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Sting in the Tail for DC Schemes?

In recent years a significant number of companies have switched from defined benefit to defined contribution pension provision in order to reduce their pension risks and reduce costs. However, there may be a potential unfunded contingent liability being stored up for these companies that has not yet come within the corporate radar.

Background

During the recessions of the eighties and early nineties many large UK companies undertook wide ranging restructuring exercises to improve efficiencies and remain competitive. This was particularly the case for those companies in the manufacturing sector who felt the economic downturn most strongly.

These restructuring exercises typically involved offering generous early retirement terms to older employees as a way of encouraging these employees to accept redundancy.

Typically, this may have meant that employees over the age of 50 were eligible to receive an immediate pension that would not be reduced to reflect early payment, possibly also allowing for any service forgone up to normal retirement age.

BAE undertook a major restructuring exercise in 1992 following its profit warning in late 1991. The company cut 47% of its workforce, with 60,000 out of 127,000 staff being made redundant.

Companies were able to use their generous defined benefit schemes as a way of financing the redundancy benefits, albeit with an uplift to the standard benefit in most cases. As a result DB schemes were used as a way of saving up for redundancy costs in a tax favoured environment and when a company wanted to reduce the head count amongst older employees it gave the employees unreduced early retirement.

These uplifts would have been financed out of the surpluses that existed in many DB schemes at that time and there would have been no immediate cash call on the company. While significant surpluses no longer exist for most DB Schemes it may be possible to spread these costs over a period of up to 10 years under the new Scheme Specific Funding Regime.

Age Discrimination Legislation

New Age Discrimination legislation was introduced in the UK

with effect from 1st December 2006 in respect of pension schemes to comply with the European Union's anti-discrimination requirements prohibiting discrimination on the grounds of age.

The legislation permits the use of a default normal retirement age and therefore, whilst it may be possible to force all employees to retire at age 65, it is not possible for companies to force younger employees to retire. Incentives are therefore required if these employees are to be encouraged to leave the workforce as part of a corporate restructuring.

The Age Discrimination legislation exempts augmentation payments provided through company pension schemes in the event of redundancy. Consequently it is possible for any pension incentives provided to target particular age groups, e.g. between the ages of 50 and 65.

The Problem

Employees covered by a DC company pension scheme may be unable to afford to retire early and employers are unable to force them to do so due to Age Discrimination legislation.

Therefore, to restructure their workforce, companies may have to pay off older workers (perhaps by topping up their DC pots) in order to encourage them to retire. In this way companies are effectively building up an un-funded future contingent liability in relation to future termination costs for employees.

The Switch from DB to DC

It is a well recorded fact that the pensions landscape has changed significantly over recent years with the gradual switch from DB to DC occupational pension provision occurring in response to the increasing risks and costs associated with more traditional DB arrangements.

According to research by the Office for National Statistics the percentage of private sector employees that are members of defined benefit pension arrangements has fallen from 46% in 1997 to 35% in 2005.

Defined contribution pension schemes do not have to be less generous than their defined benefit counterparts. However, when implementing a change to defined contribution provision companies have typically looked to control costs and frequently the new arrangement that has been put in place has provided significantly less generous benefits. The NAPF's 2005 Annual Survey showed that on

average employer contribution rates were around 16% in open defined benefit schemes compared with 6% in defined contribution schemes.

Typical DB Early Retirement Benefits vs Typical DC Early Retirement Benefits

A typical defined benefit pension scheme will provide benefits on early retirement of 1/60ths of final pensionable salary for each year of service actuarially reduced to reflect the longer period of time that the pension may be in payment. This may lead to a reduction factor of 4% simple per annum for each year the member retires prior to their normal retirement date.

An average member with 12 years of service and a final pensionable salary of £20,000 may therefore expect to receive a pension of £3,200 per annum from age 60, assuming a normal retirement age of 65.

If an uplift to this benefit were granted so as to allow the pension to be taken "unreduced" with credit for service up to age 65 this would result in a pension payable of £5,700 per annum from age 60.

In contrast, a member of a defined contribution arrangement would be entitled to a pension based on contributions paid up until retirement, rolled up with investment returns and converted into an annuity using current rates. For the same example member this may lead to a pension at age 60 of around £1,050 per annum assuming total contributions of 10% (6% by the company and 4% by the member) were paid over a period of twelve years.

Clearly the difference in benefit level is significant and the cost of addressing this difference would be high – approximately £85,000 assuming a one off uplift to the member's defined contribution pot could be paid. However, as this would contravene Inland Revenue Limits relating to the maximum contributions that can be paid subject to tax relief the member would be subject to a higher tax charge on the benefits granted.

Compounding this effect for an entire workforce, redundancies of 100 individuals would lead to a cost of the order of £8.5 million (before any adjustment for the impact of tax). Further, this cost would be an immediate cash call on the company in contrast to either being met by existing surplus funds or being spread over a number of years in accordance with Scheme Specific Funding.

Possible Solution?

To address the contingent redundancy liability that is covertly accruing, companies may wish to pre-fund these liabilities. An investment vehicle would be needed such that the pension augmentations grantable in respect of redundancies for older employees would accumulate under a tax efficient umbrella.

This could, in effect, be a DB pension scheme but with the benefit payable on the discretion of the company only. Hence, it may be possible to balance the cost of these benefits between the employer and the employee as was typically the case in a traditional DB pension scheme.

Will we see a return to DB pension provision to meet the desire by companies to retain the flexibility to restructure their workforce at a reasonable cost whilst allowing employees the financial freedom to retire early?

Where can I get further information?

This briefing note is provided for general information only and should not be relied upon as advice on your specific circumstances. For specific advice, please get in touch with your usual Punter Southall Transaction Services contact.

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