

Trustee Risk Management

Pension Scheme Design: where now?

With defined benefit pension provision reducing, particularly in the private sector, the debate on whether there are viable options to the main alternative method of defined contribution, which passes all the risks to the member, is gathering pace.

The following two articles bring out some of the issues associated with this but from different perspectives. The first, from Guus Boender and Lucas Vermeulen of Ortec, draws on experience from Europe and how this might have application to the provision of retirement benefits in the UK. The second, from Hamish Wilson, builds on these themes, making

reference to the mandatory requirements that were progressively introduced for defined benefit schemes and which may have inadvertently contributed to their decline.

Although some proposals were not included within the recent Pensions Bill, the issue of shared risk arrangements is likely to feature more prominently as the industry looks to find solutions that address some of the challenges of defined benefit and defined contribution pension schemes.

These two articles are intended to stimulate the debate in this area.

01 Improved Risk Sharing: looking for better answers to DB's faulty design?

Guus Boender and Lucas Vermeulen



Two decades ago pension regulation would rely on the self-discipline and social responsibility of the stakeholders of defined benefit occupational pension schemes. But, pension assets grew so fast in relation to Gross Domestic Product that the impact on the profits and losses of the sponsoring companies became disproportionately large. Besides the pension industry was confronted with unfortunate events like the pilfering of the pension fund's assets by Robert Maxwell and a series of pension

wind ups, leaving thousands of beneficiaries without pension. As a result, a quick succession of pension reforms followed. In the drastically reshaped pension system, the owners of risk were explicitly appointed and risk transfer mechanisms were clearly prescribed. But now we find that the well intended pension reforms have reduced risk sharing among the stakeholders and have led to the rapid closure of defined benefit (DB) schemes.

In an attempt to turn the tide, the call for improved risk sharing is advocated in order to make the generous DB schemes affordable and risk sustainable. It is pointed out that the strict UK pension regulation stands in the way of possible efficient transfers of risk and reward, leaving too much risk with a single stakeholder. Experiences in Switzerland and the Netherlands reveal that conditional indexation can be considered a commendable and highly efficient approach to resolve the issue. However, this form of risk sharing is not the panacea, as it will typically not be enough to reduce the risk incurred by the plan sponsor and/or future generations.

In this article we would like to draw on our experiences with pension reform and reflect on the strengths and weaknesses of the various pension systems. We hope that this article will be helpful in a balanced debate on pension reforms that are

much needed, not only in the UK but in other countries as well.

The need for reform

Allegedly, members of DB pension schemes bear no risk. The pensions are protected against inflation (up to some level) and payments are for life. Despite the perceived desirability of DB, or perhaps because of it, the system has come under great pressure. The most important reasons for the closure of DB plans are the very large pension risks for sponsors, particularly for public companies, in connection with unfavourable trends in the equity markets, increased costs due to ageing and longevity, and a growing administrative burden.

The easy solution has been to abandon the DB schemes and change to occupational defined contribution (DC) and personal pensions. This certainly relieves the sponsors from pension risk. But it cannot make risk disappear as it is transferred almost entirely to the individual member. Personal pensions may have worsened the pension problem even further, notably because assets of individual schemes often perform badly relative to institutional portfolios.

We believe that DB and personal pensions are both unsustainable due to huge inefficiency and new risk sharing initiatives should be adopted, for instance conditional indexation.

Why is Defined Benefit (DB) no longer the perfect solution?

Longevity and ageing

Longevity and ageing are often put forward as the main reasons for the non-sustainability of DB and the subsequent demand for pension reform. Obviously, it is extremely costly to finance the increase in the retirement period without a

corresponding increase in the length of the working life. For example, retirement a year earlier can increase the pension cost of an individual by about ten per cent. Nevertheless, we believe that longevity in itself is not a sufficient reason for the non-sustainability of DB. Longevity risk could be effectively dealt with by applying a constant ratio between working and retirement periods, e.g. one year of retirement for every two years of work.

Pension accounting and pension regulation

The IAS 19 accounting rules as well as tightened pension regulatory frameworks are mentioned as the key drivers behind the need to abandon DB systems. It would be extremely unfortunate if this were to be true. Without doubt, the new standards and rules leave plenty of room for improvement. For example, according to the International Financial Reporting Standards (IFRS), a pension system that is not completely defined contribution should be classified as defined benefit. Such a strict classification is fundamentally wrong. For instance, in Switzerland and in the Netherlands payments that a company has to make are often limited in a formal agreement between the fund and the plan sponsor. This clearly reveals that these pension systems are not purely defined benefit. However, IFRS does not recognise formal risk-sharing agreements. Classification of the schemes as full DB pension systems creates an unwarranted pressure to change to personal pensions.

