The perfect storm

JOHN HAWKINS EXPLAINS HOW GAINING A FIRM GRASP ON PENSIONS ISSUES IS OF CRITICAL IMPORTANCE FOR THE TREASURER.

Executive summary

- Pensions rarely seem to be out of the headlines these day. Activity in this area includes the work of the Pensions Commission, the 2004 Pensions Act, the 2004 HM Treasury review of the 2001 Myners recommendations, and the European Union Pensions Directive. Increasing life expectancy, revised accounting standards which increase transparency, and a slowly dawning realisation from politicians, corporates and would-be pensioners that present systems of pension provision are unsustainable make for a heady and fascinating mix.

During 2004 and the first half of 2005 there has been an extraordinary amount of activity in the area of pensions regulation and research. The reasons for the 'perfect storm' of pensions have been well documented already. This article provides a comprehensive review of key recent developments and their probable impact on the freedom of UK companies to act to control the risks inherent in their defined pension schemes.

PENSIONS COMMISSION The First Report of the Pensions Commission, published in November 2004, might initially seem to be of little direct relevance to treasurers, but its conclusions are of such fundamental importance that it would be remiss not to at least summarise the main arguments.

In a population with increasing longevity and a higher proportion entering tertiary education, the ratio of those in productive work to the total population will decrease if the retirement age remains constant. The situation will be exacerbated if the total population is declining as a result of falling birth rates.

Retirement income normally comes from three sources: personal savings (including, but not limited to personal pensions arrangements); occupational pension schemes (both final salary and money purchase); and state pensions. In the first two cases, in the UK, the pension arrangements are funded by the investment of savings in financial assets. In the third case, schemes are 'pay as you go' (PAYG), with current taxes being used to fund pensions in payment.

There is an academic debate as to whether funded schemes are superior to PAYG schemes, but from a macroeconomic perspective it is largely irrelevant. One way or another, the current workforce has to pay the whole of the pensions of the current pensioner population, either through taxes or through claims on productive output arising through the holding of securities in employers (i.e. financial assets). Second order effects, such as the impact of overseas workers, can be material in the short term, but become less so as longer time scales are considered.

The reason this is important for treasurers is that it is the stated policy of the UK government to reduce the proportion of total retirement income provided by the state and it has already taken steps to do this, for example by linking increases in pensions to retail price inflation rather than wage earnings inflation. Although a majority of people would seem to prefer to avoid worrying about their pensions, their ability to keep their heads in the sand will become increasingly limited. If individuals are concerned, their employers will have to be as well. By the time the scale of the problem is generally appreciated many employers will have managed to close defined benefit pension funds and thereby reduce risks anyway, but the focus on the adequacy of defined contribution arrangements will become intense, generating significant pressure to increase the level of contributions.

2004 PENSIONS ACT The full impact of the 2004 Pensions Act will not be felt until it is implemented in its entirety during the course of

2005. The many Regulations required have been published and the Pensions Regulator and the Chairman of the Pension Protection Fund have provided a clear idea of how they intend to interpret their statutory duties. The following provisions of the Act are not exhaustive, but probably those of most interest to treasurers:

- The Pension Protection Fund came into existence in April. For 2005 it will collect a flat rate premium, but for 2006 onwards the premium will be risk based. The risk basis has yet to be determined, but is initially likely to take into account at the least the size of the deficit and the credit rating of the employer. There are strong academic arguments, and an increasingly vocal lobby from trustees that have adopted a high degree of asset liability matching, that the risk basis should also take into account investment strategy.
- The Minimum Funding Requirement (MFR) for pension schemes is being replaced by 'scheme specific funding', which will essentially be individual funding agreements negotiated between trustees and employers, the new Pensions Regulator acting as arbitrator in cases where agreement cannot be reached. The attitude of the Pensions Regulator, part of whose remit from the government is to be more proactive than the old Occupational Pensions Regulatory Authority, will clearly be critical. With the former MFR basis widely regarded as weak, upward pressure on funding levels has to be considered likely.
- Any employer winding up a pension scheme will trigger a Debt on Employer that will now have to be calculated using market annuity rates for both pensions in payment and deferred pensions. A Debt on Employer will also be triggered when one employer leaves a multi-employer scheme, which will have an impact on corporate finance activity, particularly as the Pensions Regulator will have the power to levy contributions from former employers. (Of course, the general impact of pension deficits on corporate finance activity has already been widely publicised.)
- The ability of employers to avoid appointing one third Member Nominated Trustees has been removed. Moreover, the government has given a strong indication that it will increase the minimum number of Member Nominated Trustees to one half by 2006 or 2007.
- Trustees must now have a minimum level of knowledge not only on all key documents relating to their scheme (such as the Trust Deed and Rules), but also of relevant law and investment matters.
- Whistle blowers now extend beyond the scheme actuary and the scheme auditor to all professional advisers to schemes and others involved in their management and administration, including the trustees and the management of the employer.

2004 REVIEW OF MYNERS RECOMMENDATIONS Published in March 2001, the Myners Report on institutional investment contained many recommendations accepted by the government, including the replacement of MFR with scheme-specific funding. It also contained ten principles that it recommended be adopted by defined benefit pension schemes in relation to:

- effective decision making
- clear objectives
- focus on asset allocation
- expert advice
- explicit mandates
- activism
- appropriate benchmarks
- performance measurement
- transparency
- regular reporting.

Myners further recommended that pension schemes should either comply with the principles or explain why they were not doing so and that HM Treasury should review progress of the adoption of the principles in three years' time.

In December 2004 HM Treasury published its review of progress, which it found to be patchy. As a result of this several of the principles are to be strengthened in the areas of expert advice, explicit mandates, activism and regular reporting.

HM Treasury has also stated that it will establish a working party to facilitate communications on the implementation of the principles.

The reason this is important to treasurers is that the government has already made it clear that it will legislate where these principles are not adopted voluntarily to a significant degree, especially by the larger funds. In fact, the trustee knowledge and training provisions of the 2004 Pensions Act have already addressed one of Myners underlying concerns that it was clear were not being dealt with adequately or sufficiently promptly by schemes.

EUROPEAN UNION PENSIONS DIRECTIVE 2003/41/EC The European Pensions Directive on the activities and supervision of institutions for occupational pensions came into effect in 2003. It sets minimum standards for the provision, funding and regulation of occupational pension schemes in each member state and is likely to apply to most UK occupational schemes. In practice only one aspect of the directive is likely to have a material impact on UK schemes and this is in relation to funding. The British government is taking the position that the scheme-specific funding rules contained within the 2004 Pensions Act satisfies the technical requirements of the Directive, but this appears open to challenge given the strong emphasis in the Directive on prudence and security of members' benefits and its requirements relating to reserving for schemes that underwrite benefits linked to mortality and longevity risks.

It is constructive to consider how another EU member state has implemented the Directive. Within the euro zone, the Netherlands has the most developed pension industry with over €500 million of assets in funded defined benefit funds; these comprise industry-wide and traditional company schemes. As with other schemes, these have suffered over the last decade from poorly performing equities and low interest rates.

New proposals in respect of pension scheme funding have been released that are expected to pass into law during 2005 and to be brought into effect during 2006. At the heart of these proposals lie a new regulatory framework from the Dutch prudential supervisor, the so-called nFTK tests.

- Minimum Funding Level. The market value of assets must be at least 105% of the present value of liabilities as defined (which is on a 'market' basis). If this test is failed the regulator has to be notified and steps have to be taken to return the ratio to above 105% within one year.
- Shortfall Analysis. The probability of assets being less than 105% of liabilities over a one-year time horizon must be less than 2.5%.

Although the funding level of Dutch schemes has recently deteriorated, it is not expected that a large number will fail the first of the above tests. The second test, which has to be carried out in one of three prescribed ways, is more problematical and initial indications are that several major schemes will fail the test; this could be remedied by them in a number of ways:

- Asset Allocation Adjustment. By moving towards assets likely to have a higher correlation with liabilities (e.g. bonds), it is likely that the amount at risk will fall, all other things being equal.

