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MONEY BOX: PENSION SPECIAL

Presenter: PAUL LEWIS

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LEWIS: Hello. Final salary pension schemes are dead. That's the general consensus of a dozen people we've spoken to in the last couple of weeks, and today we're exploring that idea in a special Money Box for this Bank Holiday weekend.

ALTMANN: Final salary schemes were always a bit of a con trick. They only work when the schemes are young, when lots of money is coming in and there aren't many pensioners. It could be described as being like a Ponzi scheme. Pensions are not magic money. We've been kind of led to believe somehow that they are and that they'll always be there, and anyone who's putting money into a pension scheme somehow feels that that will guarantee them a good outcome in a way that isn't realistic.

LEWIS: Ros Altmann, Director General of Saga. Final salary pension schemes do what they say: when you retire, they pay you a pension based on your final salary. If you stay with one employer all your working life, that pension will be half or even two-thirds of the pay you got in the year you retire. Sounds ideal or, if you like, magic. But over the last 40 years final salary pension schemes have come under huge pressures. Four out of five are closed to new members of staff and many are now closed completely. Unilever is just one major employer which announced this month why it's taking that step.

UNILEVER ANNOUNCEMENT: Unilever is closing the final salary plan to

existing employee members. The changes have been proposed to help tackle the increasingly unaffordable and unsustainable costs.

LEWIS: Instead Unilever has set up a pension scheme with no guarantee of the final pension paid. The company pays into a pension pot for each member of staff. These schemes are usually called money purchase because they save up money which then purchases a pension. Or nowadays, just to confuse things, they're called defined contribution schemes because it's the amount going in which is promised, not the pension coming out. And that means of course that final salary schemes are relabelled defined benefit schemes because the benefit is promised. It was all very different in 1967 when final salary schemes were at their peak and the only scheme around. In that year, the BBC's Money Programme looked at pensions and took Unilever as its shining example.

EXTRACT: BBC MONEY PROGRAMME (1967): The big firms like Unilever are able to offer the best, most generous pension schemes. They can afford the generosity and, anyway, it makes sense: a good pension encourages a man to be loyal to his firm. Employees in this margarine factory contribute to a Unilever fund worth over £90 million and administered by experts.

UNILEVER FEMALE EMPLOYEE: I think it's very good. It's very beneficial to me. I've nearly done my 40 years service, and by the time I retire in about 5 years time, I shall receive almost a half of my wages.

LEWIS: So what's gone wrong with these pensions that, after all, offered what we wanted: a small contribution from us to get a reasonable and guaranteed pension for life? The road to ruin began in 1975. Until then, if you left your job you left the pension scheme and you left most of the money behind. All you got as you were shown the door was a small cheque for the contributions you had made - minus tax relief. All the employer's contributions and all the investment growth on those and on yours stayed behind. That's what happened to Joan who began work in an insurance company just after World War Two.

JOAN: In 1951 when I first joined my first insurance company - I was employed by Northern Insurance and was a member of their pension scheme - if you left the insurance industry (which I did in about 1970), it didn't follow; you lost the lot. And I had then over 20 years pension. All that I'd earned in that 20 years had just come to nothing really.

LEWIS: Bad news for Joan, but good news for the people who didn't leave. Their pensions would be partly paid by the 20 years contributions she left behind. This cross subsidy from early leavers to those who stayed was one reason pension scheme finances worked. It wasn't until 1975 that this unfairness was first tackled, and over the next 30 years the cross subsidy was ended altogether. And that meant pension schemes needed more money going in to fill the gap. Another unfairness was also tackled at this time. Inflation was very high throughout the 1980s and there wasn't much point in preserving or even paying a pension unless it was raised each year as well. Again a series of changes over the years slowly made sure that happened, and that inflation proofing cost pension funds even more. Ronnie Bowie is President at the Institute and Faculty of Actuaries - Britain's top actuary if you like.

BOWIE: Inflation proofing has been one of the big burdens on schemes, but the fact that it's a big burden reflects the fact that protecting people against inflation is expensive. And it was made doubly difficult because in a couple of cases it was retrospective, and the whole business of retrospective changes to pension schemes has been a theme of the last 40 years and one of the reasons that companies were unable to adjust to the changes that they were having to face.

LEWIS: We'll hear later just how much that did cost. But at the time cost wasn't an issue. Share prices were soaring and pension funds grew with them. As a result most pension schemes had far more money than actuaries said they needed to meet their pension promises and many firms wanted to take back some of that surplus.

NIGEL LAWSON (1986 BUDGET): I do need to deal with the growing problem of the rules governing pension fund surpluses. The dramatic improvement in the financial … *(fades under)*

LEWIS: Chancellor of the Exchequer Nigel Lawson in his 1986 Budget.

