The great pension delusion

IT’S FASHIONABLE FOR OCCUPATIONAL PENSIONS TO BE DESCRIBED – AND DITCHED – FOR BEING AN UNSUSTAINABLE BURDEN ON BUSINESS. CON KEATING CONSIDERS THE FACTS.

Lindsay Tomlinson, chairman of the National Association of Pension Funds, recently observed that of all the problems affecting voluntary occupational pension schemes, only one was outside their influence and control – longevity. All the rest are self-inflicted wounds, internal to the pension system. And in a paper, FSA chairman Adair Turner has challenged the idea that the developed world in general faces a pensions crisis: “Most countries in the rich developed world face an important but quite manageable challenge of pension system redesign.”

The reality is that pensions, broadly as we knew them, were and are sustainable, and affordable. Yet we are continuously assailed by “forecasts” and “analyses” that see only penury and immiseration ahead. And with bad news always a help in selling newspapers, the media are active accomplices in constructing the myth.

Collectively we are living longer, but the rate of growth of life expectancy is far lower than the growth we have seen in total productive output. With the exception of occasional years of recession, we are experiencing ever higher standards of living at all ages. Life expectancy has increased by about 0.3% annually over the last century, but gross domestic product has increased at more than 2% annually by even the most conservative estimates.

The increase in male life expectancy from 81.7 years in 1995 to 82.6 years in 2010 is, at first sight at least, cause for concern. However, one recent trend has been for men and women to retire from the labour force at later ages – men now retire at 64.5 years. In 1995 men expected to spend 18.7 years in retirement, but now this is just 17.6 years. Pension provision has actually become less onerous in this regard.

UK corporates are well positioned to deliver pensions to staff. The reported profitability of UK private non-financial corporations, net of depreciation and amortisation, has averaged 12.7% annually since 1965. Adjusted for riskiness and the variability from year to year of these corporate earnings, the long-term rate of return on capital employed is almost unchanged. It should be noted that these figures are reported after deduction of the present costs of pension provision, which are material and bias the published results towards the low end. Figure 1 indicates that it is the periods of high inflation that may prove hazardous rather than the low-inflation, low-return
environment of recent times, which has appeared so problematic.

The introduction of "market-consistent" accounting has done more to destroy defined benefit provision by the private sector than almost any other regulation. It is fundamentally misconceived. When we wish to know if a company will be able to meet its future liabilities on time and in full, we need to ask what the company will earn and what the amount of its shareholders' funds are today. These determine the security of the liability. We do not ask what yields prevail in markets, on gilts or AA corporate bonds. The use of market-consistent discount rates for liabilities and market prices for assets adds insult to injury, introducing both bias and spurious volatility to pension scheme valuations.

The extent of this spurious volatility, which is rooted in the "animal spirits" of financial markets, is really quite remarkable. The volatility of broad equity market total return indices typically lies in a range between 15% and 20%; bonds, although lower, are still typically between 7% and 10%. By comparison, the volatility of aggregate corporate earnings is less than 2%. The lack of relationship between the FTSE All-Share index and corporate earnings is illustrated in Figure 2. Note that the relationship between FTSE returns and actual corporate earnings is negative and that the explanatory power is negligible.

It is clear that the UK corporate sector can, sustainably and affordably, offer defined benefit pensions to its employees. Its position as the balance of cost underwriter of such schemes is not predicated or dependent in any way on the performance of markets for financial assets. Introducing spurious dependence through misconceived accounting standards serves only to obscure this. In fact, the central economic argument which supports the provision of occupational pensions is precisely that employers in the state and private sectors can contract to deliver pensions – which are claims on their future production – directly to employees, without recourse to financial markets.

As these statistics show, the pension problem is not a problem in aggregate for the private sector. It is therefore surprising that the Pension Protection Fund should have concerns about multi-employer schemes, such as last-man standing arrangements.

The problem, of course, is that these aggregates cover a broad distribution of differing corporate performances. Some companies will fail and, of course, the sole risk faced by a pension beneficiary under a defined benefit arrangement is sponsor insolvency. However, it is clear that the private sector is more than capable of pooling and managing such risks. Mutual indemnity insurance and even specialty commercial insurance vehicles would be viable. Incidentally, such arrangements would be far cheaper and much more efficient than the Pension Protection Fund.

The closure of defined benefit pension schemes which has resulted from these accounting standards, and the mountains of regulation based on them, has been an entirely rational response. This "de-risking" is, however, costly to society at large and to individual companies. For example, closure of a scheme to new members may limit the total future exposure of the sponsor, but it also increases the cost of provision of the residual pensions to existing members of the scheme.

It is disconcerting to see that the public sector is now the focus of attack of these free market ideologues. The idea is prevalent that these unfunded schemes are devices for intergenerational theft. This is a simple miscomprehension of the economics. A pension is a claim on future production. However, it is always current production which is divided among economically active and inactive individuals, since consumption goods cannot be stored.

The award of an unfunded pension to a nurse lowers the need for higher taxation today. This raises the disposable income of all individuals, who are free to consume or invest this today. This raises current and future production, making these pensions all the more affordable. This is in fact a true free market solution, since the alternative of taxing and investing the raised funds, under state direction would be prone to political intervention on a massive scale. The inefficiencies of this are obvious. Anyone doubting the scope for political intervention need look no further than the National Lottery for examples of diversions from original purpose.

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scheme in the absence of a conversion mechanism to transform these financial assets into a retirement income. However, the most important point is that these individuals are entirely dependent on the performance of financial markets. This is grossly inefficient. The scale of this inefficiency is stark: a two-thirds final salary pension that may require contributions of 20% of salary would cost more than 30% in contributions under a defined contribution arrangement.

Saving on the scale needed to provide an adequate pension under defined contribution arrangements is without precedent in recent UK history. This is perhaps just as well as the cost in terms of income tax revenue foregone would be measured in tens of billions of pounds.

The actual contributions that are being made – 9.6% defined contribution versus 20.5% for defined benefit – mean that pensioners will receive less than one third of the retirement income of defined benefit pensioners. In this income region, the iniquities of displacement of means-tested benefits also come to prominence. Penury and poverty become significant issues when pension provision is as inadequate as this. The advent of the National Employment Savings Trust scheme (NEST) will do little or nothing to alleviate this problem, and may even exacerbate it. Any system that provides grossly inadequate pensions will prove unsustainable.

These issues and many more are considered in much greater length and detail in a recent paper on the future of pensions entitled Don’t Stop Thinking About Tomorrow. It seems appropriate to end with the same exhortation as that paper: “If it takes just a little while, Open your eyes and look at the day, You’ll see things in a different way.”

Footnotes
1. The risk game faced by the state or private sector when offering pensions contracted on future production is simple. Risk is exogenous – a game against nature. The company is trying to maximise production given its resource constraints. An individual cannot contract in this manner on their own future production – precisely because they will be in non-productive retirement. The individual needs to make provisions, to save and to buy claims on this production in financial markets in the form of equities and gilts. The risk game here is complex. It is partly a game against nature but predominantly a game against others. Risk is much higher for the individual.
2. This report is freely available from www.futureofpensions.org

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