

PENSIONS UNDER PRESSURE



PEOPLE ARE NOW LIVING LONGER AND RETIRING EARLIER. SO JUST HOW ARE PENSION FUNDS GOING TO COPE IN THE FUTURE? **CATHY COOPER** OF DANISH RE SYNDICATES LIMITED SURVEYS THE SCENE.

Pensions are certainly a hot topic at the moment and it is easy to pin the reason for this attention at the door of a few high-profile events. The combination of recent stock market performance and the probable impact of FRS 17 on company accounts are understandably making financial directors nervous of defined benefit (DB) schemes. In addition, demographic trends such as the recent increases in life expectancy (at a rate that would have been unimaginable only a few years ago) and the pattern of early retirements have put pension funds under extra pressure at a time when they can least withstand it.

Ironically, pension funds are probably victims of their own success, at least as far as early retirement costs are concerned, since the availability of pension fund surpluses could well have been instrumental in the decision to offer 'older' (over 50) workers the chance to retire early – in the absence of surpluses to cover the additional pension liabilities incurred on early retirements, it is possible many firms may have found this a less attractive option.

So, pension schemes have gone from positions of sound financial strength to being something of a millstone around many companies' necks, and compared with the overall life of a typical pension scheme, which must be measured in decades, the turnaround has happened frighteningly quickly. This article seeks to analyse some of the reasons for this, and to assess the impact of pension schemes on the economy at large. There are two main threads to this analysis – the impact of pension schemes on the financial market, and the deeper impact of pensions on the economy as a whole.

A BALANCING ACT. Before we look at the broader implications, let us think about what pensions mean for the level of saving in the economy. Pensions are savings – what we earn today we are putting aside for retirement. This creates capital, and with the increasing life expectancy noted above, the amount required in the pension scheme to fund a pension has also increased and, as a result, the balance between current consumption and saving has shifted. Let us take a very simple example, with the following assumptions:

- A worker who begins a working career at 21 and retires at 55, with a working life of 34 years.

- Life expectancy is 85 years, so a working career of 34 years has to support 30 years of retirement.
- A long-term real rate return of 2% – ignoring inflation in the analysis.
- For simplicity, the return is to be compounded annually.
- A requirement for a pension of 50% of salary.

Note that, for the purposes of this analysis, it makes no difference whether the pension is contributory or not – the costs of employing the worker are fixed, and the mechanism of payment and funding the pension do not affect the analysis. Similarly, we have ignored taxation, but if we view taxation as current consumption spending, for example, for services such as health, education and welfare benefits, this is valid.

With these assumptions, a simple worksheet model shows that a worker needs to save about 24% of gross salary for 34 years to fund a pension of 50% of gross salary for 30 years. Historically, this seems to be a high rate of saving, and when the bulk of pension schemes are mature it will result in a high pool of capital chasing limited investment opportunities. It may be that part of what we have seen recently in the stock markets (most notably the dot.com boom) is a result of an oversupply of capital.

PENSIONS SPIRAL. With DB pension schemes, which are largely invested in other companies' stock, there is another problem inherent in the current structure, which may be thought of as a 'pensions spiral'.

A DB pension scheme is an open-ended liability, and corporate collapses affecting pension fund investments therefore rebound on the employing company. It is not hard to construct a scenario where Company A's pension fund invests in Company B stock, the Company B fund invests in Company C stock and the Company C fund invests in Company A stock. If Company C fails, there will be a resulting shortfall in the Company B fund, which forces Company B to pick up an additional pension cost. If this leads to Company B failing, the Company A fund will have a shortfall and Company A will have to meet the cost. If, in turn, this leads to Company A failing, the Company C fund will have a shortfall, but Company C is no longer

there to provide additional funds, and it is the failure of Company C that has indirectly led to the string of failures culminating in a shortfall in the Company C fund.

It could be argued that this chain of effect will, in the long term, make DB schemes unsustainable. One or two schemes may be able to lessen this risk by eschewing equities in favour of fixed-income investments, but if this becomes the norm the supply of equity capital will quickly dry up and corporate debt will consequently take on more of the risk characteristics of equity.

CAPITAL LOSSES. There is, however, another aspect to the whole pensions issue which may well underlie the effects described above, and has to do with what we are trying to do when we save for retirement. Money, as we learn from economics, has three functions – it is a means of exchange, a store of value and a unit of account. This paper is concerned with the first two definitions, how they interact and whether there are limits beyond which the functions begin to break down. It is easy to understand and take for granted the use of money as a means of exchange – barter would be inconvenient for all, and the use of small, valuable items such as gemstones or gold would be a natural progression, as would their replacement with tokens or money in a stable society, where people have confidence in the system.

Similarly, the store of value concept is straightforward in the everyday sense – we can save for a holiday or a new car, and money provides the means to do so. However, when we use money as a store of value we are putting a time dimension into the exchange transaction. To go back to the barter economy, A might clean B's windows in return for B mowing A's lawn, but with pension savings A is cleaning B's windows today in return for B mowing A's lawn in the future – anything from six months to 60 years in the future.

The existence of money as a means of exchange clearly makes this easier, and although inflation may undermine the fairness of the exchange as the period between the two sides of the transaction increases, that is not really part of this analysis.

A few people may be able to defer consumption over a prolonged period, but as the number of pensioners increases relative to the

population as a whole, money as a store of value begins to break down because the means of exchange principle cannot operate when there is insufficient goods and services being input into the system to meet the needs of pensioners using up their stores of value. To think of the system in microcosm, an isolated community in which half the population is retired, is unlikely to have sufficient workers available to bake bread, drive buses, print newspapers, staff hospitals and so on, even though the pensioners may have, on paper, sufficient savings to pay for their needs.

Capital will become very cheap, and labour will be the limiting factor in the production of goods and services. It has been suggested that the Japanese, further along this curve than the UK, identified this trend some years ago, and the movement of production plants overseas (to locations with younger populations) was a way of addressing this issue of plentiful capital but a dwindling workforce.

There are two main implications of this. First, there is a limit to the proportion of the population that can be retired and living on stored value, and this has nothing to do with the rate of saving for pensions or the performance of pension funds, but with the provision of goods and services today in return for work done several years in the past. This is beginning to be recognised, and it is only in September of this year that there has been talk of increasing the retirement age to 70.

The second implication follows on from this, and is that if we are to have a substantial proportion of the population retired, the only meaningful way for pensions to be paid is through current taxation, which brings the production (by the taxpayer) and consumption (by the pensioner) back into the same timeframe. Politically, this is difficult to argue for and this article is not intended to argue for it. But it is suggested that in the long term it is the only alternative to a retirement age that increases in line with life expectancy. Savings, except at the margin, will serve only to fuel inflation, as stored value is used to chase current production.

Cathy Cooper is Treasurer at Danish Re Syndicates Limited.
catherine.cooper@danre.net
www.danre.net