NIGEL LAWSON: Where a surplus is 5% or less of total liabilities, no action will need to be taken. Where it is higher than that, action will be required to eliminate the excess. It will be entirely a matter for the trustees and employers to decide whether the reduction is to be achieved by increasing benefits or by reducing contributions or by making a refund to the company.

LEWIS: Very few companies took the refund - they'd have been charged tax on that. Much more efficient was to take what is now called a contribution holiday - paying in nothing until the surplus disappeared. So was Lawson's Law a good idea? Bob Scott is senior partner at actuaries Lane Clark Peacock.

SCOTT: It was calculated on the basis of financial conditions in 1986. And I think had Nigel Lawson's Law lasted for you know a short period of time - perhaps 3 to 5 years to enable companies to deal with those surpluses - then things would have been very different. But companies who started on contribution holidays got used to them, and so they kept them going.

LEWIS: And over the next 20 years companies withheld nearly £20 billion of contributions and let the members off another billion. They also gave away 9 billion pounds worth of enhanced pension benefits. In total, company pension schemes lost £30 billion. Nowadays few people remember Lawson's Law. Indeed if you ask people why pension schemes are in trouble, it's another Chancellor's name that comes up.

GORDON BROWN: Many pension funds are in substantial surplus and at present many companies are enjoying pension holidays, so this is the right time to undertake a long needed reform. The last government cut tax credits paid to funds and companies. With immediate effect, I propose to abolish tax credits paid to pension funds and companies.

LEWIS: With those words Gordon Brown scrapped tax relief on dividends. The

change was supposed to make companies reinvest more of their profits - and if pension funds needed more money, well they could always end their contribution holidays. But ‘Brown’s pension tax grab’ is still seen as the event which brought many final salary schemes to their knees as people latched onto the fact that it would raise more than £5 billion for the Treasury in the first year. But not all of that was from pension funds, as the Pensions Policy Institute revealed in its research a few years later. Niki Cleal is its Director.

CLEAL: We felt that was slightly an overestimate. We estimated the true figure was closer to two and a half to three and a half billion pounds. But almost irrespective of that, I still think that it’s important to put all of these figures into the context of the global amount of money that was invested in all pension funds at that time, which was about a thousand billion pounds.

LEWIS: A trillion - a million million pounds?

CLEAL: Exactly. So even if you accept the 5 billion figure, that’s still only around half a percent of the money and the funds that were in pension funds at that time. So I think it’s hard to argue that that was a primary driver. I think there were other factors like life expectancy and high equity returns that were more responsible for the changes that we saw to final salary schemes.

LEWIS: And what does actuary Ronnie Bowie think of its significance?

BOWIE: I wouldn’t say that his tax changes were of themselves a killer blow - in part because schemes worked around them, in many ways avoided the difficulties of the scheme. The difference that Gordon Brown’s tax made to the actual investment returns was relatively modest. The real problem has been that for a decade investment returns for British pension schemes have fallen well short of the amount that those schemes were anticipating. I would guess that Brown’s tax maybe accounts for an eighth of that shortfall, but I would guess no more than that.

LEWIS: And Saga's Ros Altmann says much more important than Brown was the poor performance of Ronnie Bowie's whole profession. Actuaries are supposed to forecast the future, but they clearly didn't get it right.

ALTMANN: Actuaries failed to predict accurately the performance of equity markets. However high equity markets rose, even towards the end of the 1990s when many people could see that stock markets were in a bit of a bubble, actuaries kept on forecasting strong returns going into the future. They didn't get life expectancy forecasts right either and you ended up with a position around 2000 where increased taxes had taken away money from pension fund dividends, inaccurate life expectancy forecasts had led you to believe that pensions would need to be paid for much less time than they actually were going to be paid, and you had a stock market crash which took down the value of the assets that were supposed to be there to pay the pensions.

LEWIS: So actuaries assumed equities, share prices, would carry on rising strongly in value. But when it came to life expectancy, they assumed that would not carry on growing. Professor David Blake, Director of the Pensions Institute at Cass Business School, says that double error was unforgivable.

BLAKE: They didn't have the right models to forecast increases in life expectancy. They used old-fashioned mortality tables which weren't updated very regularly. And also the data about pension plan members simply wasn't good enough.

LEWIS: So in that sense, it wasn't their fault if you like? They just didn't have the data to do the job properly?

BLAKE: As actuaries, they ought to have realised that keeping up to date with trends in mortality should have been an important consideration for them, but they didn't start collecting the data until very recently.

LEWIS: I mean one actuary has said to us that life expectancy didn't seem that big a deal because pension funds were making so much money out of the stock market at

the end of the last century that whether you lived an extra year or two didn't really matter.