- Duration Adjustment. By moving towards bonds with a duration closer to that of the liabilities, it is likely that the amount at risk will fall, again all other things being equal.
- Increased Contributions and/or Reduced Benefits.

It is hard to believe that the UK's Pension Regulator and Chairman of the Pension Protection Fund will not take note of these developments. Lobbying by increasingly pensions-savvy trades unions and others to remove the current 105% cap on funding in the UK is only a matter of time. It is certainly ironic that the maximum level of pension funding in the UK is equivalent to the minimum level of funding in the Netherlands.

DISCOUNT RATES Accounting standards such as IAS 19 *Employee Benefits* and FRS 17 *Accounting for Retirement Benefits* generally require pension liabilities to be discounted at something close to a AA corporate bond rate. Although this is an improvement over previous actuarial practice of using a rate based on blended asset returns, there is an increasing appreciation that liabilities should actually be discounted at the risk-free rate for the period concerned. What constitutes the appropriate risk-free rate is a different question and opinion is divided. Historically, government securities have been taken as a good proxy, sometimes less a margin to provide for further improvements in longevity. There is a more conservative lobby that argues in favour of market annuity rates (since these anyway have to be used in a termination situation) and a more liberal lobby that argues in favour of the swap curve (since collateralised swaps are close to risk free and increasingly used by pension schemes to achieve duration matching). The jury is still out, but most schemes will eventually end up having to use lower rates than they do currently for at least some statutory reporting purposes. This will not go unnoticed by market analysts, some of whom are already making such adjustments.

MORTALITY It would appear that until recently both (a) the difficulties of understanding future mortality progression and (b) the magnitude of the possible financial consequences of underestimating future mortality improvement have been overlooked by the actuarial profession and others. Evidence to support this is that only in 2003 did actuaries begin a systematic review of occupational pension scheme mortality. Before this the profession had relied on the mortality experience of insurance company pension annuity business to assess mortality improvements. Evidence of the difficulties of understanding future mortality progression can be found in the debates on this subject within the profession. Prima facie evidence that there is a systematic bias in the estimation of future mortality, despite the fact that improvements are already built-in, is that revisions to actuarial mortality assumptions are consistently in the same direction, i.e. they still underestimate future mortality improvement.

The academic debate on what is happening with mortality trends continues while hard data is being collected. Whether there is any natural limit to life expectancy is an unanswered question, but the fact that a higher proportion of the population is living towards what might be some sort of limit at around 110+ is now well established and of much concern to those having to fund pension schemes. Arguments that increasing obesity will help alleviate the problem are probably misplaced. The younger generations affected most obviously are unlikely to be members of defined benefit pension schemes. On the other hand, breakthroughs in drug treatments and surgical procedures could have a material impact on the life expectancies of those who are already members of such schemes, many of which are now closed to new members.

The announcement by BNP Paribas in November 2004 of the first-ever longevity bond (i.e. where the payout increases if people live longer than expected) on behalf of the European Investment Bank was generally applauded by treasurers as another tool for reducing risk. Unfortunately, decision making on investing in such bonds by pension schemes tends to be by conservative trustees and advisers rather than treasurers and the take-up of the bond has apparently been less prompt than hoped.

It is also interesting to note that the UK Government Debt Office recently commented that although it would be issuing ‘ultra long’ fixed income and index-linked gilts in response to demand from investors, it had not encountered any demand from those it had approached (i.e. the same trustees and advisers) for longevity-related bonds and anyway did not feel that it should be asking the government to be taking a position in longevity. Again there is an irony here – unfunded UK government pension schemes have recently been estimated to comprise liabilities with a present value of around £600bn and if this does not constitute a long position in longevity it is hard to know what does.

COST OF CAPITAL As long ago as the 1970s, academics argued that the existence of defined benefit pension schemes ought to have an impact on share price performance and this has subsequently been demonstrated by research results on many occasions. Most of these research exercises concentrated on the scale of pension deficits, but more recently Robert Merton[1] and others have demonstrated that the investment strategy adopted by funds also impacts share price behaviour.

