rising deficits and regulatory intervention are the key concerns associated with running a pension scheme, according to survey respondents. The possibility that benefits may be insufficient for retirees comes some way down the list, despite widespread research to suggest that employees are not doing enough to save adequately. This suggests that funding issues for defined benefit schemes are consuming the lion's share of attention, while not enough is being done to think through the long-term impact on employees of a shift to a defined contribution model.

This is understandable, but as defined contribution replaces defined benefit as the dominant model in UK pensions, companies must think carefully about how to provide the right advisory and financial framework to ensure that employees are well served by their company pension plan. Currently, two-thirds of employers in the survey admit that they need to do more to encourage employees to make the right decisions. This suggests that there is an opportunity for forward-thinking companies to put in place adequate financial advice and potentially differentiate themselves from the pack.

### About this research

*The future of corporate pensions* is an Economist Intelligence Unit executive summary, sponsored by Buck Consultants.

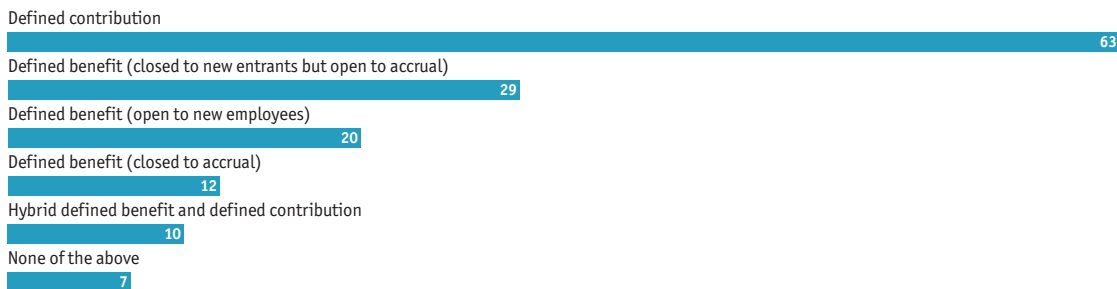
In November 2009, the Economist Intelligence Unit conducted a survey of 251 senior executives from UK companies about their perceptions of the changing pensions environment. Survey respondents represent a wide range of industries, including financial services,

professional services, manufacturing and information technology. Just over half of respondents represent companies with revenues of £250m or greater, and 50% of those surveyed were C-level, or board-level, executives.

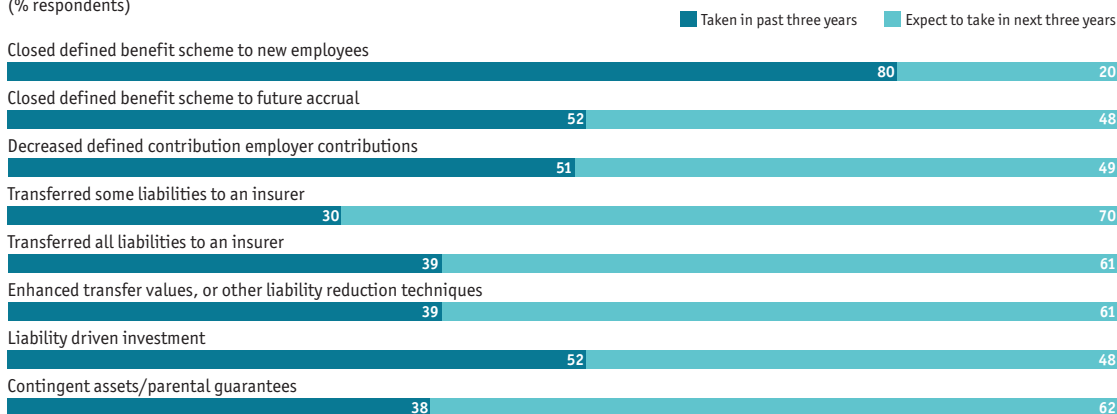
Our editorial team conducted the survey and undertook the analysis. Rob Mitchell wrote the summary and Kim Benjamin was the editor. The findings expressed in this paper do not necessarily reflect the views of the sponsor. Our thanks go to the survey respondents for their time and insight.

