

This report begins with an overview of developments in the international pensions market in 2008, followed by a review of the structure and trends. The report reviews the factors that are driving pension reform worldwide and the policies that are being implemented. It features recent developments in the UK and sets out the key challenges relating to the financing of pension provision in the UK.

OVERVIEW

The economic recession has affected pension schemes across the world in several ways. Key developments in relation to pension scheme assets have been:

- Exposure to equities that contributed to negative returns in most countries.
- Diversification into alternative asset classes that turned out to have much higher correlation to equities in a market sell off than anticipated.
- Assets in jurisdictions which required large weightings in domestic government bonds (the only safe haven asset during the year) were best protected.
- The 18% fall to \$25 trillion in the value of global pension assets between end-2007 and end-2008, the largest annual decline for many years.

The decline in assets on the liability side was partly offset by:

- A decrease in estimated liabilities (calculated off AA bond spreads) as corporate bond yields rose.
- Liabilities calculated under IAS19 were lower than liabilities simply marked to market on corporate balance sheets.

This provided some relief to defined benefit (DB) schemes, but not to defined contribution (DC) and private pension funds, where annuity values for those retiring were substantially reduced. Pension fund returns in most countries turned negative in 2008 as most asset types fell in value. Nearly all countries recorded negative nominal rates of return in the first 10 months of 2008, with an average of -19% reported across the OECD. The UK return of -10% was less negative due to declining exposure to equities and the falling value of sterling which lifted the value of income on overseas investments.

The UK faces a number of challenges relating to the financing of both public and private sector provision. Increasing costs have resulted in the closure of many private sector DB schemes: membership of open DB schemes has therefore halved to 3.3m since the early 1990s. Contributions to the DC schemes that have replaced them, at 9% of salary, are only about half that to DB schemes.

There has been increased interest from companies in the insurance buyout market as a means of partial or full exit from their pension liabilities. The aggregate deficit for FTSE 100 companies was £40bn at end-June 2008. The Pensions Act 2008 contains a number of measures aimed at encouraging greater private pension saving, particularly amongst those where pension provision is currently limited. DB remains the dominant form of provision in the public sector. While there have been some reforms to public sector schemes, a substantial unfunded deficit remains.

Chart 1 Global pension assets

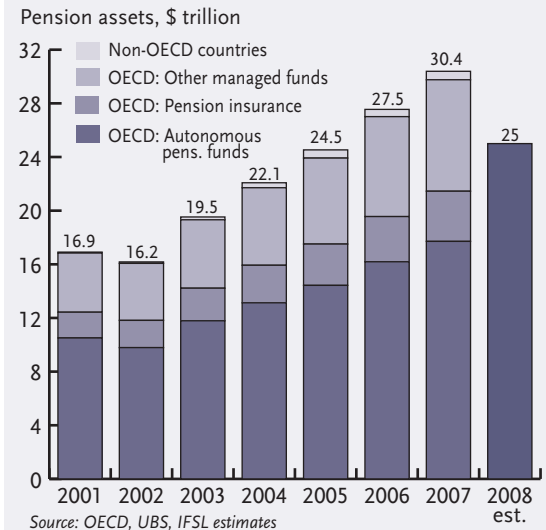


Table 1 Global pension assets

	\$bn, pension fund assets		
	2001	2006	2007
US	12515	18315	19558
Canada	743	1337	1475
UK	1486	2990	3323
Netherlands	411	843	1013
Denmark	154	443	506
Switzerland	261	465	505
Sweden	75	226	270
Finland	70	163	191
France	---	156	180
Germany	65	123	136
Spain	35	113	129
Ireland	46	110	119
Italy	25	62	77
Poland	5	38	51
Portugal	13	34	39
Iceland	7	23	28
Norway	9	23	27
Russian Federation	---	15	20
Other Europe	22	60	75
Mexico	27	99	113
Brazil	---	195	224
Chile	---	89	106
Other Latin America	8	37	49
Australia	268	692	957
Japan	581	600	874
S. Korea	---	81	89
Hong Kong	24	53	64
New Zealand	8	13	15
Other Asia	5	19	22
South Africa	---	80	90
Israel	29	45	54
World total	16894	27541	30382

Source: OECD, UBS

INTERNATIONAL PENSION MARKETS

Detailed figures for global pension assets for end-2007 were published by OECD in December 2008. The total value of pension assets managed globally rose by 10% to \$30.4 trillion at end-2007, but then fell by some 18% to \$25 trillion at end-2008 (Chart 1). The global market is dominated by the US, which accounts for 64% of assets (Table 1). The next largest markets are the UK with 11% of assets, Canada 5%, and the Netherlands, Australia and Japan, each with 3%. The large value of assets accumulated over many decades means that these countries will remain the dominant source of assets for years to come. Pension assets in Brazil were the largest outside the OECD, followed by Chile and South Africa.

Steady growth in assets between 2001 and 2007 was based on expansion in funding aided by pension reform and recovery in equity markets, although this was reversed in 2008 due to the impact of the credit crunch on the value of both equities and bonds, particularly in the final months of the year.

Growth in pension assets between 2001 and 2007 was seen in all countries listed in Table 1 for which data are available. Following the downturn in 2008, growth in assets is expected across a broad range of countries over the long term, including countries with established systems as well as those where pension markets are at an earlier stage of development. The latter include the Pacific Basin, such as China and South Korea; Latin American countries as well as countries in central and eastern Europe.

