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The lost decade for pensions?

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The lost decade for pensions?

Will the last ten years become known as the lost decade in pensions? It's a distinct possibility: over this time, the average pension scheme only managed to grow its assets at just over 2.25% a year (and that's before costs). And pension pot purchasing power has plunged: in 2000, an individual could have bought a pension of £9,000 per year with a defined contribution fund of £100,000 – now they would only get £7,000.

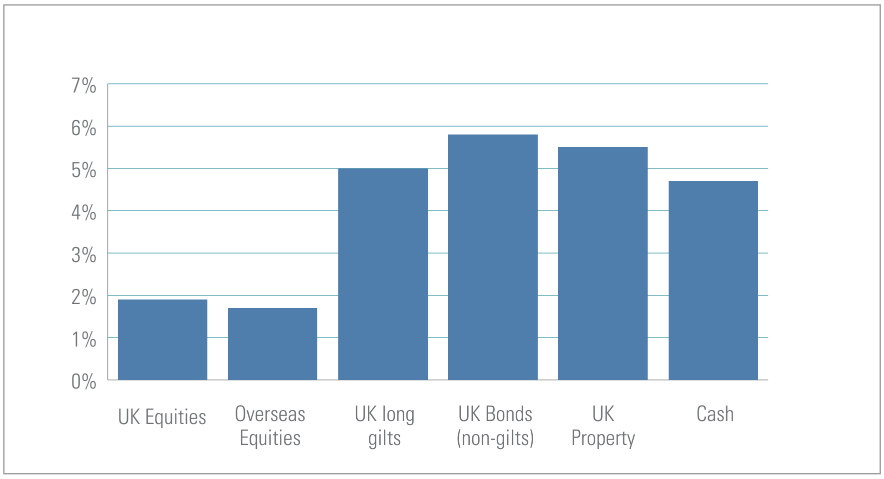
It seems everyone was a pensions loser in the noughties – most noticeably employers who are facing costs significantly higher than at the start of the decade. And this is likely to lead to them taking yet more tough decisions and meaningful actions on pensions.

More cost driven by growing life expectancies, disappointing equity returns and higher demands for cash. At the beginning of the decade, most companies were assuming that a 65 year old pensioner would live and receive a pension for the next 16 years. Now companies are expecting a 65 year old to live for 22 years – another six years of pension payments.

At the same time market conditions have dramatically impacted the cost of providing pensions. The period from 2000 to the end of 2009 tells an unfortunate story in respect of equity markets spanning from the height of the dotcom boom to the current credit crisis. Over this period a pension scheme that followed a "typical" investment strategy (according to the Mellon Caps Survey of pooled pension funds as at 31/12/99) would only have seen its investments grow at 2.25% per year. This would further be reduced by costs and compares to a return of 4.7% per annum if the assets had been kept on deposit in the bank.

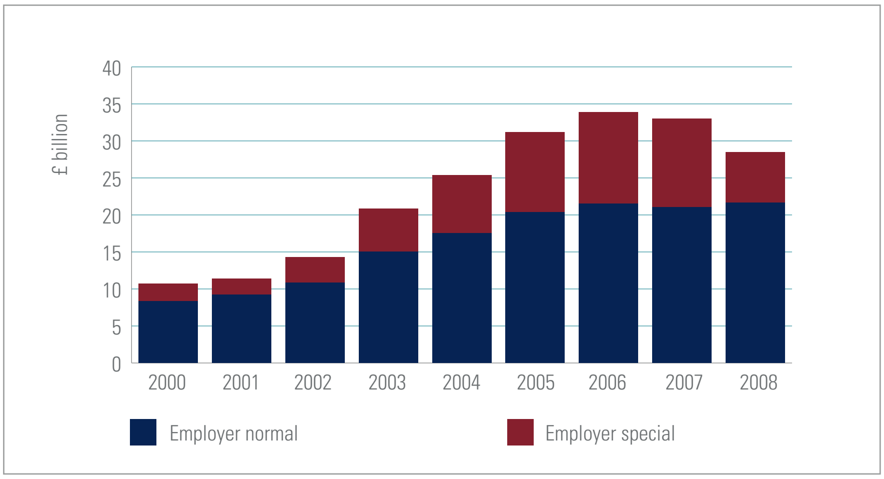
A consequence is higher cash demands being made on employers. Employer contributions to self administered pension schemes have ballooned from £11bn in 2000 to £29bn in 2008.