Funding status

Is a deficit in real or even nominal terms a valid argument for questioning the sustainability of DB? We do not think so. We believe that the deficit is likely to be overstated, because risk premiums that can be expected to be earned in the future are neglected in funding status

definitions. This in itself is not wrong at all, but deficits become much less severe if there is time to recover taking into account even very prudent future risk premiums. Therefore, we feel that the current funded status is not enough reason to reform DB either. The most important issue is risk.

Conditional Indexation

The compensation for inflation in DB schemes is largely responsible for the cost and the risk incurred by the plan sponsor. The Limited Price Indexation regime in the UK already shifts risk from the sponsor to the members. About ten years ago, we introduced another form of conditional indexation in the Netherlands. In so-called conditional indexed DB schemes accrual of pension rights to make up for inflation is conditional on the funding status of the plan, not on the level of inflation. Typically, retained indexation is reimbursed as soon as the funding status has sufficiently recovered. Consequently, the ability of the plan to recover is significantly improved, because risk premiums are automatically used to improve the funding status of the scheme if necessary. Besides, because equity returns and inflation are negatively correlated in the short-term (but positively in the long-term) conditional indexation enables the fund to avoid the negative impact of this correlation.

Maturity and solidarity

Conditional indexation is a very efficient instrument for reducing risk for the sponsor because of enhanced diversification. But will it be enough? We fear not. The most important flaw in DB schemes is the reliance on the willingness and ability of the plan's stakeholders to absorb the risk that unavoidably accompanies investments. If risk cannot be sustained by the stakeholders, clearly the pension plan should not be exposed to the amount

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of investment risk and the scheme should be reformed. Can risk be managed such that DB schemes have a future? For the current DB systems in the UK the answer to the question is for the most part no. This is because of the increasing maturity of pension plans and the resulting accumulating pension risk for sponsors and/or future members. In DB schemes, the proportion of liabilities relative to salaries increases over time. By rule of thumb, 10 per cent of the pension liabilities of a DB scheme that started 10, 25, or 50 years ago is equal to approximately 10, 25, respectively 40 per cent of salaries. This means that if a mature fund would have to make up a 10 per cent deficit, it would require an amount equal to 40 per cent of salaries. Funding deficits using contributions would put too large a burden on young people to support the old people. We see less possibility and propensity in contemporary society to do so. As a result, reform of the DB system is ineluctable.

Why personal pensions are not the answer?

The faulty arguments mentioned above have globally led to a strong movement from DB toward purely individual DC systems, initially in the US and more recently in the UK and the Netherlands as well. From the sponsor's perspective, moving to a personal pension system seems to solve the main shortcoming of DB because the contributions are fixed. However, personal pensions, in which employees bear virtually all the risk, have even more serious shortcomings than DB

Investments

Individuals typically make very poor investment decisions; they trade too often and too early or too late, and naturally suffer from a lack of economies of scale. It is estimated that individuals could underperform well managed, low-cost pension

schemes by five percentage points annually (according to a study by John Bogle in 2005). If you consider that one percentage point less return over an entire life cycle is equivalent to approximately twenty five per cent lower pensions, the performance results of individual investors can be potentially disastrous. Rather than being a solution, personal pensions are potentially the basis of a severe pension crisis.

Non-mandatory pension saving

Contributing to a personal pension is often voluntary. People can decide how much they choose to save for their retirement. Unfortunately, according to a recent survey by Brewin Dolphin around ten per cent of investors or around 2.4 million people planned to stop, reduce or interrupt their pension contributions during the next 12 months. According to the Pensions Policy Institute around 20 million people in the UK are not currently accruing any rights in a private pension. The dramatic result of this insufficient pension saving in combination with unprofessional pension investing is that large numbers of people will have insufficient retirement income to pay for their basic requirements

Time diversification

The next serious flaw of a personal pension is timing risk. For example, individuals who started saving for retirement in the early fifties of the last century would have accrued forty years later approximately half the pension capital compared to those who began saving in the late fifties. Robert J. Shiller writes in his book "The New Financial Order: Risk in the 21st Century": "The essence of finance is reducing the impact of risks by spreading them around to many people, and not just by diversifying an investment portfolio.

We must share the risk of generations in a constructive way. Making the generations depend on the success of their investments for their own retirement is not risk management".

Therefore we feel that remedying the DB pension problem by moving to personal pensions will put employees in a position of insufficient savings that are subject to significant investment performance issues and considerable timing risk. The move to personal pensions might solve the weakest point of DB for a sponsor, but ultimately it will only worsen the pension problem for society, rather than solving it.