# Appendix: Survey results

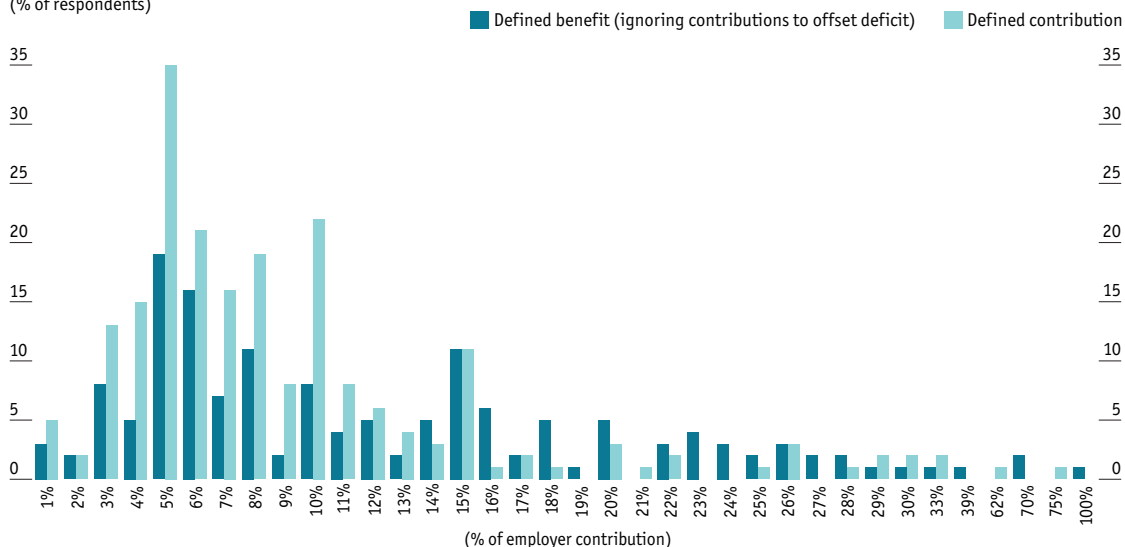
**Which of the following types of pension scheme does your company operate?** Select all that apply.  
(% respondents)



**Which of the following decisions has your company taken in the past three years and which do you expect it to take in the next three years?**  
(% respondents)

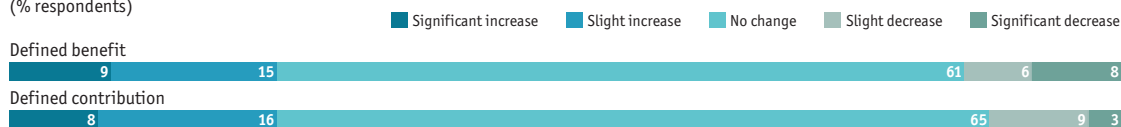


**What is your average current employer contributions to employees' pension schemes?**  
(% of respondents)



**Over the next three years, what change do you expect to make to ongoing employer contributions to your defined benefit and defined contribution pension schemes?**

