CLOSED DB SCHEMES: A NEW STRATEGY

MANY PENSION SCHEMES ARE IN DEFICIT. THOSE WHICH ARE CLOSED TO NEW MEMBERS MAY ONLY HAVE A LIMITED TIME FOR MARKET PERFORMANCE TO AID RECOVERY. **DAVID JONES** AND **TONY CUNNINGHAM** OF LANE CLARK & PEACOCK LLP EXPLORE HOW A SCHEME'S INVESTMENT STRATEGY MIGHT CHANGE TO CONTROL RISKS WITHOUT ABANDONING EQUITY INVESTMENT.

Most UK defined benefit (or final salary) pension schemes have closed to new members. This significant change in the pensions landscape has happened very quickly, although, given the pressures on sponsoring employers, the flight from defined benefit (DB) pension provision is hardly surprising.

- Unexpected contribution increases have arisen from a multitude of sources: poor investment performance; falling bond yields; low inflation; tax raids by the Chancellor; increasing compliance costs and improving life expectancy have all served to hike up the cost of pensions.
- At the same time volatility has increased, just as the position of the pension fund is highlighted in companies' accounts. The new accounting standard FRS 17 raises the prospect of very large and volatile pension scheme deficits directly hitting balance sheets.
- This onslaught has understandably created a feeling of "what next?" A finance director may quite reasonably be concerned that future changes in government policy, investment conditions or demographics could push costs up still further.

However, as many employers have already come to realise, closing the DB scheme does not eliminate, or even necessarily reduce, pension costs and risks at a stroke. In many cases, closed schemes will continue to pose significant risks to the sponsoring business for many years to come. It is essential that those responsible for risk management recognise this and quickly get to grips with the characteristics of their closed schemes.

The government's pension reform announcements on 11 June 2003 indicated that solvent employers will not be able to walk away from a DB scheme without meeting the cost of providing the benefits in full. As a result, the price of failing to manage a closed scheme properly can be very high, in some cases high enough to put the business itself at risk.

We look here at how the investment strategies of closed DB schemes can be adapted as part of the risk management process.

NEW CHARACTERISTICS OF CLOSED SCHEMES. When a scheme is closed, the supply of future members is cut off. Closure reduces, and ultimately removes, the opportunity to smooth out good and bad experience between successive generations of members. It is no longer appropriate to continue the financial management of a closed scheme on the basis of long-term average expectations.

Closure starts the countdown to wind-up. At some point in the future, the trustees will need to consider securing the remaining members' benefits with an insurance company. This 'buy-out' process may be 10, 20 or 30 years away but, significantly, it means that the scheme's future lifespan can no longer be treated as indefinite.

The average age of the active members will be expected to increase over time after closure. Turnover tends to be higher for younger employees, and there are no new, younger joiners to replace them.

Declining active membership brings forward the date when the scheme's net cashflow first becomes negative – the point when

'IN MANY CASES, CLOSED SCHEMES WILL CONTINUE TO POSE RISKS FOR MANY YEARS TO COME'
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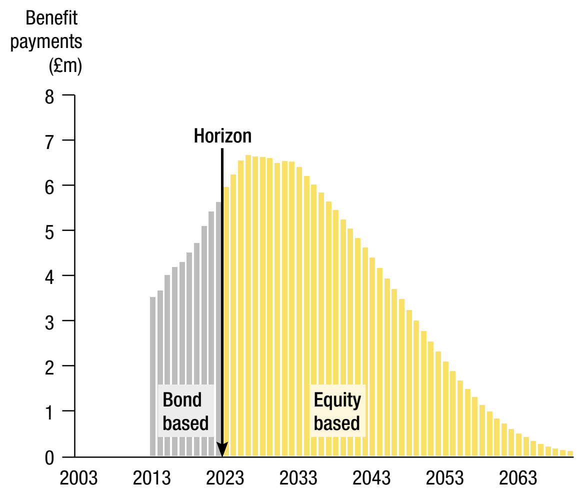
FIGURE 3
THE 'HORIZON POINT' – 10 YEARS ON