Occupational defined contribution (DC)

Because pure DB is not sustainable due to maturing plans and personal pensions have considerable shortcomings that cannot be disregarded, a system called occupational defined contribution schemes seem to be a good alternative. These schemes are typically mandatory. Investing is carried out by the collective rather than by the individual plan members. The group of course benefits from economies of scale and prevents individual members from taking poor decisions, which solves two of the most important shortcomings of personal pensions. Contributions are fixed and there are no statutory retrospective contributions. A fixed contribution is not to be understood as a fixed amount or as a fixed percentage of salaries. It can be a "fair value" contribution that varies with changing interest rates or it can change in line with assumptions about future investment returns. However, the contribution agreement does not entail any further liability to the sponsor. Consequently, in many cases the mandatory DC is superior to both pure DB and individual pension schemes.

True cost of DC

Transforming a DB into an occupational DC system, which usually comes at the request of the employer, trustees reasonably ought to demand a fair price for the risk transfer. In practice, even in cases where pension risk for the sponsor is at present significantly restricted, the price of this transfer often equals thirty per cent of the actuarial cost of the DB scheme. Employers have to consider carefully if this 'dowry' is an efficient (risk-adjusted) allocation of capital. There is a significant inefficiency of occupational DC if risk is not fairly priced.

Hybrid conditionally indexed DB and DC

Occupational DC amends important shortcomings of the pure DB and individual systems. But in spite of its advantages over DB and personal pensions, DC is no panacea for all perceived pension problems. A fair transition is costly and it lacks some of the advantages of conditional indexed DB.

Proponents of DB have argued that eliminating DB would squander an important compensation and negotiation tool for the employer. In ageing societies where workers become increasingly scarce, such a policy instrument is essential to attract and retain a strong workforce. The argument is supported by the remarkable observation that the pension scheme for board members of companies is often still final pay DB, whereas the company has moved to DC for the other employees. Clearly, DC schemes are less helpful in attracting talents.

A combination of conditionally indexed DB and DC is just what we want. It brings together the strengths of DB as well as DC but taking out their weaknesses at the same time. In a typical hybrid DB / DC system,

members accrue DB rights up to a certain salary level. For any salary above that level a DC plan is in place. The employer keeps participating in the pension scheme, but the amount of pension risk that he is able and willing to bear is restricted. Yet, because of the DB components, employees are provided an inflation-proof basic pension.

Hybrid schemes outperform both DB and DC. For employers, hybrid schemes imply lower expected pension cost and constrained risk. At the same time, it enables them to use pensions as a compensation tool, which is less possible with DC. For employees, hybrid schemes are more in accordance with the fundamental objectives of providing retirement income, i.e. a solid basis. On top of that there is a high likelihood of an additional income and negative outcomes are significantly less painful than in pure DC.

Summary and conclusions

The pressing reason for pension reform is the maturity of the plans. Employers and employees are no longer able to bear the increased liability risk resulting from the high number of retirees. As is the case in most of the current pension issues this could and should have been foreseen decades ago; now, it has grown into an unavoidable problem that simply needs to be dealt with.

One way of eliminating pension risk for the sponsor is to convert to a DC scheme or to abandon the plan entirely. For many reasons, this is the wrong remedy. First of all, the risk of the current employees will increase significantly, whereas the main cause of the problem is the relatively large amount of retirees and their pension liabilities. Secondly, there is little doubt that most individuals are unable and even unwilling to carry

out pension management on their own account.

Occupational DC pension schemes do not suffer from the shortcomings of individual retirement savings. Besides, the contribution contains no retroactive component, and as a result all pension fund risk is removed from the financial statements of the sponsoring companies. On the other hand, the collective aspect of DC guarantees that pension saving and investing is done jointly as a group, thereby avoiding the important pitfalls of personal pensions.

Although DC signifies an important step forward, it is by no means a magic potion that cures all pension problems. First of all, in order to remove pension risk from their financial statements, sponsors ought to pay the fair price for "selling" pension risk to the members. This could increase the expected pension cost up to 30 per cent. In addition, sponsors will lose pensions as an important compensation tool, a development that might especially be detrimental in an ageing society where workers are increasingly becoming scarce. We therefore strongly plead for a hybrid solution that uses the strong points of DB and DC as building blocks. It offers a limited, conditionally indexed DB pension, and on top of that an unlimited professionally managed DC at low-cost.

A hybrid scheme is a flexible and dynamic pension system that conforms in the most efficient and effective way possible to the desires and constraints of all stakeholders.