Table 2 Global pension assets

Pension fund assets managed in each country, \$bn, 2006

	Autonomous pension funds	Book reserves	Pension insurance contracts	Inv. cos. managed funds	Banks managed funds	Other funds	Total pension assets	% share
OECD countries	10238		2527	2141	340	4312	19558	64.4
US	10238		2527	2141	340	4312	19558	64.4
UK	2232	---	460	631	---	---	3323	10.9
Canada	789	152	66	---	---	468	1475	4.9
Netherlands	1013	---	---	---	---	---	1013	3.3
Australia	921	---	---	---	---	36	957	3.1
Japan	874	---	---	---	---	---	874	2.9
Denmark	101	---	269	---	68	68	506	1.7
Switzerland	505	---	---	---	---	---	505	1.7
Sweden	39	8	203	---	10	10	270	0.9
Finland	174	---	17	---	---	---	191	0.6
France	27	---	151	1	---	1	180	0.6
Germany	136	---	---	---	---	---	136	0.4
Spain	108	20	---	---	---	---	129	0.4
Ireland	119	---	---	---	---	---	119	0.4
Mexico	108	---	---	2	---	2	113	0.4
S. Korea	30	---	34	---	13	13	89	0.3
Italy	69	---	8	---	---	---	77	0.3
Poland	51	---	---	---	---	---	51	0.2
Other countries	170	---	---	4	1	5	180	0.6
OECD total	17706	181	3736	2779	431	4915	29748	97.9
Non-OECD countries								
Brazil	---	---	---	---	---	---	224	0.7
Chile	---	---	---	---	---	---	106	0.3
South Africa	---	---	---	---	---	---	90	0.3
Hong Kong	---	---	---	---	---	---	64	0.2
Other non-OECD	---	---	---	---	---	---	150	0.5
Non-OECD total							634	2.1
Global total							30382	100.0

Pension assets of \$29.7 trillion in OECD countries accounted for 98% of the end-2007 global total: they can be divided into a number of categories (Table 2):

- *Autonomous pension funds* invested in occupational pensions accounted for the bulk of assets: \$17.7 trillion, 58% of the global total.
- *Pension insurance* contracts are operated by life and pension insurance companies: \$3.7 trillion reported in 10 countries.
- *Book reserves* consist of pension reserves or provisions in the balance sheet of the sponsoring company: \$0.2 trillion identified in three countries.
- *Investment companies' managed funds* in five countries: \$2.8 trillion in five countries.
- *Banks' managed funds* in five countries: \$0.4trillion.
- *Other funds*: \$4.9 trillion

Assets of non-OECD countries:

- *Pension assets* identified in 17 non-OECD countries reached \$0.6 trillion.

Many developed countries have extensive funding pension arrangements. At end-2007 pension fund assets exceeded 100% of national income in Denmark, the US, the Netherlands, the UK, Australia, Canada and Switzerland (Chart 2).

Assets between 50% and 100% of GDP have been accumulated in Finland, Chile, Sweden and Ireland. While autonomous pension funds remain the primary focus of investment in the US, the UK, Canada and the Netherlands, they remain scarce in other large countries of western Europe: Germany, France & Italy. Pension insurance policies and personal pensions are also an important source of provision: accounting for the majority of pension assets in Denmark and Sweden, and for around 19% in the UK. Assets in retirement products, other than pension funds and pension insurance, make up 42% of assets in Canada and 35% in the US.

Rates of return Returns have suffered a major setback in 2008, with all countries, with the exception of South Korea, featured in OECD analysis, experiencing a negative nominal rate of return in the first 10 months of the year (Chart 3). Ireland, the US, Canada and Australia suffered the largest falls with nominal returns dropping by at least 20% in each of these countries. Aside from South Korea, which recorded a positive 3% return, the smallest falls in pension returns were in Italy, Spain and Germany.

Asset allocation While changes year-to-year in asset allocation over the past decade been heavily influenced by volatility in equity markets, this is less influential when viewed over the period between 2003 and 2007.

Trends in asset allocation in recent years amongst five of the major asset managing countries - the US, Japan, the UK, the Netherlands and Australia - are shown in Chart 4:

- In the UK the share of equities fell sharply from 67% in 2003 to 56% in 2007, due to a fall in domestic equities' share of pension funds' portfolio. While equities' share was relatively stable in the US, Australia and the Netherlands, Japan saw a marked increase in equities' share of pension fund assets from 44% to 51%. Amongst these five countries, at end-2007 the share of equities was highest in the US at 64% and lowest

Chart 2 Pension assets relative to size of economy

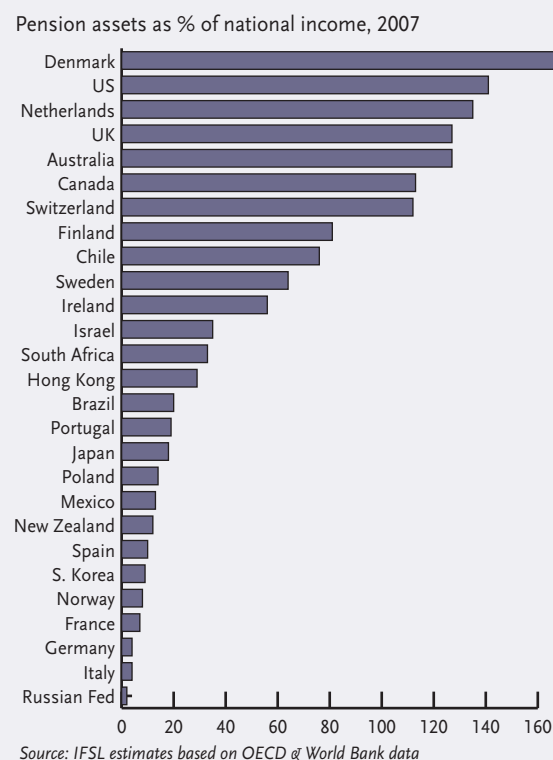
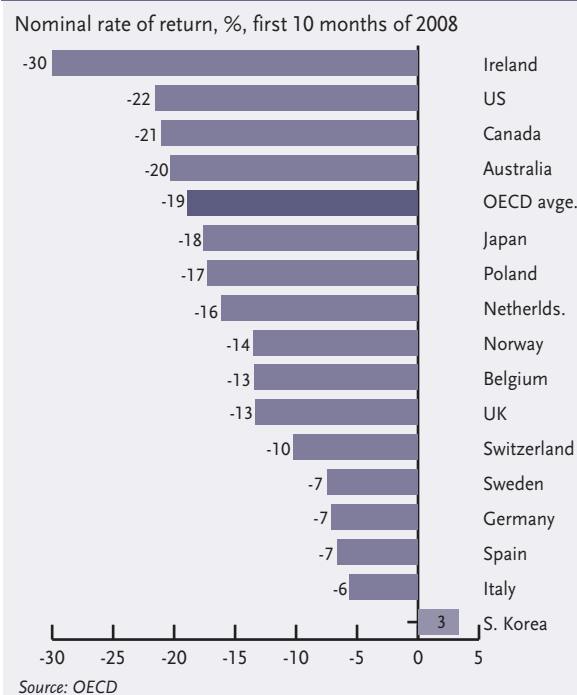


Chart 3 Pension funds nominal rate of return



in the Netherlands at 41%.

