Editorial: Protecting pensions

Prophylactics have had a wider press in recent years. Safe sex allows both pleasure and protection, and the problems of disease are clearly diminished. If only the same were true in pensions.

Safer pensions are clearly a 'good thing'. We need them both because there have been inexorable political pressures and because scheme members (or at least some scheme members) have had a pretty tough time in recent years.

Many of these tragic stories however are as a consequence of the very legislation that in 1995 was introduced (post-Maxwell) to protect scheme members, legislation that has had a counter-productive effect. The latest legislation, the Pensions Act 2004, just nine years after the first major reform, and following two interim further reforms in 1999 and 2000, is now heading our way. And, like its predecessors, it may be based on the fallacy that defined benefit schemes need funding regulations.

For over a hundred years defined benefits schemes had no minimum funding obligations. Such schemes, somewhat different from current schemes, but not that different, were established from the end of the 19th century to replace the extended family system of old age support which was destroyed by the industrial revolution. If you worked for a canal company, a cotton factory, a coal mine or a steel works (and certainly the civil service), you might expect (if you were lucky) a pension when you retired. It was not exactly a pension — it was what was called superannuation. It manifested itself in a reduced salary payable until death. It

was an indication from the employer (not a promise, and often expressed in terms to be *ex gratia*) that it would be paid. But it depended crucially on what is known these days as the employer's covenant. If the employer ceased trading between the expectation being indicated and the death of the employee, the employee would often suffer the loss of the pension. Many employees had their expectations disappointed as the cycle of capitalism destroyed old companies (though built new ones, with new schemes).

By 1921, the tax authorities allowed employers to set aside funds to try to secure the expectations. The position of employees was therefore improved — the expectation was backed by not only the rather insecure employer's covenant, but also a fund of money. But neither was guaranteed. As mentioned the company could fail; and the fund could fall in value, be badly invested, be unexpectedly taxed or subject to many other factors which would affect its value. Indeed, until 1997 there was no requirement whatsoever for a minimum amount of money in any fund established, although in practice relatively few employees were adversely affected, and indeed very few had their pension totally lost. It helped that employers' obligations could be mitigated by inflation and by lack of vesting requirements, but nonetheless comfort in the funds was high.

The lack of a regulatory funding obligation caused some surprise to the Goode Committee, the investigation that was commissioned to investigate the state of pensions law following the Maxwell episode. But the irony is that if the later

minimum funding requirements (MFRs) had been in place when Maxwell was in charge, the chances are simply that he would have allegedly misapplied more money. And the other irony is that for over 80 years the non-funding requirements had worked much better and wreaked less harm than after the MFR was introduced. In other words it was understood then that it is not actually possible, outside the state sector (and sometimes not even then), to give funding guarantees to pension scheme members. This may be an unattractive position, but the alternative is worse.

Meanwhile the attempts by the legislators to enact the impossible continue. The MFR, derided for forcing scheme trustees to adopt an investment policy which in their judicious consideration they knew was wrong, is being dismantled. It is being replaced, possibly not for very long, by the scheme-specific funding requirement known as the statutory funding objective (SFO) introduced under the Pensions Act/Bill 2004. The acronym SFO has other resonances for UK pensions professionals (it was the arm of the Inland Revenue responsible for supervision of pension schemes by the Superannuation Funds Office, for many years). Under the SFO — that is the proposed SFO — the actuary needs to certify the calculation of the scheme's 'technical provisions', ie the value placed on the pension liabilities. The details have not yet been published nor, in particular, what methods and assumptions are to be used in the calculations — and there continues to be the need for regular valuations and schedules of contributions, as well as a 'Statement of Funding Principles' (another statement) agreed by employers and trustees, with a recovery plan in place if the SFO is not met. Where agreement cannot be reached, the trustees have powers (with

employer consent) to modify the benefits for future accrual.