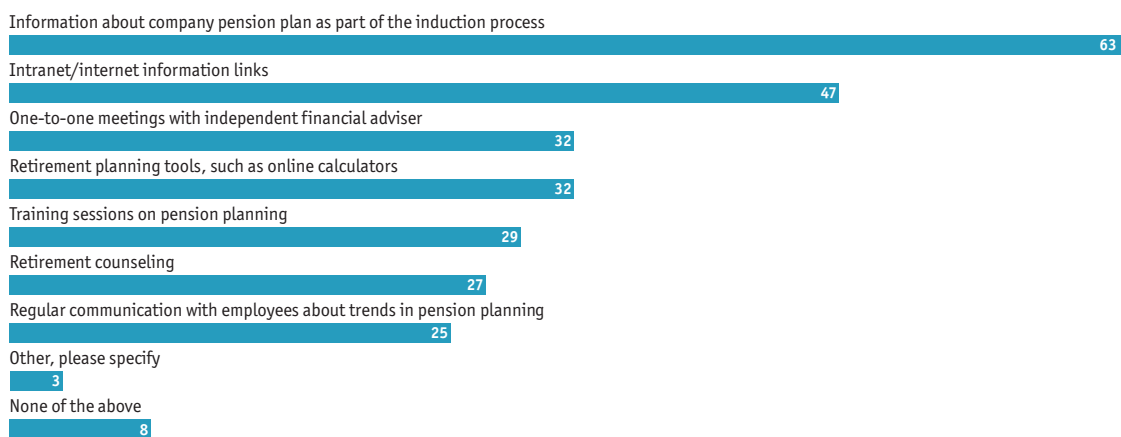
(% respondents)



**Which of the following services does your company provide to employees to help them with decisions about pensions?**

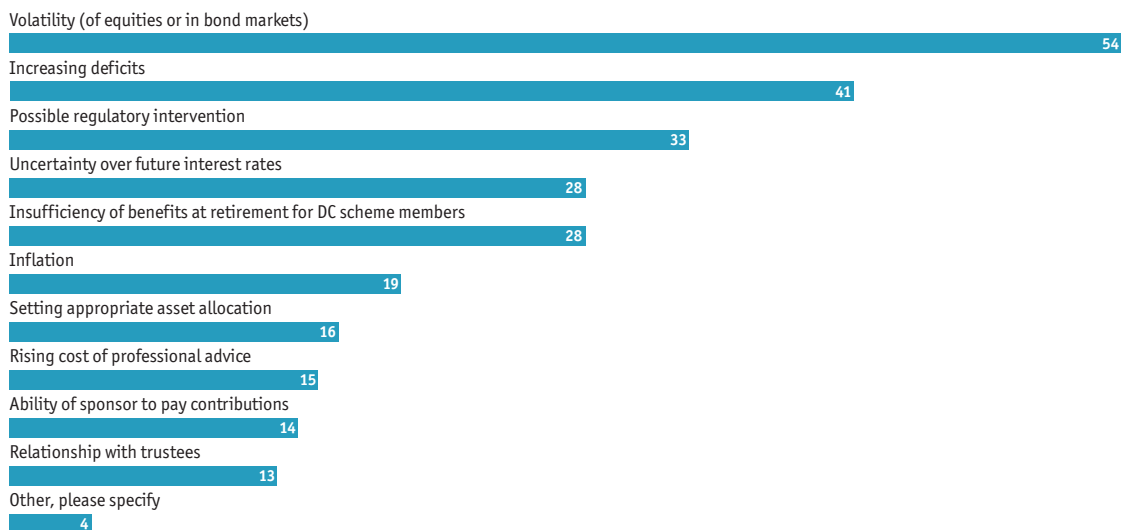
Select all that apply.

(% respondents)



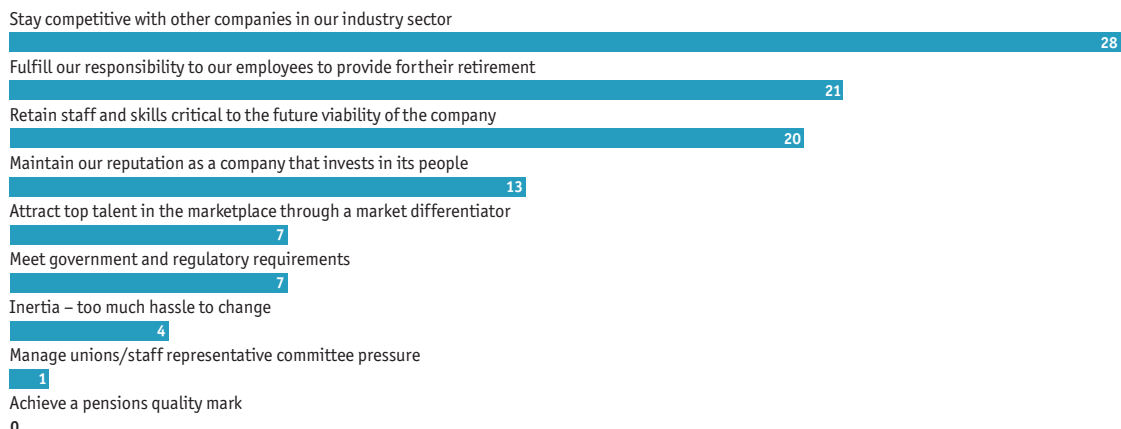
**Over the next year, what do you see as the biggest challenges ahead in managing your pension schemes? Select all that apply.**