1. Annualised returns for major asset classes over the period 1 January 2000 to 1 December 2009



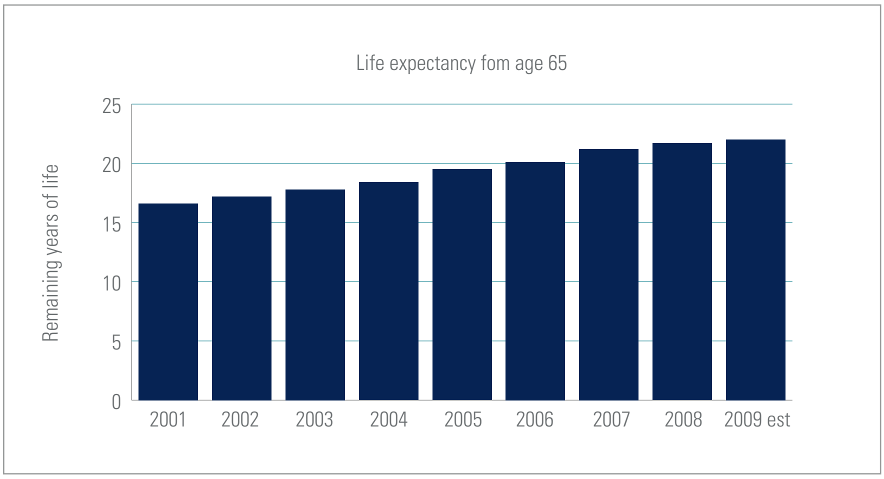
Source: UK Equities: FTSE ALL SHARE - TOT RETURN IND; Overseas equities: FTSE AW ALL-WORLD EX UK £ - TOT RETURN IND; UK Long gilts: FTSE BRIT GOVT FIXED OVER 15 YEARS - TOT RETURN IND; UK Bonds: BOFA ML £ NON-GILTS ALL STOCKS(£) - TOT RETURN IND; UK property: UK IPD: TOTAL RETURN INDEX (TIME-WEIGHTED) NADJ; Cash: UK INTERBANK 3 MONTH - MIDDLE RATE

2. Employer contributions to self administered pension schemes



Source: ONS

3. Life expectancies



Source: KPMG Pensions Accounting Surveys. 2001 assumes mortality in line with MFR requirements

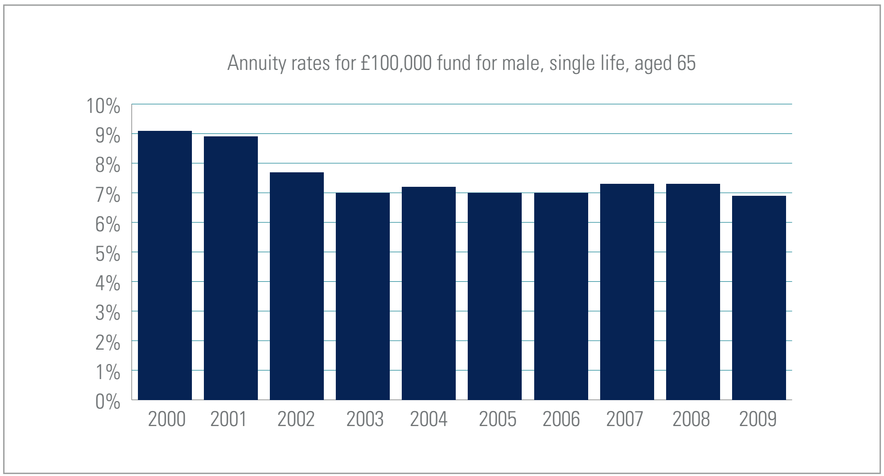
.....But fewer benefits

While a large number of employees continued to build up pensions over the last decade, the increased costs of defined benefit pensions have led to a significant reduction in the overall level of pension provision. In 2000, 4.6m employees were members of a private sector defined benefit pension scheme. In 2008 this number had fallen to 2.6m and will soon be below 2m.

The proportion of private sector defined benefit pension schemes closed to future accrual for all members rose significantly from 7% in 2000 to 17% in 2008. This proportion is expected to be even higher given the spate of closures over 2009.

