Final salary schemes - consequences of being closed to new entrants

This paper considers the consequences for a final salary scheme being closed to new entrants, the effects on employer attitudes and behaviour and the possible consequences for scheme members' future pensions and employment.

Recent survey data and our own experience indicate that the majority of final salary schemes are now closed to new entrants and more may follow. Trustees and negotiators need to consider carefully what the long term consequences of this will be.

Higher Contribution Rate
When a fund is closed there will be no new entrants, who would tend to be younger in age than the average of existing members, and the average age of the members will rise as time passes. With any pension scheme the cost of any defined level of member's benefits at retirement rises with age, as contributions are invested for a shorter time. So as the average age of members rises the average contribution rate will also rise. Depending on the actuarial method adopted this higher cost may be recognised at the time of closure or allowed to emerge at future successive valuations.

In a closed fund the proportion of the liabilities represented by pensioners and member close to retirement will increase more quickly over time than if the scheme were open. Trustees of such schemes will generally be advised and will tend to adopt more cautious investment policies. Such policies, typically a switch of investments from equities to bonds, will lead to estimated investment returns being lower and the actuary advising that a higher contribution rate is needed.

Risks associated with future deficits
Where deficits arise in a scheme, the general practice is to express the deficit contribution as an additional contributions percentage for the employer in addition to the percentage contribution required for future service. As the number of active members gets smaller relative to the size of the fund, then the size of the additional contributions percentage for any deficit will get larger and the resultant figures will weigh heavily on employers perceptions of the cost of the scheme.

Likewise, where employers determine that they cannot afford the additional contributions for a deficit and decide to make an adjustment in the future benefits or member contributions to offset that cost, the size of the adjustments will become much greater.

Contribution rates in a closed scheme are in essence more volatile. Even if the employer recognises that, and they may well not have properly considered it, and suggest they are prepared to live with it their employees may feel that they will not and so feel threatened.

Widening cost gap vis a vis a DC scheme
Employers who close final salary schemes often offer a DC scheme instead to new employees. By their nature such schemes involve a fixed cost to the employer. At the time of closure there will be a perceived relationship between the cost of the old scheme and the cost of the new scheme.

As time goes on the cost gap is likely to rise on account of the factors driving rising costs in the final salary scheme. That cost gap may be enlarged greatly if further deficits emerge in the final salary scheme in the period following closure. This will make it much more likely that employers actions may be guided, whatever their original intentions, by the size of the cost gap. In effect they may begin to treat the final salary scheme more like a DC scheme by setting a limit on their future contribution.

Dividing the workforce and undermining opposition to future cutbacks
Employees may well object to scheme closures on the basis that the new DC scheme involves a lower rate of pension pay for new employees than for old employees. This may emerge in terms of lower benefits or through new members being required to pay higher contributions to their scheme in order to achieve a comparable level of benefit. It goes against the principle of people being paid the same 'rate for the job.'

New employees may resent the fact that their 'pension pay' is lower and come to feel that members of the final salary scheme are unfairly privileged. The effects of a different pension scheme can divide the workforce and by doing so make it easier as time passes for an employer to impose changes.

Job security may be affected
Over time the higher pension costs of employees in a final salary scheme, relative to employees in a DC scheme may lead to a situation where the employer will seek to contrive that any job losses required are concentrated on the final salary scheme members.

Unions have always negotiated rates for new employees
In some companies it is established to varying extents that pension scheme benefits are negotiated. Just as employees would feel threatened by a situation where the employer brought in new employees on pay rates lower than those which had been negotiated, so also will they feel threatened by new employees being brought in on pension terms inferior to those established for existing staff.

Unions will feel they negotiate pay rates for particular jobs and not just rates that are limited to particular individuals who hold them. If pay is negotiated for a bargaining group then unions are entitled to seek to negotiate pensions for that bargaining group. While employers may argue that pension terms for new employees are nothing to do with existing employees, those existing employees may take a different view.

Should you have faith in employer assurances?
While employers may say that existing employees are not affected and that there are no plans to change schemes for existing members they will never offer a guarantee to that effect – only for the foreseeable future.

Unions may feel that the new scheme and associated contributions are what the employer wants to pay for all employees and will have limited faith in any assurance or statement that existing employees will be protected or not affected. Such assurances may be accepted in good faith but employees equally are entitled to take the view that they are no more than a tactical ploy in a strategy to reduce all employees pay over a period of time.