

THOUGHT PIECE 2

Defined benefit (DB) pension funds offer employees a pension on retirement that is usually based on a percentage of their final salary. The percentage is calculated according to pensionable years of service, as well as an accrual rate of so many per cent of final salary per year.

To provide the funding necessary to pay this pension, members and employers contribute a proportion of members' salaries each month into a fund, which then invests the cumulative contributions in the ways best calculated to generate sufficient funds to meet members' future pension requirements.

Worldwide, many pension funds have found during their regular statutory actuarial valuation that their accumulated funds are inadequate to meet their projected future obligations. There could be several reasons for this, including sustained poor stock market performance, or the increasing longevity of pensioners. It may also be that the contributions of employers and employees are simply inadequate to meet promised benefits.

When a fund has insufficient funds to meet projected liabilities it must draft a plan for addressing the shortfall. The plan must achieve either more rapid than currently projected asset growth, or it must reduce future liabilities to eliminate the shortfall. Increasing assets requires either a lump sum injection of additional funds by the employer, or for employers and/or employees to increase their monthly contributions. Reducing liabilities requires either reducing members' future pension benefits (by lowering the accrual rate) or decreasing future pension increases.

A practical example of a very large pension fund that recently found itself in this sort of difficulty is the UK's Universities Superannuation Scheme, which is the pension fund for 340 higher education institutions in the UK and has nearly 460 000 members. According to the Financial Times of 29 July 2020, this fund had a funding deficit of £12.9 billion in March 2020. This meant that the fund had only 84% of the funds required "to meet all pension promises in full". One reason for the shortfall, the Financial Times reports, was the initially negative impact of Covid-19 on stock markets, as well as low interest rates.

But the fund's difficulties predated Covid and the shortfall was already £4.4 billion a year previously. Thus, the fund's chief executive is reported as saying that Covid merely "highlighted the long-term challenges facing open DB pension schemes". These challenges include low interest rates, increasing life expectancy, and volatile financial markets, which "had already made promises of a set retirement income for life 'more expensive'" (Financial Times, 29 July 2020).

According to The Guardian (4 September 2019) the fund's deficits continue despite efforts as far back as 2011 to address them. Since 2011 the shares of salaries paid as contributions have been increased for both employers (from 16% to 20.1%) and employees (from 6.35% to 9.6%). A salary cap for defined benefits was also introduced which impacts most on those on higher salaries. According to a study for the union representing university and college employees, the typical member will now pay £40 000 more into their pension fund. Despite this, the study suggests that the member will receive nearly £200 000 less in benefits (The Guardian, 4 September 2019).