A difficult journey

Pensions Age explores how the UK workplace pensions system has evolved from one where DB retirement provision was king, to DC taking the throne as the dominant form of retirement

The UK pensions industry today is virtually unrecognisable from just a few decades ago. The industry is often accused of being slow to change, but it has managed to almost completely transform from a DB-dominant, paternalistic system in the 1980s, with DC as the poor relation, to one of DC growth flourishing and individual responsibilities reigning supreme and DB in terminal decline for all but the public sector. So how did we get here?

Setting the scene

Forty years ago, DB pensions were the norm, "but not the ones we know today", Mercer principal, innovation, policy and research, Glyn Bradley says. "Back then employers had a very limited commitment to their pension schemes – benefits were funded on a 'best endeavours' rather than guaranteed basis, and employers had considerable discretion over how money was put in."

Aries Insight director Ian Neale describes this as the 'bad old days' where if you left your job you lost all rights to a pension connected with that job. "That changed from 1975, although you still needed five years' service to qualify at all (and initially be over 26 when leaving). From April 1988 that came down to two

years," he says.

The 1980s saw the government concerned that DB schemes were being overfunded in order to avoid paying tax. "To avoid notional surpluses being tax inefficient, employers used them to provide benefit improvements, or to justify 'contribution holidays,'" Bradley states.

The advent of personal pensions

The 1986 Financial Services Act had arguably the biggest impact on the UK pensions system, generating personal pensions for people to buy. This is when the term 'mis-selling' entered the lexicon, Neale says, "as members were encouraged to transfer out of final salary schemes; notwithstanding government propaganda urging them to do just that, accompanied by official inducements".

Barber judgement

The Barber judgement of 17 May 1990 remains the watershed in equal pensions for men and women. The consequences of this ruling are still being dealt with 27 years later, as the inequality and complexity of the state scheme was baked into many DB schemes' rules, particularly through GMPs. "Many schemes think they've dealt with equalisation only to find their benefit announcements called into question many years later," Bradley says.

The Maxwell scandal

Despite being almost 30 years ago, the Maxwell scandal still resonates in the collective consciousness, contributing to public mistrust of retirement saving. Robert Maxwell controlled a large part of the UK publishing industry, but after he died in late 1991 it was found Maxwell had plundered hundreds of millions of pounds from his companies' pension schemes. This was a wake-up call for government to tackle the lax controls surrounding occupational pensions.

The 1995 Pensions Act

The result of the Maxwell scandal was the 1995 Pensions Act. This set up a regulator, Opra; imposed a massive increase in trustees' responsibilities; created a new contracting-out regime; and introduced a new obligation to fund index-linked increases to pensions in payment, having previously been voluntary on the part of sponsoring employers.

It was also made much harder to justify the return of any surplus to the employer, and for the employer to reduce benefits already built up.

The benefits offered by DB schemes became hardwired in this legislation, the PLSA notes, which while providing valuable protection for existing members, "is one of a number of factors which led inexorably to the decline of private sector DB".

The 1995 Pensions Act came into force in April 1997.

Abolition of ACT relief

In 1997, then-Chancellor Gordon Brown removed Advanced Corporation Tax relief on share dividends. "The financial penalty for pension funds was significant," Neale says, "some say as much as £100 million over the long term."

Contracting-out

Having previously been frozen, employers then had to fund revaluation over the period of deferment. Different rules applied to the GMP and non-GMP elements (most DB schemes were contracted-out). "For GMPs, there were three options; many employers preferred the most certain, fixed rate revaluation. This turned out to be more costly than they might have expected. Pre-1988 leavers, for example, enjoy 8.5 per cent pa revaluation up to GMP payment age (65 for males; 60 for females)," Neale explains.

1995 saw a new way emerge with 'section 9(2B) right's, stopping GMPs accruing and instead replacing them with a "reference scheme test" based on 80ths of final or revalued career average salary.

In 2016 contracting-out ceased altogether. GMPs are still proving to be a headache for schemes today, though ,as DB schemes attempt to reconcile their GMP records with those held by HMRC.

Stakeholder pensions

By the end of the nineties the reputation of the pensions industry had reached a nadir, according to Neale. Accompanying a huge compensation bill for mis-selling, pressure to cut charges led to the creation of stakeholder pensions, money purchase pensions which complied with a new set of standards, including a 1 per cent charge cap. "As an initiative to promote private pension saving it failed, largely because the government lacked the courage to make membership – or employer contributions – compulsory," Neale explains.

