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Pension problems

Rail pensions deficit the result of "*Alice in Wonderland* economics"

The 2013 annual report of Directly Operated Railways, the Government-owned company that operates East Coast trains, contained information that the Railways Pension Scheme (RPS) deficit in respect of staff members had grown from £87.6 million to £181.8m in a single year.

The RPS continues to be run as a unified structure, but is divided into Sections that reflect the individual employers within the industry. It is a shared cost fund, with payments from employers representing 60% of contributions made and employees 40%.

East Coast's circumstances are no different from other train operating companies, and represent a challenge to preserve the value of pensions at an affordable cost to both parties. The current industry contributions are significant, with a typical total of 27.5% of pensionable pay, of which the employee pays 11%.

The sum involved might reasonably be expected to earn an investment return that is sufficient to allow employees who retire to draw two-thirds of their final salary after 40 years' service, and be paid a tax-free lump sum.

The rules allow for a pension to be taken at any time from age 55, although there is a penalty if staff do not wait until they are aged 60. In practice, many seek to maximise benefits by completing 40 years of membership.

A number of factors have led to the current deficit position. Although a valuation estimate is made annually, it is the formal actuarial assessment (undertaken every three years) that determines the level of contributions. This includes a requirement for a firm plan to eliminate a shortfall, which can be agreed for periods that might be over ten years or more.

Two major influences have distorted the relationship between contributions and benefits.

Firstly, lower investment returns have been available since the Government pursued a policy of low interest rates, and the programme of quantitative easing that has seen the Treasury put £375 billion of cheap money into the financial system.

Secondly, increasing life expectancy means that a person under the age of 45 today can expect to receive a pension for more than 30 years if they retire at 60.

Where pension deficits have been declared, people are looking more critically at the difference between the funding requirements identified by actuaries, and the accounting calculations used by companies (which have been generating much greater shortfalls).

You might well ask why these are different, as it is a question asked by accountancy professionals as well.

Professor Dennis Leech, of Warwick University, goes as far as to describe the rules that have been established by accounting standard FRS17 as producing "*Alice in Wonderland* economics".

How is this? What has happened is that these regulations convert all future pension promises into a single projected liability that must then be added to company balance sheets, which as a result reduces the funds available for investment.

As the obligation is over many years, a

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discount rate is applied. The controversy is in this valuation - it is fixed by judgement, rather than fact, and inevitably opinions can vary greatly.

Professor Leech believes it is "a number plucked from the air", and that as a result the liabilities that are required to be

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+44 (0) 20 7264 4700
info@precise.co.uk
www.precise.co.uk

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recorded have nothing objective about them, and so represent a "fantasy world".

He goes on to say that the theory has been found to be "a house of cards so many times in the past" that it should be laid to rest, and that the real value of the fund should reflect contributions, with pensions costs calculated at the valuations made by actuaries.

Accounting deficits have generated the type of alarming figure displayed in the DOR and other TOC reports, which (if they are believed) will lead to the closure of many RPS final salary sections.

Trustees, who include management and staff representatives, consider the real picture is different, and that shortfalls are manageable by changing contribution and benefit rules. This has been a process of identifying gold-plated benefits that can be given up, and concentrating on the core index-linked pension.

Under the current regime, the trends show that it is mainly the franchised operators that have remained in the RPS, offering final salary benefits in what might be seen as the traditional manner. This has been possible because the deficits can be moved on to a subsequent franchisee, and do not therefore become the type of liability that would be experienced by (for example) a freight operator.

In the future franchised operators clearly have to adopt a more realistic approach. The aim of eliminating actuarial, if not the controversial accounting, deficits should be a part of the delivery plan for new contracts.

Another area of concern is the potential minefield in the context of devolution, and the interpretation of what constitutes a European Union cross-border scheme. Defined benefit schemes are required to be fully funded at all times, and if it becomes a cross-border scheme (which could potentially include an operator running between London and Scotland), any deficit must be removed within 24 months of the valuation date.

In addition to the issues for employees who have joined the RPS, there are concerns about future pension provision for the many that haven't - in all likelihood due to the cost of contributions.

Next year the Government is introducing a new mechanism to encourage pension scheme membership, by requiring employers to create defined contribution schemes whereby savings made by employees are matched and individual pension funds created.

The initial employee payment has been fixed at 2%, and although this is not compulsory deductions will be automatic unless the individual opts out.

This combination of a much lower level of contribution and the opt-out principle is expected to see a much greater take-up, and one that employers support as the investment risk is removed.

Everyone needs a decent pension, and it is time pension regulators got a grip of accounting standards that are mitigating against this.

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