- Allocation to bonds fell sharply in Japan, where it dropped from 45% to 32%, mostly a result of a reduction in holdings of domestic bonds. In the UK, allocation to bonds doubled from 15% to 30% largely committed to increased investment in international bonds. Elsewhere bonds' share dropped from 34% to 30% in the US while rising from 40% to 43% in the Netherlands. Bonds' share was virtually stable at 21% in Australia.
- The share of assets invested in cash, real estate and other investments varies. Australia holds over a quarter of assets in other investments including 10% each in cash and real estate. Japan has 12% in other investments such as hedge funds, private equity and derivatives. In the UK 7% of assets are allocated to each of cash and real estate.

Over the past decade there has been some convergence between these five major investing countries in the share of assets allocated to equities and bonds over the past decade. Equities' share in 2007 was in the 41-64% range, while the range for bonds' share was 21-43%; both ranges were much narrower than in 1997.

Although listed alternative funds fell as steeply as equities in 2008, there was nevertheless evidence of growing interest in alternative assets from European and Asian pension funds, as schemes sought diversification and gave more priority to absolute return and less on index risk. Gold proved to be the most successful diversifier.

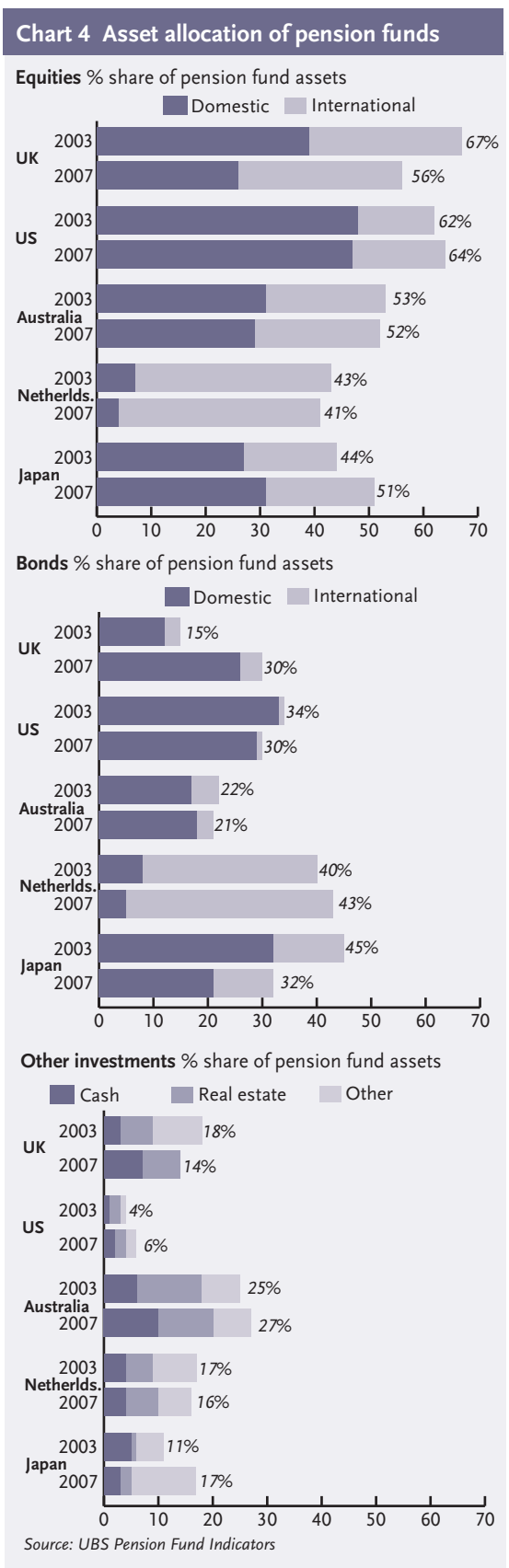
Broader trends in OECD The substantial allocation to equities in the five countries in Chart 4 is not reflected in asset allocation elsewhere in the OECD, where bonds continue to rank first. In 10 countries, including Denmark, Norway, Poland, South Korea and Spain, bonds accounted for over 50% of assets at end-2007. If cash is included then fixed interest investments make up over a half of assets in 13 countries altogether. Equities make up over a quarter of portfolios in 14 OECD countries and less than 10% in seven countries, including Belgium, Czech Republic, Italy and South Korea.

Factors driving reform of pension systems worldwide

Pension systems in many countries have been closely reviewed as a result of demographic trends and also because of accounting standards that have increased the transparency of pension liabilities:

Demographic trends Increased longevity, falling birth rates, and early retirement mean dependency ratios of many developed countries particularly in Europe and Japan are set to rise over the next half century. In Europe in 2005 there were on average around four people of working age to every pensioner, implying a dependency ratio of less than 25%. However, this dependency ratio will gradually increase by 2050 to 74% in Japan, 60% in Italy and to 54% in Germany (Chart 5). The increase to 40% in the UK is rather less than elsewhere in Europe.