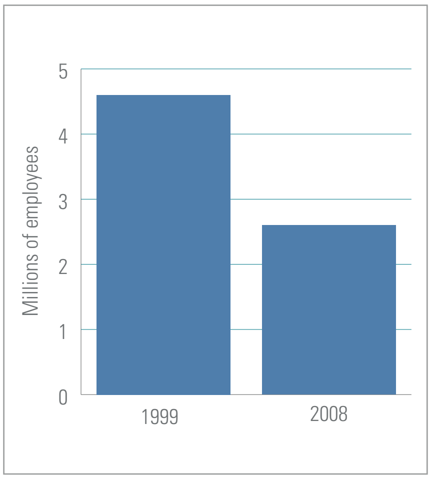
But things have also been bad for employees who are members of defined contribution arrangements. Members of these schemes will also have suffered losses on their funds – heavily dependent on the weighting they had in equities. However, they have also had to bear the brunt of increased annuity costs. A person who retired in 2000 with a fund of £100,000 at age 65 would have been able to buy a pension of around £9,000 per year. At the end of the decade, the same fund would only be able to buy a pension of around £7,000. Annuity rates are partly driven by the yields available on government bonds, which have fallen from around 5% at the start of the decade to around 4% now. Similarly index-linked gilt yields have fallen from around 2% to around 0.5%.

4. Annuity Rates



Source: William Burrows: Historic annuity chart http://www.williamburrows.com/charts/chart1990.aspx

5. Active employees in Defined Benefit pension schemes



Source: 1999: Government Actuaries Department 2000 survey; 2008: ONS

Outlook for the next decade

Looking forward to the next decade, companies will likely want to deal with their pensions hangover from the end of this one.

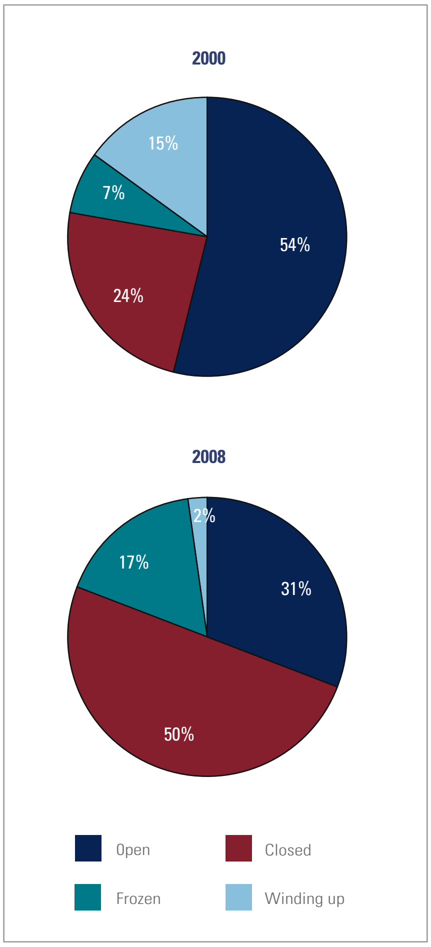
We expect more action to reduce the legacy of cost that has been created – namely more defined benefit (final salary) scheme closures and more companies "selling" or closing out their schemes when opportunities arise. In our view by the end of the next decade half of all companies may have dealt with their problem and no longer have a defined benefit scheme at all.

Individuals are likely to continue to turn away from saving for pensions – burned by the experience of the last decade and also government policy to repeatedly reduce the incentives to save. Over the next decade we predict that more and more people will retire relying on their capital or property / other assets rather than a pension scheme. And this could be a very risky strategy as these people are likely to have a very difficult job running down their capital at the right pace to potentially see them through to age 100 and beyond!

The investment landscape will also transform. Stock markets will likely change dramatically as institutional pension investors gradually pull out – either due to schemes being "sold" or invested in assets other than equities. The removal of hundreds of billions of pounds of equity investment means that companies and markets will need additional sources of funds or an increase in direct investment by private shareholders.

There is clearly a role for government and the regulatory framework to help to ensure adequate future private sector benefit provision, but against this backdrop the challenge is a significant one.

6. Changes in the status of private sector defined Benefit Schemes



Source: 2000: Government Actuaries Department 2000 survey; 2008 : The Purple Book 2008 kpmg.co.uk

Designed and produced by KPMG's LLP (UK)'s Design Services

Publication name: The lost decade for pensions?

Publication number: RRD-177121

Publication date: December 2009