BLAKE: Those were the good old days. But now we know that with volatile stock markets, a terrible decade of volatility and increasing life expectancy, it is now critical that the data sets are there to analyse the mortality experience of plan members. It was the attitude, the gung ho attitude that the British pension plans have about equity markets would always be there to bail you out of any difficulties, and we now know that's just not going to happen anymore.

LEWIS: We've looked at the changes in the law by politicians, and we now have to factor in this decade when share prices were not the sure bet they had been for a quarter of a century. And on top of that life expectancy was growing by two or three months every year that passed. We now also have to add new rules which made schemes keep far more money to meet the pension promises they'd made, turning surpluses into deficits. So how does that long list increase the cost of pensions schemes? Ronnie Bowie sets it out.

BOWIE: Well let's roll the clock back to the mid-1970s when the employee was paying in 5, the employer was paying in 6% of pay. Everybody thought they were going to get a two-thirds pension and the world was a happy place. What's happened since then? Well a series of good intentions have increased the costs substantially. Firstly the protection for people who left. That's probably taken the employer's 6 up to about 8. And then we've got the inflation protection, which is another of the good intentions, which takes the 8 up to about 15. And then we've got Brown's tax charge, which takes the 15 up to about 17. Then we've got longevity, which takes the 17 up to about 25. And then we've got the changes in the mid-2000s that said that a promise is a promise, that a company can't walk away, and that has caused companies to realise that the real cost of this pension scheme is much more onerous than they thought and that's taken the 25 up to about 35%. So in a series of small steps, the base cost - which I believe is the reason the final salary schemes are doomed now - is that base cost has risen from about 6 to about 35. That's the base cost. When you think about how far behind the assets have fallen, about the pace that we hoped that they would

keep up, they've fallen behind because investment returns have been well below those that were anticipated. And also because of greed - because many companies plundered the schemes for benefit augmentations - for contribution holidays, and so they've really sort of put shackles round the assets that couldn't grow because they were being plundered in that way.

LEWIS: And Lawson versus Brown?

BOWIE: Brown's tax probably in total has had a cumulative impact of about 50 billion. Lawson's Law, the contribution holidays and those sorts of things were taken very unevenly. But in aggregate, I would put them both at about the same level of about 50 billion each.

LEWIS: A draw then. But if it will cost a third of the pay bill to sustain final salary schemes, do they, can they have a future? David Blake.

BLAKE: There's no future in the private sector for final salary pension schemes. Very sadly, in 10 or 15 years one of the great contributions that this country built up over 150 years to give reasonable pensions in retirement to workers related to the salaries just prior to retirement has come to an end in 15 years. It's tragic.

SEGUE:

ALTMANN: I think it's the end of final salary pension schemes. I have no doubt that once a final salary pension scheme has closed to new members, it's finished. It is going to close to everybody sooner or later because there will be a fairness argument, which has already been used by companies like Boots, which is well it's not fair that we've got workers being paid the same salary today, doing the same work, but who have actually got a lot more money because they're in the final salary scheme than the equivalent workers who are in a different type of pension arrangement, so we're going to shut the final salary scheme to everybody in order to be fair.

LEWIS: Ros Altmann ending that part of our programme. To discuss if final salary pensions are dead, we brought two of those guests back into the studio, together with John Ralfe, a pensions consultant who was formerly in charge of the Boots pension scheme. Did he think they were dead?

RALFE: Well I'm afraid to say, Paul, that I think they are. And there are a whole series of things that have happened over the last few years that mean they're dead, and I would ask the question rhetorically: if we didn't have final salary pension schemes would we invent them? If we were sitting down you know starting a company, why would we want a final salary pension scheme? Answer: not quite sure.

LEWIS: But surely the reason you want them is because they give people certainty? They pay in and they know what they're going to get; whereas any other pension, you don't know that, do you?

RALFE: No, that's absolutely right. But pensions are simply a perk and the trouble is over the last 40 or 50 years we've understated the cost of providing that pension, so it appears as though you get something for nothing.

LEWIS: Yes, it certainly did, and I think now we realise that it isn't something for nothing. Also with me is Niki Cleal of the Pensions Policy Institute research organisation. Niki Cleal, what does your research show? Do you think they are dead or is there a way out?

CLEAL: Like John, I think final salary schemes are largely dead. I think increasingly we are going to see much more of the risk passed on to the scheme member instead of being held by the employer.

LEWIS: So we seem to be agreed, and we heard earlier from Ronnie Bowie who's with me in the studio as well, President of the Institute and Faculty of Actuaries. Ronnie Bowie, if they are dead - and there seems to be a general consensus - what killed them? Was it actuaries getting it wrong?

BOWIE: It wasn't actuaries. It was a whole raft of things.

LEWIS: *(over)* Well you did get it wrong, didn't you?