Lower birth rates and increased longevity are also affecting countries of Central and Eastern Europe and some Asian countries: the dependency ratio in China is set to soar from 11% to 39% over the period from 2005 to 2050, partly a result



of the policy of one child per family that has been pursued over the past 30 years. (The challenges facing China are set out in the panel below.) It will also rise to a lesser extent in India. The dependency ratio in Latin America and Asia is projected to rise from 10% at present to 29% and 27% respectively by mid-century.

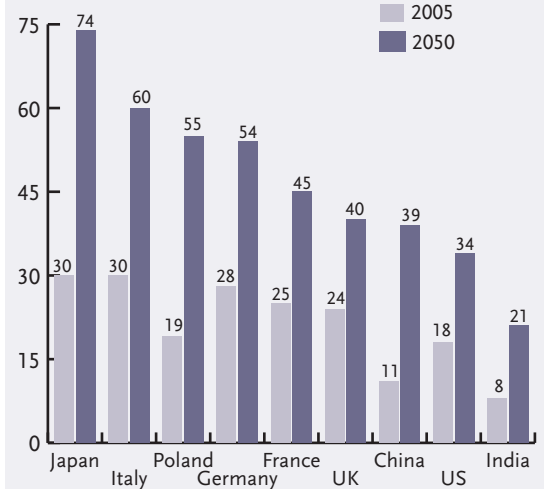
Costs and inadequacies of state pension systems State pension systems are largely funded on PAYG basis. The impact of ageing populations and increased dependency has drawn attention to the rising cost of financing generous state pension systems on a PAYG basis. This is most apparent in the measure of expenditure on PAYG pensions as a share of GDP being in the range of 9-14% in Italy, France, Germany and Spain, compared with 7% in the UK. This cost burden is unsustainable and has been the key driving force in policy responses including pension reform that have taken place in the larger countries of continental Europe.

In many developing countries economic growth and rising living standards have highlighted the inadequacies of state pension systems and their failure to meet the increasing aspirations of individuals for a bigger income in retirement. Inadequacies are revealed in poorly managed systems, high contribution rates, growing evasion and increasing likelihood of deficits. Most emerging market countries that are members of the International Federation of Pension Fund Administrators (FIAP) have reformed their pension system.

Deficits in occupational defined benefit (DB) schemes Occupational DB pension schemes in a number of countries face long-term deficits caused by a gap between assets and liabilities. Deficits have been highlighted by the convergence of international accounting standards which mean that unfunded pension liabilities must be reported on a marked to market basis, using bond yields for discounting the liabilities. As a result deficits of pension schemes have become transparent on the balance sheets of sponsoring companies.

Chart 5 Elderly dependency ratios by country

Population aged over 65 as a percentage of working age population (15-64)



Source: UN Population Division: World Population Prospects: 2006 Revision

Table 3 Pension deficits in global stocks

	Number of companies	Surplus/	Surp./def.		Liabilities	
		deficit	Mkt.cap	as % of	Liabilities	as % of
		€bn	€bn	mkt.cap	€bn	mkt.value
France	6	-8.7	245	-3.6	24	10
Germany	6	-4.7	249	-1.9	55	22
Netherlands	3	1.1	121	0.9	37	31
Switzerland	7	0.5	364	0.1	55	15
UK	15	3.5	833	0.4	125	15
US	42	9.6	2086	0.5	229	11
Asia Pacific	11	-5.1	417	-1.2	42	10
Other EU	7	-13.8	242	-5.7	29	12
Total	97	-17.7	4556	-0.4	596	13

Source: Lane Clark & Peacock

China's pension challenge

The demographic shift facing China in the coming decades represents perhaps one of the biggest challenges worldwide in pension provision. China's elderly dependency ratio is expected to rise steeply from 11% in 2005 to 39% by 2050. Although some of the more advanced countries face a higher elderly dependency ratio at that stage, China is facing the challenge at an earlier stage in its economic development. State family planning policy has reduced the birth rate to around 1.5 while improvements in income, diet and welfare have dramatically raised life expectancy. Key challenges for China highlighted by a World Economic Forum report on *The Future of Pensions and Healthcare in a Rapidly Aging World* relate to:

Coverage: Only 20% of those over 60 are covered by pension programmes, although this disguises a major divide between 40% covered in urban areas and 5% in rural areas.

Sustainability: With most pensions on a pay as you go system from employers' current revenues there are major concerns about sustainability as the number of pensioners increases.

Portability: The 200m migrant workers lack pension coverage because they can withdraw their own social insurance contributions on changing jobs but not those of their employer.

While some reforms have been implemented they have had limited effect. However, there is political commitment to further reform with agreement at the highest level that elderly should be covered by social security by 2020.

A survey by the actuarial firm Lane Clark & Peacock found that many of world's largest companies had substantial pension deficits in 2007. The six French and six German companies included in the Dow Jones STOXX 80 had the largest aggregate deficit, respectively, of 4% and 2% of market capitalisation (Table 3). Companies from the Netherlands, the UK and Switzerland recorded an aggregate surplus of between 0.1% and 0.9% of market capitalisation, although this masks a broad spread with some companies recording a deficit. Moreover, the position of many companies' pension fund will have deteriorated substantially during 2008.

International policy responses

The prime response of governments throughout the world has been to implement policies that will increase the labour supply and to put in place new structures, including tax incentives and the supply of long-term investment, that will underpin pension provision in the public and private sectors over the long term. Corporate sponsors of pensions have developed defined contribution schemes particularly for new employees while terms of remaining defined benefit schemes have been revised.

While DB plans been revised in some countries to ensure their sustainability, funds in many other countries are now based on DC. In Switzerland and Poland all occupational schemes are based on DC while in Spain, Italy and Australia occupational schemes based on DC plans account for over 80% of pension assets (Chart 6). In the US and the UK, where DB was dominant a decade ago, DC plans account for 36% and 25% of assets respectively.

These policy responses have occurred in countries where pension provision in one form or another is already established. For other countries without pension provision, governments need first to put in place a structure and strategy for pensions as indicated in the panel below.

