Opinion **Pensions crisis**

We must find the right fix for the UK's defined benefit pensions

'Superfunds' reform could put the system on a sounder footing

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Jonathan Ford YESTERDAY

Are defined benefit pension schemes really a problem that needs fixing? It may seem an odd question to ask when so many remain mired in funding deficits. The UK's DB schemes had a collective shortfall of £210bn at the end of January, according to PwC's Skyval index.

But cast your mind back, and that picture isn't quite so scary. Just three years ago the collective deficit stood at a towering £710bn.

Back then people worried that the growing shortfall could presage a series of huge failures, filling the industry-funded safety net, the Pension Protection Fund, and tipping more pension funds towards disaster. While the fear has not dissolved entirely, the deficit problem now seems more cyclical than chronic. Should interest rates normalise and shrink pension fund liabilities, it may recede some more.

Which all raises a question about the latest big reform that is proposed for the UK's 6,000 pension schemes. That is the idea of lumping them into larger units called "superfunds". It's a bit like pension insurance buyouts but without forcing companies to stump up the same hefty premiums. The aim is to get benefits of scale, reduce investment risk and give sponsoring companies an incentive to close deficits on the understanding they can cut the link with their fund. To protect members, they need the consent of the scheme's trustees.

True, this may do little to prettify the aggregate deficit. Many companies with the creakiest funds won't be able to finance the superfund premium. But the reform could still put the system on a sounder footing. For there are plenty of other ailments menacing the health of schemes.

The biggest is the solvency of sponsor employers. Save for those whose liabilities have been "bought out" and passed to an insurer, each scheme relies on the employer's creditworthiness; something that's hard to mitigate short of the rare expedient of overfunding.

Companies are far from immortal. A 2012 study from the pension consultancy Gazelle looked at FTSE 100 index constituents (among the strongest covenants available) from 1985 and how they had fared in the 27 years to 2012. A full 7 per cent had failed. A further 26 per cent had experienced financial stress (defined as an event resulting in "a serious impairment in pension funding affordability").

And that's before you consider the self-inflicted wounds of restructuring. Remember that, before 2007, an employer's covenant could be hollowed out as conglomerates disposed of subsidiaries to appeal to the stock market's fashion for more "focused" investments.

The future looks no easier, especially when you remember that the ranks of DB employers include few dynamic, growing businesses. They are mostly at the mature end, with a long tail in diminished sectors such as basic manufacturing and high street retailing. These face existential threats to their business, mainly from disruptive competitors. So it's easy to see how attrition rates could rise.

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Nor should one ignore the mindset of company bosses. Most schemes are now long closed and will soon have no members left in the business. According to Ros Altmann, a former pensions minister, that may harden attitudes. "In five to 10 years, there won't be any connection between this liability and their ongoing business," she says. "If they cannot afford a scheme buyout, they may just try to engineer insolvency, and hence to push the scheme into the Pension Protection Fund."

So there is a problem to fix, if only to increase the range of options to deal with the bumps that will occur as the DB system slowly runs off over the next three to four decades. At present, the only way companies can break the link is to pay the insurers' king's ransom (which few can afford) or — alternatively — to file for bankruptcy and head for the PPF, where employees face an average haircut of 25 per cent on their benefits.

Filling this yawning gap equitably is important. It means balancing today's investment and jobs with the interests of DB members. The government must resist the urge to protect the insurance industry by regulating superfunds in ways that eliminate the premium saving.

Finding the right mechanism isn't a choice, it's a must.

Indeed the bigger question is whether the pathway to superfunds needs to be wider. Some 42 per cent of schemes are either impaired or at risk of becoming so. As pensions expert John Ralfe points out, few if any of these will have the funds to participate.

But helping them aboard may require more than slimmer premiums; it may mean looking at benefit levels too.

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