(% respondents)



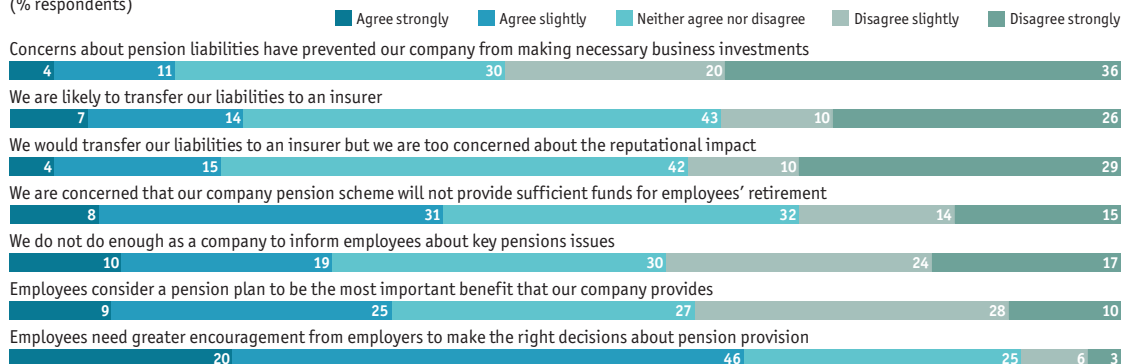
### What is your top reason for offering a pension scheme (either DB or DC) to your employees?

(% respondents)



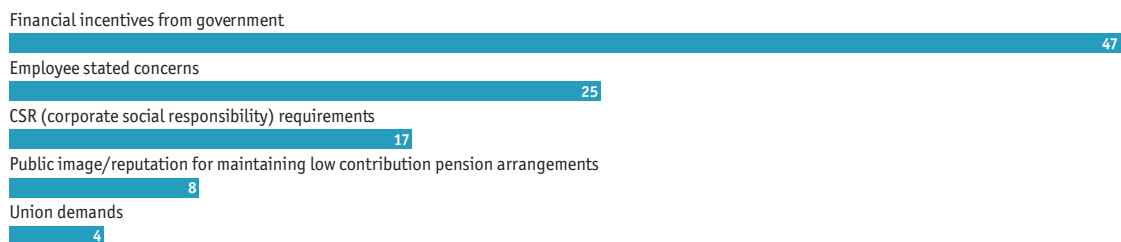
### Please indicate whether you agree or disagree with the following statements.

(% respondents)



### What would influence you to move from a basic personal accounts arrangement to a pensions arrangement that would meet a pensions quality mark?

(% respondents)



### When do you predict that defined benefit schemes will no longer exist?

(% respondents)