IFSL Pension Group: Key elements of pension reform

The guiding principle is for government to develop a framework that enables pension funds to take appropriate account of risks in the investment of retirement savings. Key factors include:

Commitment to macroeconomic stability, low inflation and a balanced fiscal strategy to facilitate effective functioning of securities markets and institutional investment.

Establishing a pension system that is affordable by future generations through: constraining the size of benefits particularly state pensions to a sustainable level, but that also ensures poverty is alleviated; adjusting earnings-related pensions so that there is a direct link between lifetime benefits and contributions; and raising advance funding in countries where pay-as-you-go dominates to meet future liabilities

Establishing an efficient financial market infrastructure including a legal framework, a financial and accounting system, regulatory and supervisory framework, clearing and settlement systems and a structure for the trading of securities. A risk-based supervisory framework should identify any weaknesses in the funded pension system through the use of sensitivity analysis and stress testing.

Ensuring the financial security of pension funds and protection of pension beneficiaries This will help to maintain the confidence of beneficiaries and the public at large. It includes a number of features: licensing of pension

institutions; separating assets of pension funds from employers control; meeting capital requirements or solvency rules and establishing minimum funding rules; and effective supervision and self-regulation.

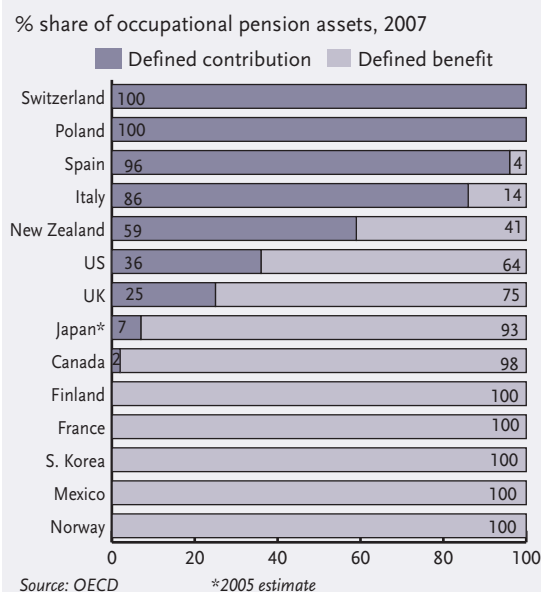
Applying prudent investment principles The application of rules that follow the 'prudent man' principle have proven their worth, enabling asset managers to access international financial markets while also ensuring a high degree of investor protection.

Encouraging people to save: introducing fiscal incentives Experience has shown that precisely targeted tax incentives are required if people are to save for their own retirement. Care has to be taken to avoid interaction of the tax and benefit systems which might encourage early retirement or distort the general savings and investment markets.

The taxation of pension assets can in principle be applied at any one of three points: to contributions, investment income and payment of pensions. The most favourable model from the investors' viewpoint is to exempt the contribution and investment income but tax the payment of pensions. This arrangement is known as EET (exempt, exempt, tax). EET and other models less favourable to the investor are set out in Chart 5.

Developing an appropriate framework for each country This commonly includes one pillar of state provision and another of private provision, although different forms of provision may be included under each pillar.

Chart 6 DB & DC share of occupational plans



UK PENSIONS MARKET

Analysis of the UK pensions market begins with recent trends in size and allocation of assets as well as returns. It continues with the key challenges facing the pensions industry and the UK's policy response.

Market size The pensions industry in the UK is the second largest in the world after the US, with assets managed on behalf of domestic clients totalling £1,660bn at end-2007. The sizeable asset base arises from substantial funding of pensions and significant voluntary provision, with £1,115bn managed in occupational schemes, £230bn of funds in pension insurance contracts and assets totalling £315bn in personal pensions. About 75% of assets in occupational schemes are defined benefit and 25% in defined contribution. However, the closure of many private sector pension schemes means that DC share is growing steadily. There is less dependence on the state pension and the long-term demographic profile is more favourable than in many other European countries.

Asset allocation The majority of assets in UK pension funds are invested in equities although their share in portfolios has dropped from 73% in 1997 to 56% in 2007, as indicated in Chart 3. The steep decline in equity markets in 2008 is likely to have pushed the share of equities down to 50% or less. The balance in 2007 also shifted towards investment in foreign equities, which accounted for 30% of assets, up from 20% a decade before. The biggest change over the past decade has been growth in domestic bonds which accounted for 26% of assets in 2007, up from 12% ten years earlier, although this in part reflects the steady growth in the issue of government bonds as borrowing has risen. The year 2007 saw further movement by pension funds out of UK equities. Contributory factors included: accounting changes stemming from FRS17 and the requirement to 'mark to market'; regulatory changes associated with the Pension Protection Fund (PPF); and the pursuit of Liability Driven Investment (LDI) strategies.

Rates of return The nominal rate of return of UK pension funds fell by 10% in 2008, implying a real fall of 14%, according to an BNY Mellon (Chart 7). The drop in real return was constrained by the shift from equities to fixed interest in pension fund portfolios and also by the depreciation of sterling which increased the sterling value of returns from overseas investments. However, a total of four years of negative returns over the past decade mean that real returns have averaged only 1.5% a year between 1999 and 2008. Over the 45 years since 1963 UK pension funds have generated real returns averaging 4.2% a year.

Key challenges relating to financing of UK pensions

The UK faces a variety of challenges in relation to the financing of both public and private sector pension provision.