There is an important corollary to this result. If the market is viewing the company and its associated pension schemes as an integrated economic whole, then management should take the whole of that balance sheet into account when calculating weighted average cost of capital (WACC) for investment appraisal purposes. Further, although computations of WACC can usually ignore the risk characteristics of operating assets, this simplification is not generally possible in the case of pension fund assets. Simply adding the ‘off balance sheet’ pension fund liabilities to a company’s net debt and assigning it zero cost before re-computing a WACC is therefore not the solution and a more sophisticated approach is required.

Applying such an approach to a number of leading US companies has led Merton to the conclusion that, at least in his sample, the adjustments would consistently result in a lowering of the cost of capital; in other words, unless they make such an adjustment these companies are likely to be rejecting investment opportunities that they ought otherwise to be accepting.

This is certainly an area of research that ought to be replicated in the UK, with a particular emphasis on any companies that have large schemes relative to their own market capitalisations. Meanwhile, any company in this category should be giving careful thought to its existing methodology for computing WACC.

CONFLICTS OF INTEREST There has been a certain amount of debate in the past on the subject of whether directors and other senior executives of employing companies can also act as trustees without being unduly conflicted. The arguments on both sides are fairly obvious and will not be repeated here, but there is another area where conflict can occur – the use by both the employer and the pension scheme trustees of the same professional advisers.

This has recently been an area addressed quite seriously by the actuarial profession, but of course it also applies to auditors and to legal and other professional advisers. The current state of play seems to be as follows:

- Mandates should explicitly recognise the possibility of conflicts of interest and deal with the procedure that will occur if an actual conflict occurs (which in most cases will be that the adviser will afterwards act only for the trustees).
- The employer and the trustees should be represented by separate partners within the firm and properly documented and monitored ‘Chinese wall’ arrangements should be put in place, although whether these could stand up to legal challenge is questionable.

There has to be a strong possibility that professional firms will increasingly be unwilling to act as advisers to both parties, although giving up lucrative business to achieve this will be difficult for some. They may be forced to do so by a combination of legal test cases, statute and professional indemnity insurance exclusions. For many companies it may make sense not only to ensure that they are complying with best practice on Chinese walls, etc., but also that they have a contingency plan in place to deal with the unexpected loss of a key adviser.

NO ROOM FOR COMPLACENCY In May’s issue of *The Treasurer* the question was posed, “Do treasurers think pension fund trustees and companies are panicking about pension fund deficits?” No doubt some are and some that should be are not, but the real key for treasurers is to ensure that they do not become complacent. By some means, probably a combination of dedicated internal and external resources, they must understand the impact of the many strategic developments currently occurring, or likely to occur in the short term. This is in addition to technical areas in which they may be able to add value, for example assisting trustees with specific aspects of investment management, such as duration matching. For both the career treasurer and the aspiring finance director, gaining a firm grasp on pension issues is of critical importance.

John W Hawkins, FCT, is former Head of Finance and Risk, Invensys and Chairman of The Treasurers’ Conference 2005.
johnwh@rakshasa.demon.co.uk

1. Robert C Merton, *The Real Problem with Pensions,* Harvard Business Review, December 2004 and Li Jin, Robert C Merton and Zvi Bodie, *Do a Firm’s Equity Returns Reflect the Risk of its Pension Plan?,* Harvard Business School Working Paper #05-011, August 2004.

Diary date: 29 June 2005, *The ACT 2005 Pensions Conference*
Venue: ABN AMRO, 250 Bishopsgate, London
Sponsored by Mercer and ABN AMRO.
For further information go to www.treasurers.org/events.

New Certificate Paper in Pensions: The ACT will be launching a new paper in Pensions at the end of 2005. This paper will provide an understanding of the legislative and regulatory framework surrounding pensions, including the role of trustees, risk management implications and associated governance issues. Watch the website **www.treasurers.org/amct** for information.