On thin ice

With woefully inadequate private sector DC contributions and increasingly unaffordable unfunded public sector provision, is the UK's pension system teetering on the brink of disaster?

Summary
• The low bar set by soft compulsion and rock-bottom minimum contribution levels has left millions with inadequate pension savings.
• Raising contributions is vital, but barriers remain to reform, not least in the Treasury.
• Unfunded public sector pensions are draining government finances.
• The LGPS continues to be a success story, proving that funded public sector DB schemes are sustainable in the long term.

Optimism is a scarcely-found commodity in UK pensions circles these days. It has been replaced by a stoicism born from a knowledge of what is required to improve retirement provision and an acceptance that it will all be implemented far too slowly – if at all.

Ten years on from the heady days that followed the introduction of auto-enrolment into the UK's retirement savings system, it is now clear, as defined benefit (DB) schemes slowly fade out of the picture, that the low bar set by soft compulsion and rock-bottom minimum contribution levels has left millions with inadequate pension savings. At the same time, the sustainability of current public sector pension funds continues to be questioned, as politicians struggle to balance the books in a post-Covid, highly indebted, fiscal environment.

Former pensions minister and current LCP partner, Steve Webb, summed up the situation in June when speaking at a Work and Pensions Committee hearing, calling the UK

pensions system a "slow-motion car crash".

Webb warned that there was a generation of people in the "middle" who are in their forties, who missed out on DB in large measures, and who have been auto-enrolled into schemes with minimum contribution rates.

"We are roughly at peak DB at the moment," he told the committee. "For people retiring this year, it is about as good as it is going to get in the private sector. Every year thereafter we think that the real value of people at retirement from DB is dropping and dropping. In 20 years, it will be vanishingly small. The DB tide is going out; the DC cavalry is nowhere to be seen."

It is hard to accuse Webb of hyperbolic language. In a survey, B&CE recently found that 54 per cent of households and 57 per cent of individuals are not saving enough to meet the replacement rates set by the Pension Commission in the mid-2000s. While the Association of Consulting Actuaries (ACA) has discovered that over 2021, the number of employers seeing a material increase in auto-enrolment cessation rates doubled from one in 10, to one in five because of the pandemic.

PLSA director of policy and advocacy, Nigel Peaple, says that the association has long argued that current contribution levels are not likely to give people the level of retirement income they expect or need. "In the PLSA's 2016 report on retirement income adequacy, we showed that if the level of automatic-enrolment contributions is not raised, only about half of people eligible for workplace pensions will achieve the 2005 Pension Commission's target retirement income replacement rates — and only 3 per cent if, as typical today, people have defined contribution, rather than defined benefit, pension savings."

Arriving at the wrong time

As Aegon head of pensions, Kate Smith, points out, this impending crisis has come around at precisely the wrong time. With high inflation tightening many family budgets, the challenge of improving pensions contributions into DC schemes has become even harder.

"Pre-auto-enrolment, the number of employees saving in a workplace pension was in severe decline," she says. "The stakeholder pension rules, introduced in 2001, did very little to address the pension savings gap, as employers (with five or more employees) only had to make available a workplace pension, but unlike auto-enrolment they didn't have to pay into it.

"This 'lost generation' of pension savers could now find themselves with inadequate retirement savings and now face the huge challenge of catching up on years' worth of contributions to plug the gap. The cost-of-living squeeze has made this increasingly challenging."

What can be done?

In order to tackle the problem, Smith says that implementing the recommendations of the 2017 Auto-Enrolment Review would be a start.

"Reducing the minimum age from 22 to 18 will at least give employees potentially four more years to save and benefit from an employer contribution, albeit probably based on a low salary," she says. "Removing the salary offset, so contributions are calculated from the first pound will also mean pension contributions are based on a greater proportion of salary, so both employers and employees are paying higher contributions. But these are tweaks and more radical thinking is needed. Total auto-enrolment contributions need to be gradually phased in to 12 per cent of salary equally shared between employers and employees. This is likely to take a number of years to implement."

