**The pension's timebomb**
*Pensions in context*

**Martin Upton**
Hello. I'm Martin Upton from the Open University. I'm here with my colleagues Jonquil Lowe and Alan Shipman and we are talking about pensions and developments in the pensions industry in the UK.

Jonquil **-** I've seen a lot of attention in the last few months turn to what is going to happen to public sector pensions. I just wondered if you had any thoughts on this.

**Jonquil**
Well what we've seen in the private sector is the defined benefit scheme the kind of pension scheme that promises you a certain level of pension the final schemes for example. We've seen those go into decline so that only about a quarter of those schemes are now open to new members where as ten years ago it was ninety per cent of schemes. So very rapid decline. That's opening up a very big divide when compared with the public sector. So there's this whole issue of equity: what's fair, is it right that people who work in the public sector should retain these very generous pensions while other workers are having to take more risk that they'll end u with inadequate income in their old age.

**Martin**
I certainly heard John .. of the CBI talking the other day about the spiralling cost to the government of provision of public sector pensions. He was talking about the cost rising by an extra ten billion in each financial year. I just wondered what measures could be undertaken to reduce that cost.

**Jonquil**
Well I think partly one has to look at how the cost is being measured. One of the problems for defining benefit schemes and this is something that the National Association of Pension Funds has picked up on, is that the way companies have to account for pensions is really at odds with the long term nature of pension funds. So essentially they are accounting on a very short term basis which means that pension deficits can appear and they then hit the profit and loss account and the balance sheet of companies, making a crisis if you like, whereas pension schemes are designed to run over the long term. So I think you have to be a little bit careful about how you're measuring cost but undoubtedly defined benefit schemes are becoming more expensive and more uncertain for firms. The expense is coming partly from people living longer so unless people are willing to work a lot longer in order to keep the period in retirement roughly the same then these schemes are just becoming unaffordable.

**Martin**
Turning to Alan okay the option of working longer is one way of dealing with the need for additional finances when you're beyond the normal retirement age. But there are economic constraints upon the ability of the economy to deliver those jobs surely.

**Alan**
There are but the difficulty for many people approaching retirement now is that a combination of low returns on the money they have put into their investment funds and the low returns on the annuity that they will convert those funds into means that there may not just be enough for them to retire on so they will have to solve the problem by continuing to work if they can find work well into what would normally have been their retirement age unless of course the State is willing to supplement people's private pensions. But the State certainly doesn't want to do that when it already has an unfunded gap in it's own public pension provision.

**Martin**
So what could be some of the perhaps unexpected consequences of the situation? Will you see people almost as a matter of routine being force fed as a property as they retire to produce a pension pot and what will that do to property prices?

**Alan**
It's certainly the case that a lot of people approaching retirement have little or no pension saving but they do have a house which they bought on a mortgage and that is really a fund that they can tap in to if they have a form of equity release. It might involve selling the house and renting or trading down. It might involve reversing the mortgage process through an equity release scheme where it gradually goes back into the possession of the bank and the bank provides the equity released for the pensioner to live on. We are in uncharted territory here because houses were never designed as a retirement provision but certainly it's something that will have to be explored given that's where people's assets quite often are

**Jonquil**
That approach does worry me a lot though because very often the kind of housing that an older person needs perhaps sheltered housing, is not necessarily cheaper than the family house that they own and of course we mustn't forget that not everybody owns a house anyway. Twenty per cent or so are renting so they don't have that facility to fall back on. And the other aspect is of course the government is suggesting that the solution to long term care may well be loan secured against housing. So how many policy targets can housing meet? It sounds like too many here to me.

**Martin**
We've seen in recent months a number of industrial disputes, most recently BAA where employers have been looking to change pension schemes and the employees have said no that's not fair. How easy is it for an employer to change an existing pension contract?

**Jonquil**
It's generally not that easy but it depends quite what you mean. The normal employment contract will say that the employee has the right to belong to a pension scheme. It's very rare that it specifies what sort of pension scheme that is. And so going forward usually the employer can change the scheme. What employers generally can't do is take away the right to benefits that's already built up. So there is some cost and uncertainty built in for employers even if they change the system today.

**Martin**
Okay. So things aren't really guaranteed completely in terms of what you're going to get even with a state or company pension scheme?

**Jonquil**
Certainly not looking forward – yeah exactly. You may have thought that you would build up a pension over forty years and actually what you find is you've built up a pension over twenty years and then for the next twenty years you're in a different type of scheme that's offering you something less.

**Martin**
Okay. Let's look at the worst possible outcome. Can companies actually walk away from their company pension schemes altogether? Is there covenant risk here?

**Jonquil**
There is if the employer goes out of business. If the employer stays in business then there is an onus on the employer to fund any gap that's in the pension scheme but remember that pension scheme gaps only occur with these defined benefit schemes that are promising a level of benefits. If an employer can switch employees to what's called defined contribution which is more like a savings pot that builds up and is just used to buy a pension when retirement comes with that sort of scheme there is by definition no funding gap. You just get whatever pension your pot will buy.

**Martin**
So there is risk there then if the company goes bust. I mean the company pension scheme could go bust with it.

**Jonquil**
It could. There is now a pension protection fund, which didn't exist in the past but that does step in and it would replace pensions up to a certain level not fully for a higher earner. In the States there has been such a scheme for quite a while and there are now concerns about the cost of that protection scheme and whether it's really viable in the long run if you had a lot of companies going out of business at the same time with gaps in their pension scheme would there be enough schemes left to finance the cost of the compensation which is financed through a levy on all defined benefit schemes.

