



# Pensions – guarantees or promises?

This distinction is at the heart of the MFR debate on what assets a fund needs to meet its liabilities. A simple soul will say – “does my fund have enough in it to pay me my promised pension?” The answer can only be yes if the fund is backed by a guarantee from a highly credit-worthy institution, but even then it can never be absolutely certain because the guarantor may fail.

The ABI’s recent proposal, to create a panel of wise men to determine the discount rate on a fund’s liabilities, is interesting. It also has the virtues of allowing a consensus rate to be reached on a quarterly basis which is applied to the fund’s actuarially assessed liabilities to obtain the NPV of those liabilities. The difference between this value and the market value of the fund’s investments is the surplus or shortfall, the size of which is a measure of how far short of a guarantee the promise lies. It has the virtue of independence and of ignoring the asset allocation of the fund being assessed. But it is a long way from providing the answer to my question.

Each member of a fund has a different perspective. A 25 year-old employee may not be fussed to hear that, with his company’s present fund, the current promise is worth only a 75% probability of a two-thirds final salary pension at retirement at 60, because of the company’s potential to become insolvent in the next 35 years. A 55-year old would want a much higher probability the guarantee would be met, and the pensioner would want near certainty. Hopefully each member would understand that his circumstances differed from the others and accept, in time, the difference between the promise and a guarantee.

Now imagine that the actuarial profession could agree to a standard model which expressed the asset allocation ratios, needed for any pension fund, as a function of each individual’s circumstances from young employee to old age pensioner. Such a standard model would have as a key assumption an agreed probability of delivery of the promise as a

function of members’ ages. These probabilities would need to be understood and accepted by each member. Additionally, as now, the company would need to agree its future fund contribution rates and probable earnings growth for each employee based on standard assumptions such as the future income and price inflation rates that would apply across all funds.

Once this is achieved, aggregating the asset allocations from the standard model over all members gives a fund’s standard asset allocation. We are now close to finding the liabilities’ discount rate, but still have to agree on the total return yields to be assumed for each asset class. This is where subjectivity really bites. The ideal discount rate is a

function of time, since yields can be temporarily distorted from their long run averages by an over or under-priced market correcting itself in the near term. If both the short-term distortion and the long term yields can be agreed by the wise men, and a standard model devised, the ABI’s idea may have arrived in the nick of

time to allow my question to be answered fairly. It would also solve the transfer value problem since all companies would be assessing values on comparable assumptions.

Something has to be done to square the circle between pensions accounting, investment strategy, the promise, the guarantee and the minimum funding requirement. The treasurer’s knowledge of financial markets and his comfort when dealing with probabilities make him an ideal intermediary between his pension fund members and his company; that is as a pension fund trustee.

An alliance between the actuarial profession, the ACT and the ABI could mark the way forward. ■

OCEANUS

*Oceanus welcomes comment from readers, which may be published anonymously if requested. [oceanus@treasurers.co.uk](mailto:oceanus@treasurers.co.uk) or fax to 020 7248 2591.*

The ABI’s  
idea may have  
arrived in the nick  
of time