Financing of private sector DB schemes The increasing cost of operating DB schemes in the private sector has resulted in closure of many such schemes to new members. As a result the number of members in open private sector schemes dropped from a peak of 6.5m in the early 1990s to 3.6m in 2007 (Chart 8). A January 2009 survey by the National Association of Pension Funds

Chart 7 UK pension fund rates of return

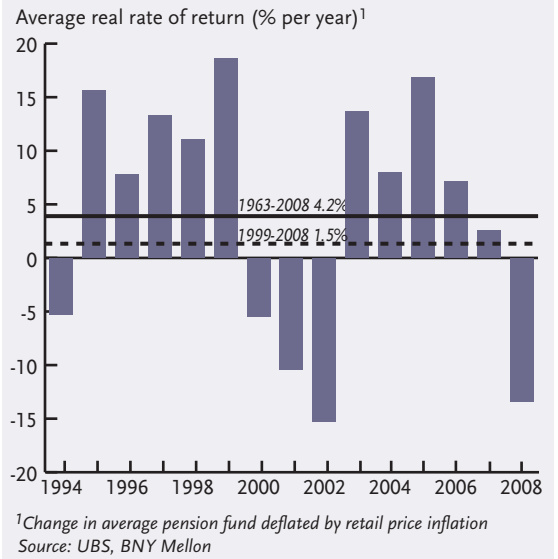
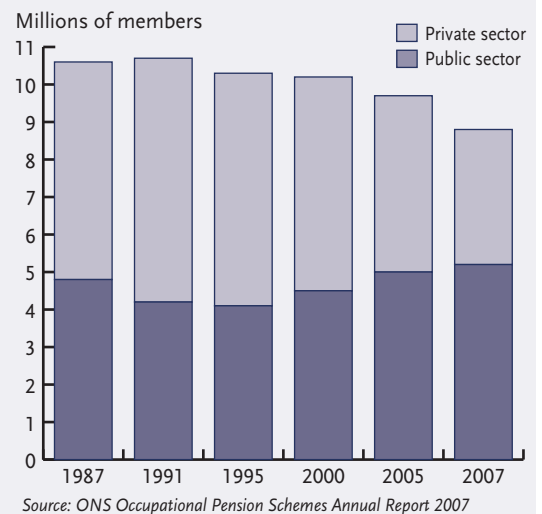


Chart 8 Membership of open defined benefit pension schemes in UK



predicted that over 1,000 of the remaining 2,240 open DB schemes could face closure to new entrants in the next five years. By contrast, membership of open public sector schemes has grown steadily from 4.1m in 1995 to 5.5m in 2007. For all private sector defined benefit schemes, whether open or closed, the sponsor of the pension fund has to match assets and liabilities over the long term. The value of UK pension funds is calculated on a going concern basis so schemes may require additional injection of funds for a variety of reasons: these include a decline in value of scheme assets, an increase in life expectancy and lower yields on long-term government bonds.

Insurance buyout market For companies that have closed their defined benefit schemes, the insurance buyout market represents an option for full or partial exit from managing their pension liabilities. Until recently the main recourse to this market was for businesses that were insolvent or in serious difficulty. The buyout market provides a means of securitising pension liabilities with an insurance company with the eventual aim of winding up the scheme. Business written in the insured buyout market averaged a modest £0.5bn in the first three quarters of 2007 but rose to £1.8bn in the fourth quarter and to £2.2bn in Q1 2008 (Chart 9).

In the medium term, trustees are more likely to be attracted to the security that buyout brings. However, the volatility of credit markets in the closing months of 2008 led many trustee boards to defer the decision to buyout until market outlook, particularly for defaults, becomes more predictable. They will also have been deterred by higher charges imposed by insurance companies for buyouts following the fall in value of pension fund assets.

FTSE 100 pension schemes The financial position of FTSE 100 pension schemes deteriorated considerably between mid-2007 and mid-2008. Lane Clark & Peacock estimates that FTSE 100 companies in aggregate recorded a net deficit in their pension funds of £41bn in mid-2008, down from a net surplus of £12bn in 2007 (Chart 10). The mid-2008 valuation is comparable with that in mid-2006 when it was £45bn.

Despite the substantial drop in equity markets since mid-2008, pension funds financial position has been underpinned in the final quarter of 2008 by a fall in liabilities caused by soaring yields in the AA corporate bonds. These bonds are set as the benchmark in IAS19 accounting regulations for discounting the net present value of future liabilities. The rise in yields to above 9% for 5-year bonds in the autumn of 2008 from 6% a year earlier, means that the a drop in value of liabilities has occurred alongside declining value of assets related to falling equity markets. The higher long-term bond yields have stemmed from widening spreads related to the credit crunch.

There is unlikely to be significant improvement in credit markets in the short term. It is possible that an eventual narrowing of spreads will be accompanied by recovering equity markets which would contribute to some equilibrium in the aggregate position of pension funds. If however a narrowing of spreads occurs ahead of any significant recovery in equity markets then the financial position of pension funds will deteriorate and further capital injections may be required.

Chart 9 Insurance buyout market for UK pensions

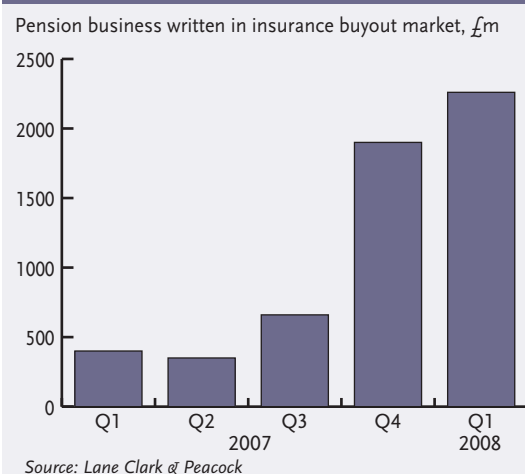
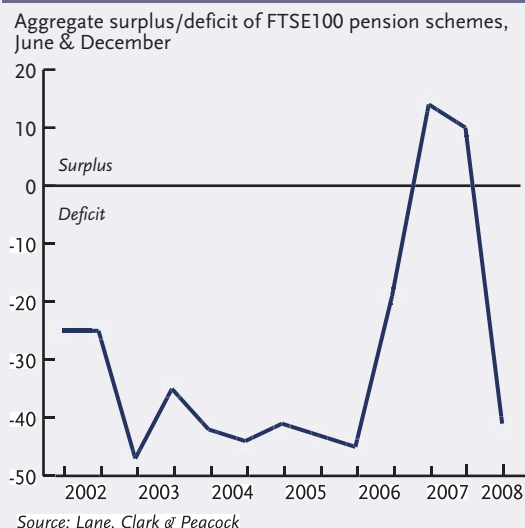


Chart 10 FTSE 100 pension schemes



Companies with the largest pension deficits in 2007 were BAe Systems, British Airways, AstraZeneca, HSBC, Tesco and Rio Tinto. Some schemes have been obliged for regulatory reasons to reduce their equity exposure.