BOWIE: No, I don't think actuaries did get it wrong in the sense that I suspect critics would say. When actuaries do their sums, they say that the amount of money going into the pension scheme will be sufficient provided you get a return of x. In fact we didn't get x and we were derailed by a whole load of other things. But it would be wrong to say …

LEWIS: *(over)* And life expectancy was longer than you expected as well.

BOWIE: Life expectancy was longer than anybody expected. So the basis on which final salary schemes were operated turned out to be over optimistic, but to say that any particular group got it wrong wouldn't be true. It's very difficult for the public to understand uncertainty. People really have no grasp of the range of possible outcomes from investing in stock markets.

LEWIS: John Ralfe, where do you think we went wrong?

RALFE: Well I think in fairness to actuaries, however much blame should be attached to them, they were playing to a willing audience of company directors who were quite happy to take the sorts of risks that we now see as being rather dangerous. What I like to say is that final salary defined benefit pension schemes have operated on the basis of investing in equities …

LEWIS: In shares, yes.

RALFE: … in shares, in taking a very, very significant risk. Would the company be prepared to take that risk directly - in other words to go out and issue lots of long-term debt and use the cash from that long-term debt to buy shares? And the answer is well no, they wouldn't. So I say well if you wouldn't do it directly on your balance sheet,

why on earth would you do it you know through your pension scheme?

LEWIS: And you've always thought that the pension scheme should invest not in shares but in bonds that have at least a return you can pretty well predict over the term of the pension?

RALFE: Yes, I mean my overall view is that whatever risk the company wants to take should be clearly articulated with its shareholders. And having articulated with your shareholders what you want, you should then take that risk in a transparent way and in a way that's tax efficient, which rules out holding equities in the pension scheme.

LEWIS: Niki Cleal, where do you think we went wrong?

CLEAL: I think the two key things were underestimating life expectancy. I mean in 1967, which was when occupational pensions were at their peak, a 65 year old man might have lived for a further 12 years. In 2011, a 65 year old man might live for 22 years. I mean that's extraordinary in terms of the impact on the cost of offering a pension promise.

LEWIS: In a simple way, it's almost doubling the cost?

CLEAL: You know it's extraordinary and I just don't think that we foresaw the medical and technological advances that were going to extend life to that extent. And I think that wouldn't necessarily have been a problem if we'd have started to think about retirement in a different way, if people had started to retire later. I think we are going to have to get into a world where both employers and individuals start to change their expectations about when they will retire.

LEWIS: Ronnie Bowie, can you say now how long we should prepare for people to live? Can we ever have a figure that is realistic?

BOWIE: I think what we can have is better predictors and better early warning systems of what's going to happen. So we now know that the assumptions that actuaries are typically making will be correct and therefore if medical science goes faster than that, we'll be much quicker onto the matter than before. If medical science doesn't work out or obesity becomes a bigger problem, we'll be able to react more quickly.

LEWIS: The Department for Work and Pensions said the other week, I think, that a quarter of the under-16s alive today could live to be 100.

BOWIE: And they also said a big proportion of the current 65 year olds will also live to 100. So we have huge social change to come, which won't be fixed by pension schemes, but the best we can do is firstly to be on the ball in spotting the changes and the trends and, secondly, to be much more flexible in our reaction.

LEWIS: John Ralfe, where would you see pensions in say 20 years time?

RALFE: Well rightly or wrongly, we're going to have some sort of defined contribution arrangement where the individual employee and the employer puts an amount away in a pot. That is invested in line with the wishes of the individual and at retirement you then buy an annuity.

CLEAL: In large part actually, I agree with John that the future for private sector pensions is mainly likely to be defined contribution arrangements.

LEWIS: So where you decide what you put in rather than what you get out. Ronnie Bowie, is that sustainable?

BOWIE: I think it is. Look at it from the point of view of the employer. In the public sector there's still some incentive for employers to give defined benefit pension schemes because people move around and it helps with retention. In the private sector there's nothing in it for the employer to have a defined benefit pension scheme. So I

think what we'll see is an evolution of the defined contribution product. That's the trend I see for the next 10 to 15 years.

LEWIS: Ronnie Bowie ending that discussion. So everyone concludes that final salary pension schemes are dead, though some compromise of relating pensions to average salary might keep these so-called defined benefit schemes alive a bit longer. But the real future for company pensions is paying money into a pension pot - a defined contribution scheme - and leaving it to chance how much our pension will be. My thanks to all those who took part today. There's more on our website: bbc.co.uk/moneybox. Email us with your thoughts on the death and future of pensions: moneybox@bbc.co.uk. Vincent Duggleby's here on Wednesday with Money Box Live taking questions on student finance. I'm back next Saturday at noon with Money Box and on my twitter, Paullewismoney, whenever I'm awake. Today the producer was Charlotte McDonald and I'm Paul Lewis.