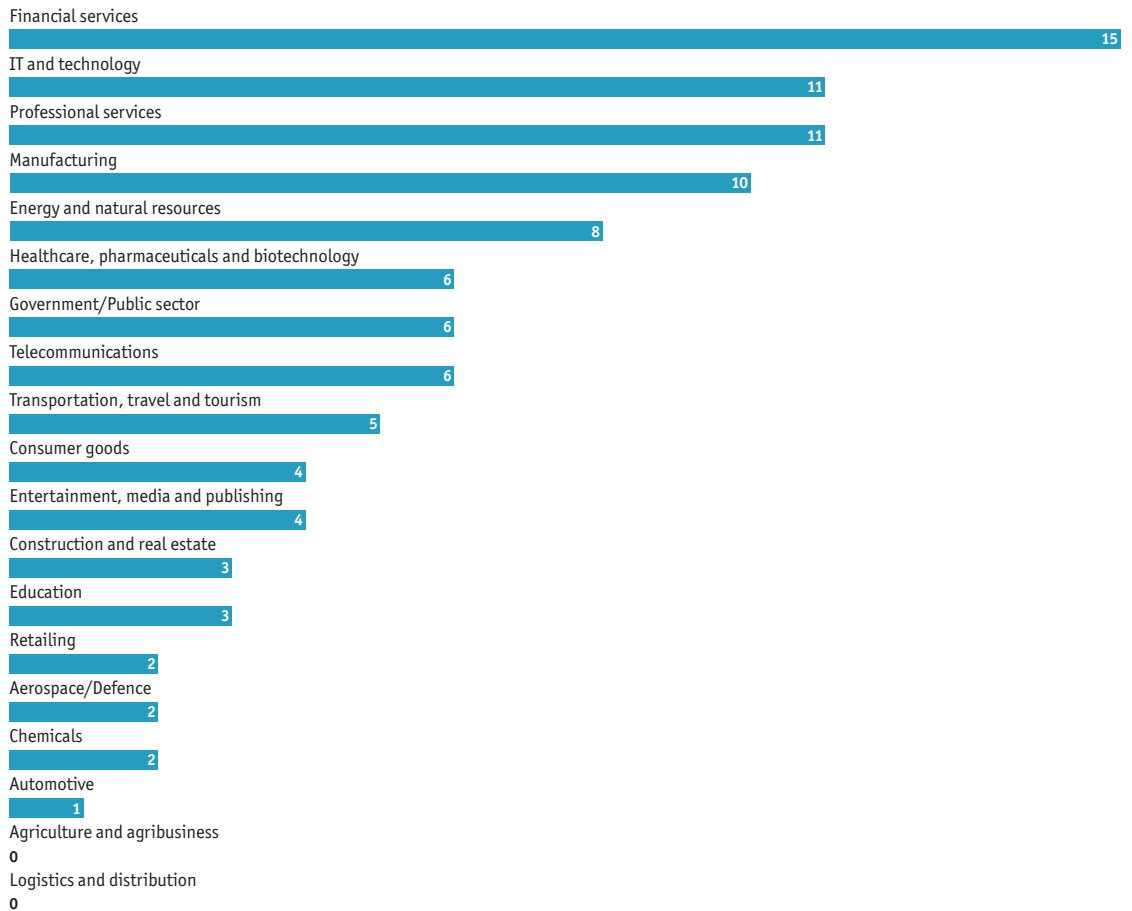
**In which country are you personally based?**

(% respondents)



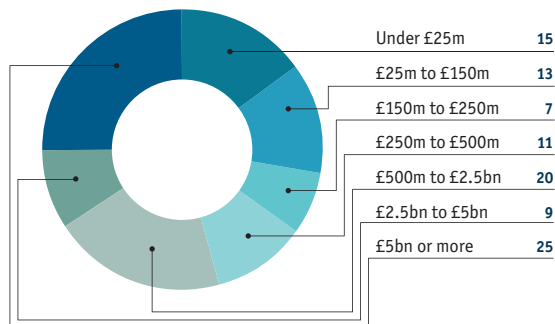
**What is your primary industry?**

(% respondents)