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02 Towards a new beginning?

Hamish Wilson



To begin at the beginning

Once upon a time well-meaning employers concluded it would be a good idea to provide pensions to former staff. Typically pensions were a fraction of the member's salary (often dependent on the length of service).

The final salary pension scheme was born. The employer had the satisfaction of providing an element of financial support in retirement. The pension supported the business too, enabling it to attract and retain staff in the good times but also making the break less painful particularly in hard times.

What happened next?

Over time, a whole new industry developed to support this provision of pension. A new structure arose with trustees given significant powers over the schemes which arose to deliver pensions. The well meaning employers had begun to lose control.

A large raft of advisers and service providers arrived on the scene. They explained that reluctantly, they had to charge the market rate. The market rate was not cheap.

The Government became interested, imposing taxation and more seriously making employers 'guarantee' pension benefits that had previously been discretionary i.e. in effect dependent on employers changing fortunes which of course are not guaranteed.

In the beginning there was no obligation to provide increases in either payment or deferment and usually no obligation to provide any pension to members who left service well before retirement.

Government introduced various requirements to reduce discrimination between various classes of members (specifically pensioners, deferred pensioners and active members). That was a noble aim. But it couldn't stop at legislating through principle (allowing employers to find a sustainable solution). It thought it knew best and instead forced employers who had voluntarily introduced pensions to:

- provide pensions to members with five years' service (shortened subsequently to two years and now three months)
- increase pensions between the date of leaving and retirement date in line with inflation (subject to a ceiling of 5%pa) Worse still, it made this requirement retrospective in some circumstances
- increase pensions in payment in line with inflation (subject to a ceiling of 5%pa).

These three improvements, taken

alone have probably acted to double the cost of pension provision.

In addition to the above further legislation introduced to avoid discrimination on grounds of sex and age has tended to impose additional costs with actual or perceived obligations to level up to the better benefits in either case.

In each of the three years from 2000 to 2002 the equity market fell. As 2000 neared its end investment consultants reassured us that these things do not happen two years running. Yet now we find ourselves in 2008 with the FTSE equity index (admittedly ignoring dividends) still well below its end 1999 level. Past returns and historically low 'risk-free' investment returns mean that schemes are in deficit and provision continues to be expensive.

And finally there is increasing longevity. It is a measure of how punch drunk the industry has become that this is perceived as almost entirely a bad thing (with industry figures delivering an unconvincing throw-away line that it might be good for 'people in general' but...).

Those who forget the past are condemned to repeat it

The preceding catalogue (and readers will have their own additions) is included because we must learn from the past (as well as for masochistic purposes!).

Many of the improvements (in particular those that eliminate discrimination) are right and proper. However it is the levelling up associated with them that is unsustainable.

I believe there is now a greater acceptance that uncertainty is part of our lives. In the pensions arena this arises primarily from investment returns and longevity.

In a climate of uncertainty it is not realistic to keep imposing additional burdens without the system breaking at some point. The existence of the Pension Protection Fund (PPF) is a direct acknowledgement of this point.

The employers exposed to these additional costs now find their businesses are under threat in the illusory pursuit of a 'guaranteed' high quality benefit. Interestingly, the PPF has provisions which allow it to reduce its compensation in certain circumstances. Yet the Government denies similar flexibility to those well meaning employers wishing to provide good quality benefits.

Money purchase benefits

The knee-jerk reaction to the evils of the past has been the introduction of money purchase or defined contribution pension provision. The advantage of this approach (from the employer's perspective) is that the cost of benefit provision becomes fixed giving rise to the additional benefit of simple accounting.

From the member's perspective it is a less than satisfactory solution. Put simply all the uncertainty over the cost of benefit provision is transferred from the employer to the individual.

In the new spirit of individuals taking control of their own destinies DC members are expected to assess the adequacy of personal funding plans

and make complex investment decisions, often with little more than the spurious comfort that their money is being invested in a default 'cautiously invested' fund.

A minority of members can cope with this (or have sufficiently thick skin or wallet to weather the storm if it goes wrong). The vast majority are ill equipped to do so or lack the will to do so (there are many more pleasurable ways to spend time).

A number have already suffered as a result of retiring at the wrong time; hit by the 'triple whammy' of low equity markets and low interest rates coupled with emerging awareness of increasing longevity and its adverse effect on annuity rates.

The relative immaturity of DC provision coupled with the greater lobbying power of 'corporate UK' as opposed to 'employee UK' mean that adverse publicity from inadequate DC provision has yet to hit the headlines to the same extent as DB provision. But it will...