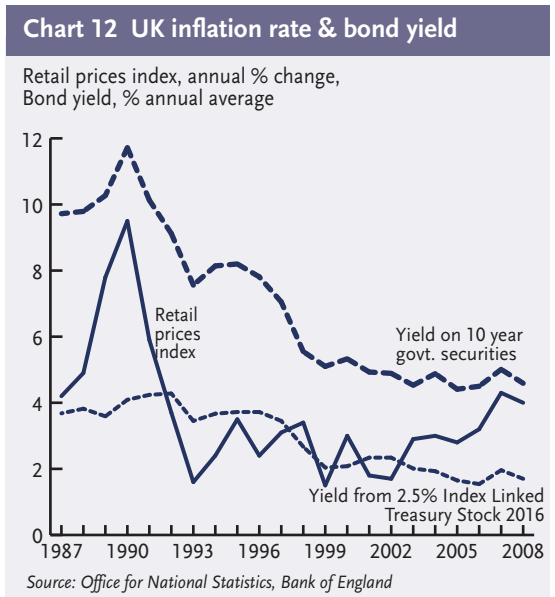
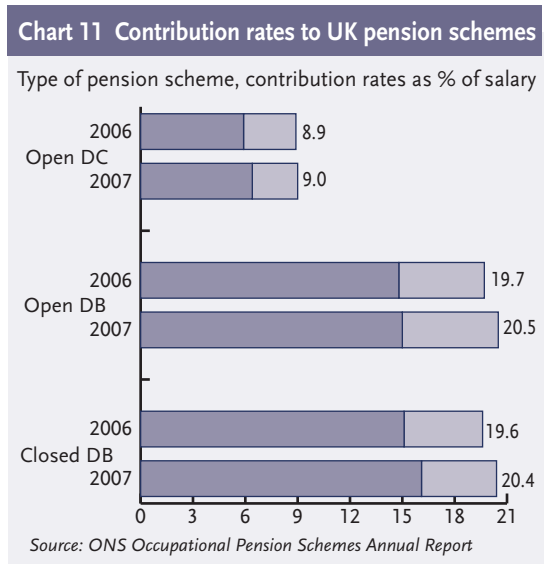
Pension Protection Fund The Pension Protection Fund (PPF) was established in 2005 to compensate members of eligible defined benefit pension schemes in the event of their employer becoming insolvent and where there are insufficient assets in the pension scheme to cover Pension Protection Fund levels of compensation. The PPF is funded by levies on all eligible pension funds. Assets under management doubled to nearly £1.5bn at end-March 2008. Increased pressure on companies finances resulted in the number of schemes transferred to the PPF rising from 38 to 67 between March and December 2008. The number of members in transferred schemes also increased from 12,000 to 20,600. A further 273 schemes with 121,000 members were under assessment at the end of 2008.

Exposure of pension schemes to ‘toxic assets’ that have been at the centre of the credit crunch is on average limited although a few individual schemes have higher levels of exposure. PPF has indicated that the two key risks to pension schemes are the general fall in asset values and the emerging pressures on the solvency of sponsoring employers. In the light of these risks, the PPF in November 2008 put forward proposals that would make the pension protection levy paid by eligible pension schemes more tailored to the individual risk each scheme poses to the PPF. Two key features of the proposals are:

- To assess the probability of a scheme’s sponsoring employer going out of business during a five year period – as well as separately assessing, as now, the probability of it going out of business during a one year period.
- To take account of the risk that a scheme’s investment strategy poses to the PPF when calculating its individual levy.

Financing of DC schemes The rising cost of DB schemes has led companies and other organisations to switch funding of pension schemes to defined contribution (DC), particularly for new employees. Average investment into DC schemes is substantially less than the DB schemes they have replaced. The Occupational Pension Schemes Survey conducted by the Office for National Statistics, found that in 2007, open DC schemes were only contributing 9.0% of salary, compared with over 20% for open and closed DB schemes (Chart 11). Employer contribution was 6.4% in the open DC schemes less than half the 15.0% of open DB schemes and 15.0% of closed DB schemes. Member contributions to open DB schemes had increased from 4.9% to 5.5% of salary. Overall contributions to open and closed DB schemes rose by about 1% of salary in 2007 in contrast with DC schemes where there was a marginal 0.1% rise in share of salary.

There are concerns that retirement income generated from these schemes will prove to be inadequate because funding is on average only half that of a DB scheme. Moreover, expected payouts on annuities financed by DC schemes have fallen as expectations of lower inflation over the long term has reduced the yield on long term government securities. Retail price inflation rose to an average of



4% in 2007 and 2008, although the 12-month rate had fallen back to 1% by December. The previous 15 years had seen a relatively low rate of inflation averaging 2.7% a year sustained (Chart 12). As a result yields on government securities, which are used as the basis for payouts on annuities, have been much lower. The average yield on 2.5% index-linked bonds eased back to 1.7% in 2008 from 1.96% in 2007. Over the longer term the yield has more than halved from over 4% in the early 1990s. The average yield on government securities with a 10 year term, which had also picked up to 5.0% in 2007, fell back to 4.6% in 2008.

The impact of low levels of pensions and other retirement income is reflected in growing employment in those of pensionable age. Having risen slightly during the 1990s employment in this group has increased at a faster pace in recent years: by around 70,000 a year or 425,000 in total from 900,000 at end-2002 to 1.32m at Q3 2008 (Chart 13).