As part of the path to simplification it follows something of a dead end. The point of the increasingly forgotten Pickering principles, published as a Department of Work and Pensions (DWP) discussion document in 2002, was to leave more matters in the hands of trustees and their discretions, and to avoid the heavy-handed and counter-productive intrusive and inappropriate legislation. The way in which the simplified proposals have been designed suggests that the legislation is longer, more complex, less facilitative and more bedevilled with minutiae than the existing system — and still imposes funding strategies that are inappropriate for a normally-managed pension fund. The new structure looks to be in danger of being more rather than less complex. And this time the reason may be not the fault of the DWP as much as the Treasury, which failed horribly to realise the impact of the terms of the European Pensions Directive, which has to take effect by September 2005 at the latest in the UK. The SFO requires schemes to have 'sufficient and appropriate' assets to meet their 'technical provisions' (the term used in the Directive to refer to scheme liabilities). And that reflects the requirement in the Directive which requires defined benefit schemes to be 'fully funded at all times'. The Treasury in late 2003 assured the industry that this meant simply that schemes could include the future contributions expected from an employer (back to the employer's covenant again). The DWP, reading the phrase in the cold light of day, now suspects it actually means what it says on the tin. And meanwhile the first draft (and it always gets longer during the legislative process) requires 12 sections plus an unknown number of regulations — compared with the former MFR's

five sections plus 29 regulations. No prizes for guessing the new stuff will be more than the old stuff. In pensions, it seems, less is very definitely more.

The new funding requirements are linked closely with the pensions protection fund (PPF), whose premiums are just as closely linked to the health of the funding of the schemes it is intended to protect. But even the *Financial Times* noted that there is no back-stop to the guarantee offered by the PPF, and suggested that scheme members will be misled if they think their pensions are guaranteed. The problems of the drafting of the PPF have been explored in depth elsewhere — but the issues of moral hazard (that people will plot to exploit the benefits offered by the fund) have yet to be worked out in practice. There will be people even now plotting to give themselves benefits they or their company cannot afford or deciding not yet to wind up the scheme that is in terminal decline so as to gain benefits from the fund. And there are deep criticisms of the PPF (and its as yet unknown methods of calculating premiums) and of the complexity of the industry's regulator, with its human-rights-designed checks and balances (smaller board, complex review procedures and special appeal arrangements) which do nothing for the dream of less and simpler regulation.

It is inevitable that in the long run, since they do not underpin the market mechanics of defined benefit arrangements (and there is no obligation to provide such arrangements) that the new protective systems will fail. It is just not possible to protect pension 'rights' gained, earned or awarded over 60 years against an employer's insolvency and collapses in the market (bond as well as equity), interest rates and falls, and mortality and longevity trends at a price which commerce can afford, or perhaps

even at any price. There is no long-lasting model for it, and history shows that few insurers reach their centenary. There is no pleasure in such a statement; but yet another failure of the system will do little to restore confidence in the prudence of buying protection against living too long. What no government seems prepared to be able to countenance is to tell people the facts of life — that there are risks in defined benefit schemes, that they can be limited and constrained but not guaranteed, but that on balance they are much better and have historically delivered much more, and to more people, than any of the other systems.

It is probable that within the next decade an aggrieved scheme member will issue court proceedings against the UK government when a pension scheme fails, the PPF in turn fails to deliver the protection it led citizens to expect, and the government is accused under the principles expressed in the *Francovich* case [1991] ECR I-5357, [1993] 2 CMLR 66, (in which the European Court of Justice for the first time fully addressed the question of state liability for breach of EU law) that it did not implement the European Pensions Directive and its requirement that schemes are fully funded at all times. Meanwhile a reducing number of defined benefit schemes are likely to pay an increasing levy to the PPF, and in due course the legislature may have to come to terms with the facts of life that only governments can give the kind of guarantee that it wishes the private sector to offer.

Many of the changes in the legislation will offer useful reforms. Indeed even the flawed design of the PPF may operate to provide a semi-statutory, semi-guarantee far and away superior to that offered by defined contribution arrangements, even if the cost begins to rise. The chances are high that there will be an increasing

demand for such schemes from the workforce as they understand the benefits, and may look to do deals with employers to have a defined benefit scheme at perhaps a lower accrual rate and a later retirement age. The vast majority of scheme members seek security and are often prepared to sacrifice benefit levels to get it.

Over the next 20 years defined benefit schemes may enjoy a modest rebirth. The reforms offered by the current UK legislation are limited, inadequate, often

counter-productive and inelegantly drafted. But if they are bad enough it may be that there is now an appetite for a holistic review of the UK pension system, once the glory of the developed world and now a sad apology for a pension system, which may offer hope to an increasingly greying population. But we must make sure not to leave it for too long.

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