

Dr Frank Eich, senior economist at Pension Corporation, explains how systemic risk is affecting the pensions market

Pensions' very own systemic risk

The term “systemic risk” is normally used to describe the risk that idiosyncratic shocks affecting individual businesses could be transmitted throughout the financial market, with the result that the whole market could become unstable or even collapse. As the world economy has become ever more integrated, this risk has gradually increased over time but until recently appeared to be more a theoretical phenomenon than a real issue. Over the last year we have all seen how serious this risk is in the real world, with the collapse of Lehman Brothers nearly bringing the whole global financial system to its knees and pulling the world economy into recession.

Taking a slightly more liberal definition of “systemic risk” there are many other areas in which adverse developments in one part of the market could affect other parts, with the result that the overall structure could become unsustainable over time.

One such area is pensions; as it is the British pension system provides a particularly good example. The system is based on a highly complex structure, with the different players – individuals, firms and government – interlinked in myriad explicit and implicit ways. State pensions (with a large means-testing element but also an earnings-related component), occupational pensions (defined benefit but increasingly defined contribution based) and private pensions (to be boosted by personal accounts in 2012) are all meant to work together to avoid pensioner poverty and enable pensioners to enjoy a quality of life similar to that prior to retirement. The issue becomes even more complicated once the housing market, which provides an important mechanism for building up assets to fund consumption in retirement, is brought into the equation. Government, quangos such as The Pensions Regulator or the Personal Accounts Delivery Authority, corporate sponsors and pension fund trustees, independent financial advisers and last but not least the individual (hopefully entirely rational, forward looking and financially literate) all play pivotal roles to keep the pension system alive.

A failure of one part of the system to deliver what it is meant to deliver could jeopardise the smooth functioning of other parts of the system, making the entire structure eventually unsustainable. The key difference between the “systemic” risk in the British pension system and the financial markets is perhaps the time span over which the problems materialise and become apparent. In the case of pensions the developments are driven to a large extent by slow-moving demographic change so the collapse will resemble more a slow decline than a rapid wildfire. While the seriousness of the issue is perhaps similar, the slow collapse at least gives plenty of time to act. Unfortunately, as we have seen again and again, it also gives plenty of time to procrastinate.

Looking back

So, what is wrong with the British pension system? To answer this question one has to go back at least 10 years. Up to the late 1990s the British pension system was charac-



terised by modest state provision aimed at alleviating pensioner poverty and solid occupational pensions for those on medium or higher incomes, with defined benefit pension schemes widespread in the public and private sectors. Back then, around 60% of all pension incomes came from the state, the remainder from the private sector.

Since the beginning of the new century this tried and tested model has come under increasing strain, with corporate sponsors of defined benefit pension schemes waking up to the true costs of the promises made and increasingly struggling to make the required contributions to meet the government's funding requirements for these schemes. Many corporate sponsors concluded that the only way forward was to close their existing DB schemes and shift the



2012 onwards, increasing the state pension age from 65 years in 2010 to 68 years by the mid-2040s as a response to the projected increase in longevity and the establishment of personal accounts as a private savings vehicle for those on moderate incomes also by 2012.

This brief history of recent pension developments in the UK illustrates that the system was far from stable before the financial and economic crisis unfolded. The crisis has set in motion further developments as it has had an adverse impact on all aspects of the pension landscape.

The first development is the further decline of DB pensions in the UK – a trend that was not inevitable as a number of larger scale employers in the private sector appeared to remain committed to these schemes pre crisis. In June alone, BP, Morrisons and Barclays all announced the closure of their schemes either to new members or to future accruals, with the result that DB pensions have become exclusive to public sector workers. This means that most private sector workers have to deal with all the risks associated with pension provision – longevity, inflation, investment – on their own. In theory the crisis could also stress test the viability of the Pension Protection Fund, which was set up under the provisions of the Pensions Act 2004 to help members of DB pension schemes whose corporate sponsors have run into financial difficulties. Second, those in defined contribution pension schemes have also done badly, with the stock market offering disappointing returns over the last 10 years and more. This leaves those close to retirement or contemplating buying an annuity with lower pension wealth than previously expected and perhaps looking for the government to make up any shortfall.

Retirement income

With businesses disowning – perhaps rightly in a changing world in which jobs-for-life no longer exist – their responsibility to provide a guaranteed retirement income to their employees and individuals badly placed to deal with the risks they increasingly face, the role of government in ensuring reasonable incomes in retirement might have to be revisited. But the shock that has impacted on DB and DC schemes has also affected the government's ability to help out. The economic crisis has been a major blow to the public finances in the UK, with the government now running one of the largest public deficits anywhere in the developed world. This leaves the government in a weak position to meet any potential demands from those on disappointing DB or DC pensions for higher state spending to fill the gap and could jeopardise the recent policy reforms before they have even been launched.

In other words, the continued closure of DB schemes and weak performance of DC schemes could stretch the government's ability to meet its own side of the pensions bargain, representing its very own kind of "systemic risk". If this were indeed to happen then nothing but a complete rebuild of the UK pension system would suffice to put pensions on a sound footing in the first half of this century.

risks associated with pension provision to the individual by offering defined contribution schemes instead.

Meanwhile, the government focused increasingly on targeting state pensions on those in greatest need by introducing first the minimum income guarantee and later the pension credit to keep state pension spending at a minimum. In an acknowledgement that not everything was rosy though, in 2002 the government established the Pensions Commission to develop ideas on how to help those on moderate earnings save for retirement while keeping the public finances sustainable. The Pensions Commission suggested three major policy reforms, which the government more or less implemented as new policy: linking the basic state pension to earnings growth rather than inflation from