**British company pensions:** Everyone's headache

**Companies wake up to the risks of equity and defined-benefit schemes**

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THE “pension time-bomb” in Europe is ticking more loudly these days. With investment returns falling and life expectancy rising, every country is engaged in a debate on pensions. Most European countries are hoping that the private sector will assume more of the burden. They look enviously across the Atlantic, notably at companies' individual retirement-savings accounts. Yet even these much-lauded 401(k) plans, launched 20 years ago, have not always lived up to their promises—a glaring example is Enron.

Britain offers some useful lessons for these debates. Until recently, British policymakers and bosses smugly saw pensions as a continental problem. British spending on state pensions is much lower as a proportion of GDP than in most other rich countries. Britain has already transferred about 40% of the burden of providing pensions to the funded private sector. And its corporate pension funds, heavily invested in equities, had produced good returns thanks to the bull market.

Yet much of this has now changed. The government's stakeholder pension plan, a new scheme launched in April, had a disappointing start. More worryingly, British corporate pension plans have run into trouble over the past year. Many of them are contemplating dwindling assets that no longer cover their liabilities.

The Unilever case might inspire similar lawsuits; Sainsbury, another former Mercury client, is looking at it especially closely. But companies are not only reaching for their lawyers. They are also rethinking their entire pension fund policy.

Some are rebalancing their asset allocation, shifting their funds out of equities and into bonds. Over the past 15 months Boots, a drug firm, has switched its entire £2.3 billion pension scheme into long-dated bonds. “A company should minimise financial risk to creditors and shareholders,” argues John Ralfe, Boots' head of corporate finance.

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Many other companies have transformed their defined-benefit pension plans, which guarantee employees a pension related to their final salaries, into defined-contribution schemes that make no promises about ultimate benefits. About three-quarters of Britain's corporate pension plans are still defined-benefit plans.

A recent survey by the National Association of Pension Funds found a sharp increase in the number of companies closing their defined-benefit plans to new entrants. Marks and Spencer is just one of 46 companies that axed their defined-benefit plans in the first ten months of this year, compared with only 18 companies in the whole of 2000.

A switch to defined-contribution plans shifts the investment risk of pension funds from employers to employees. Defined-benefit plans, in contrast, are a looming liability that can eat into a company's profits (in case of unanticipated cash calls to top up a pension-fund shortfall). With defined-contribution plans employees instead accumulate a cash pile during their working life to pay for their own pensions.

As defined-contribution plans are more attractive for employers, why did companies not make the switch earlier? One explanation is that companies did not worry when equity markets were rising. Investment returns were so good in the 1990s that companies could even take holidays from contributing to their pension funds. Another reason is that the red tape surrounding defined-benefit schemes has got much worse. Pension funds also suffered in 1997 from the end of relief from advance corporation tax, a tax on dividends paid to shareholders. The catalyst for the move away from defined-benefit plans was the fall in equity prices, which has hit Britain's pension funds particularly hard. As much as three-quarters of British pension-fund assets are in equities, a much higher proportion than continental and even American pension funds. Over the past two years British pension funds have lost 20% of their value.

Another deterrent to defined-benefit plans is a new accounting standard that will make a company's pension costs crystal-clear. In a couple of years FRS 17, a standard similar to America's FAS 87, will be introduced. FRS 17 will clearly show a company's pension liabilities by valuing pension assets at current market prices and demanding that a pension fund's short-term deficits appear in the company's balance sheet. “There will be no more smoothing of companies' pension costs,” says Alan Rubenstein at Morgan Stanley.

Pushed by weak equity markets and more stringent accounting rules, Britain is likely to follow the American path of 20 years ago. More companies will opt for defined-contribution plans; and a higher proportion of pension funds will be invested in bonds. Today roughly half of American corporate pension plans are defined-contribution schemes, primarily 401(k) plans.

The American corporate pension model is considered a success, even though last year, for the first time, participants in 401(k) plans lost money. A few companies, including General Motors and Ford, have cut or suspended employers' contributions to these plans, citing economic difficulties. “It is a curiosity that defined-benefit plans in Britain lasted for so long,” says John Shuttleworth at PricewaterhouseCoopers, a consultancy. Employees have to agree to the transformation of a defined-benefit into a defined-contribution plan, which many will do only reluctantly. But many more are now having to go along with the idea.