**Martin**
Okay. Turning to the demographics of the population we well know that the baby boom generation is heading towards retirement age. Now is this really a big part of the problem?

**Jonquil**
It's – yes it's a huge part of the problem because what we are talking about here is a change in what's called the support ratio. So the pensions of the people who are retired are essentially funded by the people in work and as the boom goes through that support ratio is falling.

**Martin**
So the baby boomers are getting the blame for lots of things currently I see and this is another one.

**Jonquil**
Yes they are. I think it's probably a bit unfair to call them a selfish generation. I don't think they ever set out to rob their children.

**Martin**
You can't be responsible for the age you're born into basically.

**Alan**
But there is the problem for the people in work currently that they are the double paying generation. They pay taxes to fund the pensions of those already retired but they are having to pay into their own pension schemes as well. And from 2012 the government will actually be trying to persuade more people to save through the personal accounts initiative - an actual opt out scheme which people are being enrolled into unless they decide otherwise. So there is the problem what justice is there in today's younger generation having to pay for their own pensions on a defined contributions basis and also pay for the previous generation's pensions.

**Jonquil**
Looking at what happens when a generation retires though you have a certain national income that the country is producing and that is carved up between people in work, people out of work. If the size of the cake were the same whether you provided pensions through a state system or whether people saved up with their own funds, if the size of the cake was the same the mechanism for giving a share to the pensioners might be different but they wouldn't necessarily get a different share of the cake.

**Alan**
I can see that and I can also see if the economy is growing well and presenting growth opportunities which generate high returns from investment then we might get through this problem just through pension funds performing better and generating more income. Is there a danger though in going for higher returns on their investment pension funds are going to start taking more risks which could work out very well or could be a disaster for those lifelong earnings people have put aside.

**Jonquil**
Well I think we've defined benefit schemes, certainly the way the accounting rules work at the moment they can't really afford to take more risk. The accounting rules are almost forcing them to go down a lower risk route investing more money in bonds rather than in equities. With defined contribution schemes of course the risk is borne by the scheme member, by the individual, not by the company. And I certainly personally I have grave doubts about people having to fund their core retirement income through defined contribution schemes. It seems to me that it's quite an inequitable system where some people will do well because when they retire the stop market is buoyant and they get a big fund. Other people will do less well and to me it's a sort of rationing b risk. It seems to me that there are two issues that have been conflated here. One is can society afford a certain level of pension – that's one question. And how do we provide that level of pension is another and at the moment they seem to have been rolled into one so that defined contribution schemes, I think, may well deliver lower pensions on average but it just won't be obvious that that's what happening until people start to complain well my neighbour retired on a good pension. I saved just as much but I've got a bad pension.

**Martin**
It's very difficult to pick out any good news stories about pensions currently and we've explored many of the issues behind that. I just wonder if going forward you are going to have the situation where the basic State Pension ends up being means tested as a reflection of the financial difficulties the government will have in meeting its pension obligations.

**Alan**
Certainly at the moment we are talking about how the government needs to reduce its deficit and pay down its debt. And there is what people argue is a structural deficit where even if the economy recovers, gets back to it's normal level of production, there will be a gap between what the government spends and what it raises in taxation. That structural deficit calculation does look far worse if we factor in the unfunded State Pension obligations and also the State's costs of age related health care. So it does begin to look as if the government may have a chronic gap between what it takes in revenue wise and what it needs to spend. And then we are looking either at reducing government spending or raising taxation to cover that gap, both of which are very painful options.

**Jonquil**
I think though that means testing is not necessarily a solution because means testing has a disincentive affect on people's own saving for retirement because they have to save enough to get past the means tested pension before they start to clock u any extra for themselves. So for many people means testing might just mean why should I save? I'll only displace my means tested pension.

**Alan**
Yes it's the old poverty trap isn't it? The problem with means testing is that at a certain point if people raise their incomes they lose a lot of benefits and they're left worse off and as you say if they raise their savings and that deprives them of certain benefit entitlement again they're worse off and they won't do the saving. So governments generally have tried to move welfare benefits away from means testing and they wouldn't want to be forced back towards it.

**Martin**
The government has certainly been encouraging savings as a way of dealing with the issues of pensions and the potentially inadequacy of pensions as people reach later years of their life. But I've seen from recent data that the savings ratio in this country is back down to a record low again and it seems clear that the government's message is not getting through.

**Alan**
Well the government has two messages. In the short run it actually wants people to save less and spend more because that helps get us out of recession. And in the longer run it recognises the need for more saving both because that will help people fund their retirements and because it funds the investment that generates the growth that will create the resources for those retirements. So it's very much a case of governments wanting it one way in the short

run and another way, the opposite way, in the longer run and that is the logic of an economy that goes through cycles and at the moment needs more expenditure in order to combat recession.

**Martin**
Any last thoughts?

**Alan**
We used to think that if we privatised the pension problem moving people out of the state scheme into occupational schemes or their own personal pension plans that this would in some way get us round the difficulty presented by demography and rising pension costs. I think what we are seeing is the public sector pension arrangements has problems and private sector arrangements has problems. We can't get round it. There is a general difficulty redistributing income from those in work to those in retirement and whether it's public or private that does create a lot of conflict.

**Jonquil**
I think we should remember though that there have been great strides over the last few decades in reducing pensioner poverty and a lot of those improvements have come from greater participation in occupational schemes.