Shared risk arrangements

In the circumstances it seems extraordinary that no middle ground has been found between DB and DC. The failure of the recent Pensions Bill even to pave the way is particularly disappointing, but perhaps not surprising – what incentive do politicians have to address the problem?

One can only speculate that removal of the excellent civil service (and the even more generous MPs') final salary pensions, with full indexation and underwritten by taxation, might be needed before the required

understanding of pensions is achieved. Certainly the high turnover of pensions ministers does not suggest the issue is regarded as important.

From any perspective this seems short-sighted. With an increasingly ageing population, the Government should welcome anything that increases pensioner prosperity so harnessing the 'grey haired' vote and minimising potential problems from means testing in the future.

The pensions industry itself has been subdued (albeit with several honourable exceptions). This is perhaps surprising as the people within it may be amongst the biggest losers from the current demise of DB pension provision. Perhaps the older members of the industry, whilst regretting the current DB wasteland, no longer have the energy for the fight and take too much comfort from the thought that the current state of affairs will nevertheless 'see them through'. And perhaps the younger ones have forgotten how to think at all.

But of course this is primarily about employers and their employees. The current state of affairs perpetuates the position where all the risk falls on either the former (DB) or for the latter (DC). It seems a universally accepted truth that a healthy relationship should involve some 'give and take' yet the UK pension regime does not allow this.

A solution (the Association of Consulting Actuaries model)

It is probably worth starting with the solution proposed by the Association

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of Consulting Actuaries (whose President Ian Farr has been a vocal champion of the 'middle way'). Their proposal involves;

- a career average salary pension (this avoids the unfairness of differential revaluation rates implicit in final salary pensions)
- an expectation that each year's pension should increase in deferment and payment in line with inflation (subject to a cap such as 2.5%pa) (it is important that these are the same to avoid discrimination between different classes of member)
- ability for the employer to withhold these increases if the scheme's assets were insufficient to cover the past service benefits (protection for the employer in adverse conditions)
- retention of the current scheme specific funding regime meaning that employers would fund for future increases (and so helping ensure funds exist to support benefits)
- the ability to wind up the scheme without paying full future increases in deferment and payment (so that employers are not ruined if unable to meet them)
- other safeguards (eg the ability to reduce future accrual or to increase retirement age if longevity increased).

This approach is essentially closer to the defined benefit model but with the proviso that increases are conditional upon affordability. It might be the natural starting point for employers currently struggling with DB provision but nervous about exposing employees to the full brunt of DC. The ACA reckons some 900,000 private sector employees continue to accrue DB benefits.

Another solution (the HamishWilson model)

An alternative approach which we have promoted is modelled more

closely on the defined contribution regime and involves:

- a known employer contribution commitment just like DC schemes (so fixed with discretion to change giving employers the ability to control costs)
- an underlying defined benefit target (not guaranteed – but chosen to be easily affordable at the chosen level of employer contribution and so reasonably robust. This provides members with a high degree of certainty over the level of benefit) comprising
 - a career average pension (as in the ACA proposal)
 - an intention (so not guaranteed) to provide increases in deferment and in payment (it is essential these are the same to avoid discriminating between different classes of members)
- the ability to wind up at any stage without employer debt (so that the arrangement does not ultimately bring the sponsoring employer to its knees)
- management of the scheme to be delegated to trustees (including crucially the extent of increases in deferment and payment).

With the underpin of the known employer contribution, this sort of scenario is a more natural harbour for those who have already moved in that direction (the majority of the private sector) but would welcome the opportunity to improve risk sharing between members – both within and between different cohorts.

Alternatives

It would be possible to come up with various alternatives (and tempting to offer the ritual bottle of champagne for the best suggestion).

In short, it does not matter which sort of approach is adopted; a healthy

market (supported by principle driven legislation) will always have a good choice.

The baggage

The main objection to risk sharing is that current legislation will not permit it. This is a smokescreen from those lacking the will to consider an alternative.

We do understand and respect the legislation that has built up in the past and (perhaps reluctantly) accept that it needs to be retained (but only for benefits accrued to date).

For the future (if indeed the pensions industry is to have one) we need the vision and courage to shake off the chains of the past. It can be done!

Conclusion

I have yet to find anyone who objects absolutely to either DB or DC (the objections, such as they are, sit in a given context). In the circumstances it seems hard to understand how anyone could object to a solution that sits between them.

I am forced to conclude that the lack of progress reflects an inability of MPs and legislators to engage with a problem which sits outside their own comfortable experience.

The sad fact is that if action for risk sharing schemes is not taken quickly, the opportunity will be lost. It will be the next generation that are the losers and it will be our job to explain why we let them down.

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