In the short term, therefore, Smith suggests improving member engagement via innovative nudge techniques and support. "Engaging people with their pension will mean they can find out how much they need to save for retirement and adjust contributions accordingly."

The PLSA has similar proposals. "Now is the right time for the government to commit to levelling up pensions, gradually, over the next decade, in three affordable steps," says Peaple.

"First, the government should implement its plans of extending pension savings to the over-18s, and commence pension saving on each pound of savings, from the mid-2020s. Then around the end of the decade, pensions should be 'levelled up' so that employers match employee contributions. This would mean 10 per cent of pay goes into pensions but would not require extra contributions by workers. Finally, when affordable, in the early 2030s, contributions should be increased to 12 per cent."

The Investing and Saving Alliance head of retirement, Renny Biggins, says that quickly increasing minimum wage contributions on what he calls 'The Sandwich Generation' cited by Webb, could mitigate a crisis to some extent, but its effect is not likely to have a significant impact on the older group within that cohort.

"We need to increase awareness of

what retirement outcomes people are expecting based on their existing trajectory and what impact any changes will have on that outcome, so people can plan accordingly. The pensions dashboards will help to raise awareness to a degree and MoneyHelper provides good support to those who use the service. In addition, we have government working on consumers being given a mid-life financial and wellbeing MOT.

"But unless changes happen at a far quicker pace, with greater consumer engagement, then many of these initiatives will be too little too late for this group."

The small problem of the Treasury

Moving matters at speed, is not, however, an easy task at the best of times in pensions. Today, with a cash-strapped government, the undertaking becomes even more daunting.

As Webb told the committee in June, the Treasury is a stumbling block to further pensions reform. "If you want to crack pensions in this country, you don't have another commission of people of good will who are not politicians; you hold the Treasury's feet to the fire," he said.

Webb went on to say that if he had only one recommendation for the committee, then it would be to join forces with the Treasury Committee and put maximum pressure on the Treasury to accept the need for pension tax relief. "The reason they are blocking the auto-enrolment review is tax relief," he said. "You might think that the Treasury wants people to save more for their retirement, but it doesn't, because every extra £1 in pension is £1 less in tax.

"We need to tackle the Treasury. The politicians will not hand over decisions to a commission. The politicians have got to take the decision themselves."

In the public eye

At the same time as being accused of displaying reluctance to encourage further pension saving, the Treasury is also suspected to be unsympathetic to the cost of unfunded public sector schemes.

According to the Office for Budget Responsibility, the Treasury is expected to spend £2.5 billion on unfunded public sector pensions in 2022-2023 (reflecting £49.7 billion of total payments less £47.2 billion of contributions), with the figure rising to £4.8 billion the following year. And the Treasury's *Whole of Government Accounts* now show that the value of all unfunded public service pension promises – made up to 2067 – was £2.19 trillion in 2019-20.

Figures such as these, no doubt, prompted Pensions Minister, Guy Opperman, to go on record recently with his view that public sector DB pensions are unsustainable and need to be overhauled.

Barnett Waddingham partner, Barry McKay, says that some tweaks to unfunded schemes may be enough to alleviate fears of runaway public sector pensions.

"The unfunded public sector schemes do have a cost control mechanism in place, which should help control with stability of cost and hence sustainability," he says. "However, only certain factors are included in the mechanism and so costs are still subject to other factors that can cause material changes."

One alteration that could help is to the SCAPE discount rate. The current consultation on the SCAPE rate has come in response to an increase in costs. It is hoped that a change to the rate could prevent large future increases, providing greater stability and consistency of cost and some much-needed respite for unfunded schemes.

"The other thing is, given the 40-year high on inflation, is changing how the funds are linked to inflation," suggests McKay. "At present, they remain linked to inflation and are not capped in any way. So if inflation is 10 per cent, then that's what we have to increase benefits at. Contrast that with the private sector schemes we're dealing with recently who increase pensions in line with inflation, but up to a maximum of 5 per cent, let's say as quite a common example.

