Back to the drawing board

TWO RECENT STUDIES – ONE INTO DEFINED BENEFITS PENSIONS AND THE OTHER INTO DEFINED CONTRIBUTIONS – AGREE THAT UK PENSION SCHEME POLICY HAS GONE ADRIFT, BUT SUGGEST DIFFERENT REMEDIES. **GRAHAM BUCK** EXPLAINS.

Two recently published research papers on the future of UK pension schemes draw contrasting conclusions as to how pension policy should develop over the years ahead.

The first paper, Don't Stop Believing: The State and Future of UK Occupational Pensions, is published by Long Finance. Its author is Con Keating, head of research for insurance group BrightonRock and a member of the steering committee of the financial econometrics research centre at Warwick University and of the Société Universitaire Européene de Recherches Financières.

Keating's latest work follows his previous report for Long Finance in 2010, Don't Stop Thinking about Tomorrow: The Future of Pensions, which proposed a new approach in restoring the status of UK occupational pension schemes as "the envy of the world" in the 1970s. The Don't Stop Thinking about Tomorrow report argued that defined benefit (DB) schemes could continue to work well if properly regulated, while Don't Stop Believing investigates the reasons for the decline in DB schemes and suggests suitable remedial action.

The second paper, Outcome Orientated Investing for Retirement, is sponsored by Bank of New York Mellon and co-authored by Cass Business School's professor of asset management Andrew Clare, with Douglas Wright, a senior lecturer at Cass. It focuses on the traditional investment strategies adopted by defined contribution (DC) pension schemes, which typically include a strategy known as lifestyling. This involves "automatically and mechanistically" switching investors' pension pots out of equities and into government bonds in the 10 years leading up to their retirement. According to Clare and Wright, pension schemes that use lifestyling have served members poorly by producing smaller pension pots than ever and they propose that more dynamic strategies be substituted.

LAMENTABLE STATE OF DB SCHEMES Keating observes that UK occupational pensions are in a "lamentable state", with discussions of traditional DB schemes focusing on minimising the cost of closure and winding schemes up. Inadequate DC arrangements are usually offered as a poor substitute. "The idea has become prevalent that occupational DB pension schemes are unaffordable and unsustainable," Keating says. "We find these beliefs unfounded."

In fact, Keating believes that a host of commonly held beliefs are wrong, and he dismisses all of the following:

- pensions are unaffordable and unsustainable;
- employers should not be in the business of providing pensions;
- the individual should provide for his/her own pension;
- rising longevity has been the main cause of rising pension costs;
- pensioners are now better protected by UK pensions regulations;
- the accounting standards are merely the messenger of the parlous state of DB pensions; and
- asset and liability management techniques can resolve the problem.

He argues that it is now time to rewrite regulation in order to encourage the revival of DB schemes by restoring the incentives for employers to sponsor them. "A society with deferred pay is more civilised than one without," he declares.

Much of the initial attention attracted by the report has centred on its finding that the big increases in DB contributions made in the last decade, a radical shift in fund asset allocation and the advent of supposedly sophisticated management strategies such as liability-driven investment have all proved costly but ineffectual. However, Keating thinks that "misguided regulation" has been even more detrimental, generating costs for pension schemes and their members without noticeably increasing members' security or benefits. "The regulator-inspired culture of reckless 'prudence' on the part of trustees is no small part of this," he adds.

Keating acknowledges that the UK's DB pension system of the 1970s was not without flaws, such as the loss of benefits for any members leaving a scheme early on, and the poor treatment of dependents of a scheme member. "The system penalised labour mobility," he says. "Members' rights were really rather weak." However, regulation introduced over the next two decades to strengthen members' rights more than doubled the true cost of provision.

The result has been employers reducing or eliminating their provision of voluntary occupational DB schemes, although many actions, such as closing off the schemes to new members, "raise the cost of provision of the existing stock of pension benefit liabilities".

The most evident of these actions has been the shift to offering DC rather than DB pensions, "even though these will likely provide

grossly insufficient retirement incomes". Keating describes the DC system as "massively less efficient" than an occupational DB as it results in insufficient retirement incomes for most people and greater income inequity among the retired population.

Although DB schemes deliver pensions most efficiently, Keating contends that funding such a scheme is "a grossly inefficient device to protect scheme members against sponsor insolvency, the sole risk that they face in the UK". He proposes unfunded DB, with the scheme insured against sponsor insolvency, which he contends is both a more efficient model and one that can actually be rewarding.

The experience of Sweden, where such pension indemnity assurance is both available and widely used is proof of this, as dividends have exceeded premiums for many years. "Once insured, funding is entirely redundant, not merely an incomplete and inefficient security device," Keating says. "This frees the contributions for investment (as book-entry) in the sponsor employer, which, among other things, should increase their productive capacity and competitiveness. It also aligns more closely the interests of employees and the sponsor employer and enhances industrial relations."

Keating says that the cost of unfunded insured DB depends on the profitability of the sponsor employer, but the pension indemnity insurance seems inexpensive; in Sweden the premium rate averages 0.3% per year of scheme liabilities. "Even if we see continuing increases in lifespan, we should expect that, for most companies, a two-thirds final salary scheme should have a contribution cost of between 10% and 20% of wages."

THE SHORTCOMINGS OF DEFINED CONTRIBUTION SCHEMES

The Clare and Wright report is equally frank about the shortcomings of the DC scheme in its current form. Unlike Keating, though, the authors do not suggest resurrecting DB schemes.

"Much is made of the fact that DC is different from DB and rightly so," says David Calfo, BNY Mellon's group head of DC strategy. "DB schemes treat members' assets as a single pool with corresponding liabilities, whereas DC schemes have historically focused on scheme members' assets, with little consideration to their needs in retirement. In view of this we wanted to investigate the extent to which aspects of the way in which DB schemes view and treat assets in the context of liabilities could be applied to DC schemes."

The report notes that most DC scheme members invest their pension pots in the scheme's default fund. As saving for a pension is a long-term investment commitment for most people, most if not all DC funds are heavily weighted to equities "on the assumption that, in the long run, equities will outperform all other asset classes".

The other common feature of a typical DC investment strategy is the lifestyling that usually takes place over the 10 years preceding the scheme member's retirement and full annuitisation, when the pension pot is switched automatically from equities to government bonds "with little reference to the risk preferences of the member, to the size of the investment fund accumulated over this period or indeed to financial market developments".

Clare says research shows that the equity bear market and the decline in annuity rates over the last 10 to 15 years have devastated the final pensions of DC savers who relied on the mechanical lifestyling approach. "A more enlightened and more flexible approach to the DC accumulation phase is definitely needed," he stresses.

Clare and Wright suggest that DC pension schemes should adopt a risk strategy that is "outcome-driven, recognises investors' attitudes to risk and takes a flexible approach to the 'decumulation' phase". This would involve investors receiving a tailored investment solution and give them a greater chance of achieving pension targets, they say.

Clare says the report challenges the asset management industry to respond with workable products, solution and technology. "These approaches will require the industry to rethink how it engages with scheme members, and challenge assumptions on the key inputs for future product developments."

Commenting on the report's findings, Calfo says the key to future pension scheme strategy is to treat people as individuals. "Past and present solutions treat people of a like age and/or number of years before they retire as if they have the same income objectives in retirement, and fail to consider how close individuals are to actually achieving their target retirement sum. In practice this means that in most DC schemes two people of the same age, with entirely different retirement income objectives, where one is 'on target' and the other significantly 'under target', will have identical asset allocation profiles. This is clearly wrong and something pension schemes need to address to assist individuals to attain financial well-being."

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