



PENSION CAPITAL STRATEGIES
Innovative Alternatives

THE PCS ALERT

The latest in DB Pensions

WE ANNOUNCE THE DEATH OF FINAL SALARY PENSION SCHEMES

Dear Sid

It is with great sadness that we announce the death of final salary pension schemes. They will be mourned by many – but possibly not by those companies that have suffered decades of government interference and successive legislation which has increased costs and risks to a level where companies are now saying enough is enough.

Of course, the patient has been sick and on a life support system for many years. The Government started hammering nails into the final salary coffin back in the 1980s when regulations introduced increasingly onerous and costly guarantees. Then we had Barber v GRE and sex equality requirements imposed on pension schemes. The 1990s saw the introduction of statutory minimum funding and the Government taxing equity investment in pension schemes. More recently, we have seen the introduction of additional costs arising from the PPF levy and an increasingly aggressive Pensions Regulator. Add in the changing economic environment and employers have seen their typical final salary pension costs soar from under 10% to over 30% of pensionable salaries.



Another big nail in the coffin was the introduction of tax simplification (and the recent freezing of the lifetime allowance). This has had the effect of forcing company executives out of their generous final salary pension schemes. With little or no personal interest from the management in saving the patient, is it surprising that the writing was on the wall for final salary pension schemes?

The death of final salary pension schemes has been predicted so many times that the death throes of the patient have been long drawn out and very painful to watch. Indeed the 'final nail in the coffin' has supposedly been hammered in many times. But the final final nail in the coffin for pension schemes (in the private sector at least) is the present financial crisis.

Faced with ever-escalating costs, and pension scheme liabilities and deficits that have grown out of control, companies are being forced by the present financial crisis to take action. PCS has over 350 clients, and the large majority of these have either closed their pension schemes to all members or are in the process of so doing. We have been taken aback by the number of companies that have come to us in the last few weeks and told us that they need to close the pension scheme to all future benefits.

In a recent survey of nearly 400 smaller firms, the Association of Consulting Actuaries found that half of their final salary pension schemes were closed to all future benefit accrual. PCS predicts that within two years the large majority of all final salary pension schemes will be closed to all members.

The FTSE 100 companies most at risk from their pension schemes

To see the impact that the present financial crisis is having on companies with large pension schemes we can simply look at those FTSE 100 companies who are most exposed. The table below shows those FTSE 100 companies who are most at risk from their pension schemes:

	Company size (£m)	Pension scheme vs Company	30% increase in pension liabilities vs Company size
British Airways	1,627	8.3 x	250%
BT	8,285	4.2 x	126%
Invensys	1,438	3.4 x	103%
Royal Bank of Scotland	9,469	2.9 x	87%
FirstGroup	1,392	2.0 x	60%
Barclays	8,776	2.0 x	60%
Lloyds Banking Group	17,162	1.4 x	43%
BAE Systems	13,651	1.3 x	38%
Rolls-Royce	6,156	1.1 x	34%
Marks & Spencer	4,249	1.1 x	32%
Totals	72,205	2.1 x	64%

This table shows those FTSE 100 companies with the largest reported pension liabilities (taken from the most recently published accounts) relative to the value of the company at close of business on 6 February. It is staggering to note that the top ten FTSE 100 companies most at risk are valued at £72 billion but have reported pension liabilities of over £150 billion.

Pension deficits in company accounts look deceptively benign just now. But, as PCS has previously commented, due to a quirk in accounting standards (which links the value of pension liabilities to the value of AA bonds) the current valuation of pension scheme liabilities under accounting rules is artificially low. The recent unprecedented conditions in financial markets have seen values of AA bonds fall significantly – but it doesn't logically follow that pension liabilities are also correspondingly lower, although it does give companies some breathing space to sort out their pension problems.

Either a change in the accounting standards (which has been mooted but is unlikely in the short term) or a market correction could see the impact of this "quirk" reversed. If pension liabilities had been valued on more "normal" levels of credit spreads (with AA bond discount rates at gilts + 0.8% to 1%), then on average companies would see a 30% increase in their pension liabilities. For those companies most at risk, a 30% increase in their pension liabilities could be more than the total value of the company.

The other key feature of the present financial crisis is companies' desperate need to save money. Expensive final salary pension schemes add significantly to employment costs. Faced with the inevitable need to cut costs, most workforces will reluctantly accept that the loss of their final salary pension scheme is a price worth paying to avoid further redundancies.

Preparing for 2012

In all this confusion, employers also have to plan for the radical shake up in pensions that is going to hit us in 2012. The introduction of Personal Accounts, auto-enrolment and compulsory employer contributions means that it is all change once again in the pensions world. Companies need to start planning now for what sort of pension arrangements they want to put in place from 2012. Sadly, the old-style final salary pension schemes are likely to have no part in this future.

In conclusion ...

On the 200th anniversary of the birth of one of the greatest of all Britons – the naturalist and evolutionist, Charles Darwin – it is perhaps fitting that we are reminded that the survival of the fittest is not just a law of nature. Final salary pension schemes in the private sector (the public sector inhabits a different economic reality) have lost the fight for survival and are no longer fit for purpose. It is with much sadness that we say it is time to turn off the life support machine and allow the patient to die.

It is not quite as simple as that. The body will not be easily buried. Even with a detailed programme of managing out pension liabilities, it will likely take 20 years to dispose of the toxic debt in the pension scheme. We encourage companies to consider programmes to offload pension liabilities through progressive buyouts of pensions in payment and enhanced transfer value programmes to reduce deferred pensioner liabilities.

Then too, there is all the planning needed for 2012 and Personal Accounts. Again, we suggest that companies need to take a fresh look now at pensions and decide what sort of benefits they want to provide to employees in the future.

PCS and our sister company Jardine Lloyd Thompson can help companies in all aspects of managing down their historic pension liabilities and planning for 2012 and beyond. For more information on how we might help, please contact Rob Dales on 0113 203 5883 or Charles Cowling on 0161 242 5388.

Yours sincerely,



Rob Dales



For further information on the services PCS can offer you, please email us at solutions@pensionstrategies.co.uk or visit our website at www.pensionstrategies.co.uk to register your interest. Alternatively call Charles Cowling on 0161 242 5388 or Rob Dales on 0113 203 5883.

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