"That would be a possible change that could be considered to make it more sustainable."

LGPS: Success story?

On the funded side of public sector pensions however, there is some good news.

The Local Government Pension Scheme (LGPS) has enjoyed a successful recent period following reforms that saw the UK's 86 LGPS funds pool their assets into eight fund management organisations that run all LGPS investments.

As McKay, who works on the scheme says, the section 13 valuation carried out by the Government Actuary's Department (GAD) in 2019 showed the entire scheme was 109 per cent funded. And for the LGPS as a whole, contributions actually reduced in 2019. He says it is likely that employer contributions will stay at similar levels on average, with an

DB schemes on target for endgames

The general malaise hanging over the UK's pension system may be a heavy one, but DB trustees and members do have something to cheer about. Many DB schemes are in robust health and are on target to meet their endgame plans, thanks to rising gilt yields, which are improving funding levels.

According to *The Pension Protection Fund (PPF) 7800 Index*'s June update, the aggregate funding ratio of DB pension schemes in the UK reached a record high of 118.9 per cent at the end of May, up from 114 per cent a month before. The aggregate surplus of the 5,215 schemes in the index was estimated to have increased by £55.4 billion in May, from £206.2 billion at the end of April 2022 to £261.6 billion at the end of May 2022, with assets totalling £1,642.6 billion and liabilities coming in at £1,381 billion.

It was also revealed that 1,450 schemes were in deficit – the lowest number on record – and that 3,765 schemes in surplus. The aggregate deficit of the schemes in deficit at the end of May found to be £28.2 billion, down from £47.8 billion at the end of April.

Further encouraging news has come from XPS Pensions Group's *DB:UK Funding Tracker*, which found that DB schemes' deficits against long-term funding targets decreased by £45 billion in May to £152 billion.

Based on assets of £1,689 billion and liabilities of £1,841 billion, the average funding level of UK pension schemes on a long-term target basis was 91.8 per cent as of 30 May 2022, and XPS estimated that the average pension scheme would need an additional £15,000 per member to ensure it can pay their pensions into the long term.

In addition, LCP has suggested that FTSE 100 DB pension funds could be sitting on additional £10 billion of 'hidden' pension surplus due to the long-term impact of the Covid-19 crisis on life expectancy, which it estimated could result in up to a 2 per cent fall in liabilities.

increase in future cost (the primary rate) but lower deficit contributions (the secondary rate) with lots of variability by fund and employer.

"I would expect that *[the funding position]* is even stronger now," says McKay. "Because all the funds have had good performance. So, if anything, it's going to be even better when we come to the 2022 evaluations, which we'll be working on soon. Some funds may recognise the improvement in funding level and take some risk off the table with a more defensive investment strategy, which will reduce volatility of results and further help to improve the sustainability and stability of the LGPS."

This favourable situation, partnered with the LGPS's cost cap mechanism, should provide some reassurance as to the overall sustainability of the LGPS. "If it does get into place where people are living much longer, then there is a mechanism for pulling costs back," says Hymans Robertson head of LGPS consulting, Catherine McFayden.

Not only is the LGPS in a healthy state, but it is also an example, to a certain extent, of how DB schemes can still be run effectively.

"It's obvious why people would ask questions about the huge gap that now exists between DB public sector schemes and the provision that is typically provided in the private sector. But one of the questions we might ask ourselves is, what is the right level of provision? Essentially, are people saving enough in the private sector? So, it's very tempting to look at the costs and contrast them and say, well, the public sector ones are the ones that got it wrong, the private sector ones are right.

"But if you're looking for people to have a sort of sustainable lifestyle in retirement, then the public service pensions might be closer to the marker as to what's actually needed to do that."

Written by Marek Handzel, a freelance journalist