Red tape

While 1992 saw regulation make DB pensions shift from being a voluntary employer commitment to one with a price tag to walk away from, through the introduction of a statutory debt for employers winding up a pension scheme, it was the early noughties that saw a mass of red tape for those responsible for providing pension provision.

From June 2003, a solvent employer

winding up a pension scheme is now liable to a full buyout debt, with limited exceptions. "Pension promises are no longer 'best endeavours' but have been transformed into binding legal commitments, and in effect employers are now underwriting more or less guaranteed commitments but within a looser regulatory regime," Bradley explains, driving the private sector to accelerate the closure of DB schemes.

In 2005, money purchase benefits no longer had to be provided in the form of an indexed annuity, and the first valuations under the Pension Act 2004's statutory funding regime occured, requiring trustees to negotiate prudent technical provisions and submit their recovery plans to the regulator. DB accrual indexation maximum was cut to 2.5 per cent per annum at this time, "but for employers this is too little too late and they continue to turn their backs on DB", Bradley says.

The Pensions Regulator and the Pension Protection Fund

In the wake of high-profile failures, the Pension Protection Fund was set up in 2005 to protect employees if their employer goes bust and its pension scheme can no longer afford to pay the promised pension. This underlined not only the fact that 'gold-plated' schemes could fail but that the regulator and industry were sufficiently concerned to take proactive steps, the PLSA says.

This time also saw the introduction of The Pensions Regulator, replacing the previous body, Opra. "Despite the previous strengthening of legislation, an authority was now required to oversee DB scheme activities," MNOPF and Ensign pension policy director Ivan Laws says.

A Day

'A Day' – 6 April 2006 - was an attempt by government to simplify the rules that govern pensions by introducing a single set of new rules. This marked the start of the current pensions tax regime, applying to all types of pension arrangement, with generous protections for existing rights and high allowances for annual and lifetime saving.

According to Bradley, 'simplification' was short-lived as the savings allowances have been cut back repeatedly since implementation, while the cash transfer sums effectively extend transfer value rights to members with three months' service.

Automatic enrolment

Ten long years in the waiting; 2012 saw auto-enrolment commence, which requires employers to automatically enrol eligible staff into a workplace pension scheme and pay contributions into their employees' schemes. Eligible jobholders will still not have all been enrolled until April 2019. So far nine million people have been auto-enrolled into a workplace pension.

"For the first time in UK pensions history, employers are being required to contribute to pensions for employees (unless the worker opts out)," Neale says.

A consequence of auto-enrolment is the boom in master trusts, enabling employers to pass on the responsibility of managing a trust-based DC scheme by enrolling their staff into a master trust.

Pension freedoms

Another contender for 'biggest impact on the UK pensions system' is the freedom and choice reforms, announced by then-Chancellor George Osborne in March 2014. These reforms removed the effective requirement for an individual to purchase an annuity with their retirement savings.

"Among other consequences of 'flexible access' (not an unmixed blessing), is it accelerated member demand for transfers out of DB schemes to take advantage of the new options to 'cash out,'" Neale says.

While the pension freedoms were met with joy by the public, an unintended negative consequence of the reforms has been the rise in scammers trying to con people out of their retirement funds.

Where are we now?

After all the twisting and turning of retirement saving over the decades, we are left with an occupational pensions system where DC has emerged as the dominant savings vehicle for workers and DB schemes are closing fast, being passed over to insurers in the form of buyouts as employers and trustees struggle under the weight of legislation and deficits.

Bradley notes that DB is "far more regulated and protected than it ever was in the past, but at the cost of the almost complete closure of such schemes, at least in the private sector".

Laws agrees, stating that: "The DC world is now the only world in pensions terms and the legislation is all pointing towards strengthening governance and putting protections in place so that members have a real chance of an adequate retirement."

Some of this protection comes in the form of two increasingly-powerful regulators – the Financial Conduct Authority and The Pensions Regulator – imposing ever-more costly compliance requirements at the same time as they bear down on charges, Neale says.

These changes over the years have seen responsibility for company pensions transferred from employers to trustees, and in the case of DC, the risk of inadequate funds at retirement passed to the individual. Upcoming innovations, such as the pensions dashboard, should help people become more engaged, or at least more aware of their pension pots and how much they need to save.

"Individualism has replaced paternalism but it remains to be seen how well members can meet the challenges of managing their retirement income without help from their employers and scheme providers," Bradley warns.

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