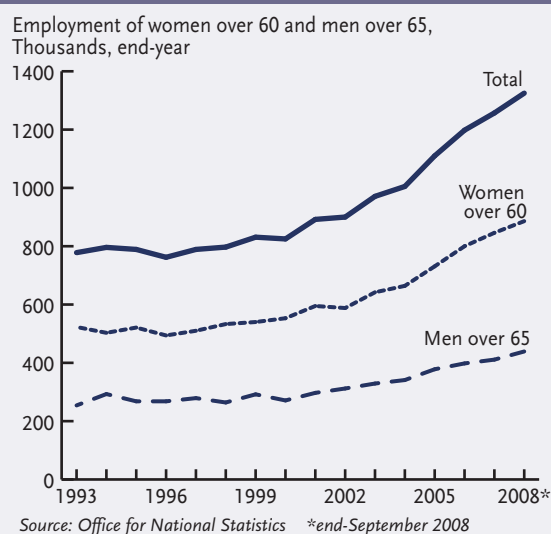
Financing of public sector DB schemes The substantial shift to DC in the private sector is not reflected in the public sector where employees are largely financed through DB schemes. As indicated in Chart 8, members of public sector pension schemes have grown to 5.5m. Some reforms have been put in place to address the growing liabilities. These include a move in some cases to career average salary instead of final salary; a move to sharing costs above a certain defined level between employees and employers; and a move to higher pension ages for new entrants. Despite these reforms a substantial unfunded deficit is outstanding, officially estimated at £600bn although some independent estimates of liabilities are much higher. Without further reform, this shortfall will have to be funded on an ongoing basis by the taxpayer.

UK policy response

Recent years have seen a raft of measures to reform pension provision and map out the proposed way forward on pensions in the UK. These measures culminated in the legislation as set out in The Pensions Act 2007 and The Pensions Act 2008. The Pensions Act 2007, set out in the side panel on page 11, focused on developments in the state pension system and state pension age, while The Pensions Act 2008, featured on page 11, sets out reforms in private provision including auto enrolment with minimum employer contributions. The overall intention is to put the financing of pension provision on a sustainable basis over the long-term and to ensure appropriate pension provision for each individual.

These measures followed other reforms to personal and workplace pensions that have come into force in recent years. The Pension Protection Fund, described on page 9, was established in 2005 while key measures in 2006 were intended to simplify and standardise pension provision. These included: a lifetime limit on the value of any personal pension fund, initially set at £1.5m; tax-free lump sum on retirement fixed at a maximum of 25% of the fund; and pension contributions of up to £2,800 a year to be eligible for tax relief even when the contributor is not a taxpayer.

Chart 13 UK employment in people of pensionable age



The Pensions Act 2008

The Pensions Act 2008 contains a number of measures aimed at encouraging greater private pension saving. From 2012 it is planned that all eligible workers, who are not already in a good quality workplace scheme, will be automatically enrolled into either their employers' pension scheme or a new savings vehicle, which is currently known as a personal account scheme. To encourage participation, employees' pension contributions will be supplemented by contributions from employers and tax relief.

Automatic enrolment It is planned that from 2012, employers will automatically enrol eligible workers' between the ages of 22 and State Pension Age who are not in a qualifying scheme into a qualifying workplace pension scheme (which can include the new 'personal accounts' scheme). Automatic enrolment means instead of choosing whether to join a workplace pension scheme provided by their employer, all eligible workers will have to actively decide not to be in a scheme, if for any reason they feel this is not a suitable form of personal saving for their situation.

Minimum employer contribution For the first time all employers will be required to contribute a minimum of 3 percent (on a band of earnings) to an eligible employee's workplace pension scheme. This will supplement the 4 percent contribution from the employee and around 1 percent from the Government in the form of tax relief.

The personal accounts scheme From 2012 it is planned to introduce a new low cost saving vehicle (the personal accounts scheme) aimed at employees who don't have access to a good quality work based pension scheme - in the main, median to low earners. The scheme, which will run as an occupational pension scheme, will have low charges and have a contribution limit of £3,600 per year and a general ban on transfers in and out of the scheme, to focus the scheme on the target market.

The government has moved to appoint a Personal Accounts Delivery Authority (PADA), in line with the Pensions Act of 2007. However, there has been criticism from the pensions sector about combining the launch of Personal Accounts designed to catch those without pensions, predominantly the less well off, while retaining means tested pensions credit. The pensions sector argues that this might result in the provision of more benefits without requiring any individual contribution. The pensions sector has also expressed concerns that companies currently making higher contributions to their own DC schemes might reduce them to the lower level of the Personal Accounts option. While auto enrolment might capture many of the 10 million people without pensions at present, there remain 4.7 million who work for companies with pension schemes but do not opt in to their schemes.

The Act also includes a number of other measures designed to simplify the existing system, for both state and private pensions, and makes a number of changes relating to the operation of the PPF.

The Pensions Act 2007

The Pensions Act 2007 put into law reforms to the state pension system set out in the White Paper, *Security in retirement: towards a new pension system* published in 2006. Reforms cover the Basic State Pension and the State Second Pension and will change some of the qualifying conditions for both. Key changes include:

1. **Basic State Pension (BSP)** The number of qualifying years needed to receive a full BSP will be reduced from 39 for women and 44 for men to 30 years for both. Annual cost of living increases in BSP will be linked to earnings rather than price. Subject to affordability and the fiscal position the intention is to start in 2012 but, if not then, by the end of the next Parliament at the latest.
2. **State Second Pension (S2P)** From 2010 national insurance credits will be introduced for those with long-term disabilities and people with caring responsibilities so that they can build up additional pension entitlement.
3. **State Pension Age** State pension age will be increased gradually, between 2024 and 2046, to 68 for both men and women to reflect increasing longevity in society and make the state pension affordable in the long term.

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