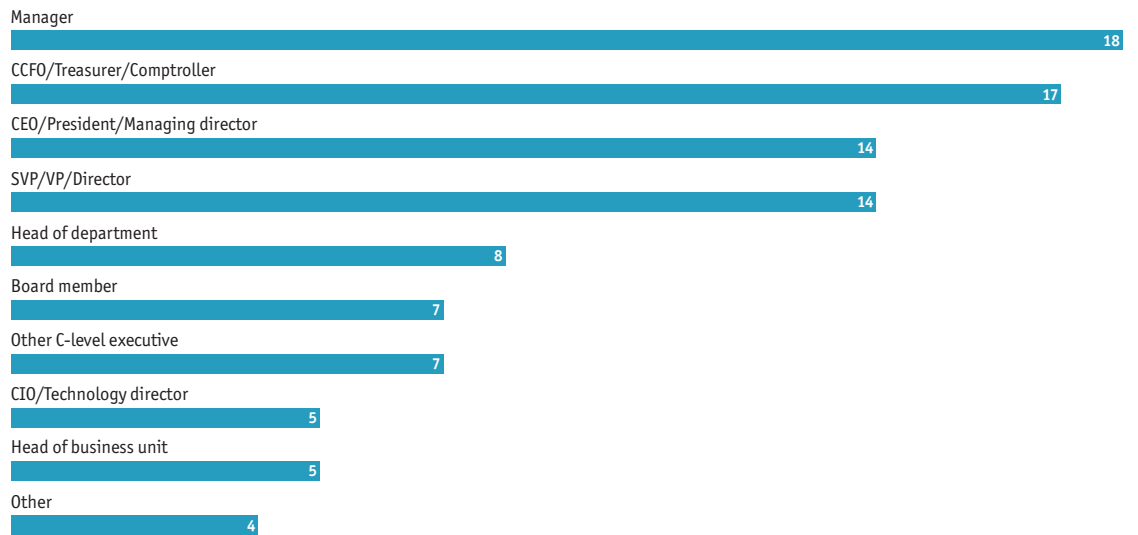
**What are your company's annual global revenues in UK Pounds Sterling?**

(% respondents)



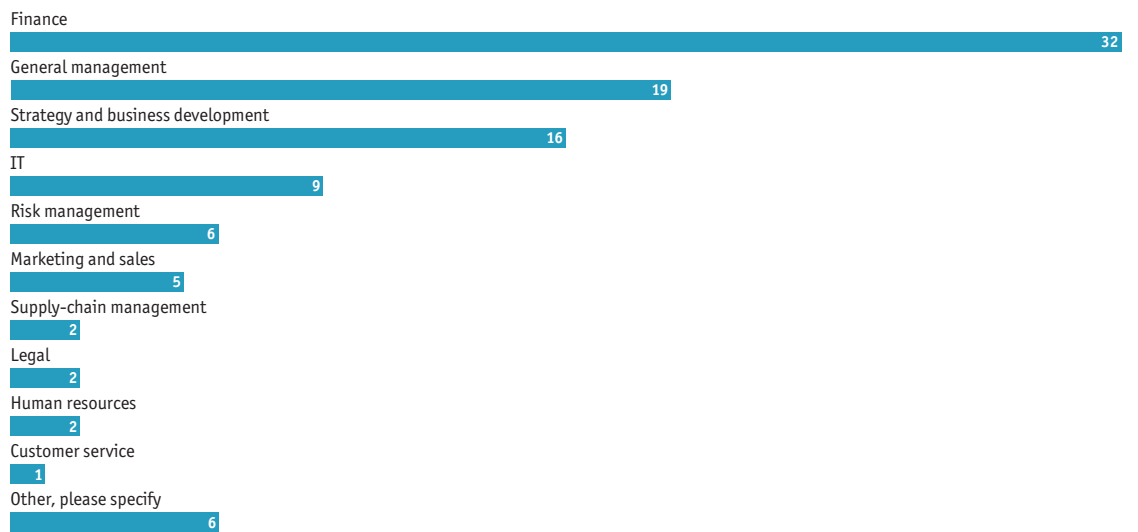
**What is your title?**

(% respondents)



**What is your main functional role?**

(% respondents)



Whilst every effort has been taken to verify the accuracy of this information, neither The Economist Intelligence Unit Ltd. nor the sponsor of this report can accept any responsibility or liability for reliance by any person on this white paper or any of the information, opinions or conclusions set out in the white paper.

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