'A CASHFLOW-BASED STRATEGY SHOWS HOW EQUITY RISK CAN BE KEPT WHERE IT BELONGS – IN THE LONG TERM' *DAVID JONES*

FIGURE 1
BENEFIT PAYMENTS FOLLOWING CLOSURE

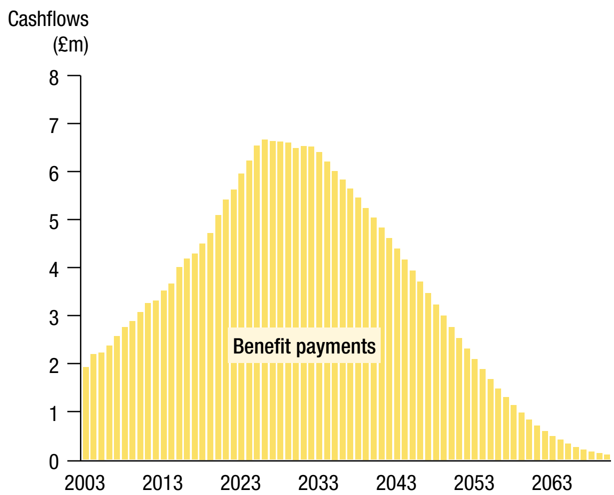
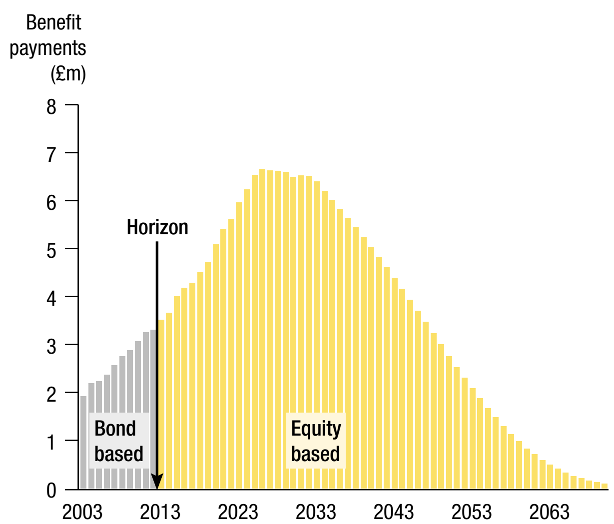


FIGURE 2
THE FIRST HORIZON POINT



benefit payments first exceed contribution income (although high levels of deficit contributions mean that many closed schemes are still strongly cashflow positive at present).

Most schemes have been net investors to date, stockpiling a portfolio of assets that will be needed to meet future benefit payments. It should not come as a surprise that scheme assets have to be sold to provide cash for benefit payments: this is why they were acquired in the first place. However, this process needs to be managed in an orderly fashion; in particular, to avoid finding oneself a forced seller of assets with volatile capital values, such as equities.

IMPLICATIONS FOR INVESTMENT STRATEGY. Each scheme's investment strategy should be set with regard to the trustees' and employers' objectives, bearing in mind the nature and term of the scheme's liabilities and its solvency. Responsibility for investment strategy lies with the trustees, but they are required to consult with the employer.

It is necessary to find a framework for the investment strategy that recognises the changes to the nature and term of the liabilities brought about by closure. To do this, it helps to go back to first principles.

Fundamentally, the assets are held so the scheme can provide promised benefit payments. Following closure, we know the name of every member who will ever receive a benefit from the scheme. It is therefore possible to project the scheme's future benefit payments with far greater certainty, as illustrated in *Figure 1*.

Benefit payments increase for a number of years as active and deferred members retire and pensions increase in payment. Ultimately, all members will be receiving pensions and, as the pensioners die, so the benefit payments gradually reduce to zero. The whole process may take 70 or more years from the point of closure (think of the 30 year-old member today, who lives to 100).

The pension scheme's job, in simple terms, is to provide these benefit payments, and so it seems sensible to construct an investment strategy around this fact.

Some of the cashflow payments fall due in the near future. The trustees need to feel confident that cash will be available to meet these payments. So a low-risk investment strategy, cash or short-term bonds, might be held to back these cashflow obligations.

Some projected cashflows fall many years in the future. When considering what kind of assets should be held to back these liabilities, the trustees and employer may feel comfortable taking more risk in pursuit of better long-term performance. How much risk is likely to depend on the solvency level of the scheme and the degree to which the employer can be persuaded to contribute.

CASHFLOW-BASED INVESTMENT STRATEGIES. Application of the above principles points to a cashflow-based investment strategy as represented in *Figure 2*.

Benefit payments that fall before a 'horizon point' chosen by the trustees (typically at least 10 years away) are matched with a high degree of certainty by investing in an appropriate mix of cash, gilts and bonds. This provides comfort that the pension scheme should be able to meet its cashflow obligations over this period, irrespective of market conditions.

Cashflows that fall beyond the horizon point can be backed by higher-risk investments, such as equities, that are focused on delivering better performance in the medium to long-term.

Several features of the strategy including, critically, the time to the horizon point, can be varied according to each scheme's specific circumstances and investment objectives.

The strategy is dynamic. Once established, it will develop appropriately in response to the changing profile of the scheme membership, based on regular updates of projected cashflows from the scheme. To illustrate this, the strategy for the above scheme, 10 years later, may look as shown in *Figure 2*. This shows how the proportion of assets held in bonds increases automatically in a way that tracks the ageing process of the membership.

ADVANTAGES OF THE CASHFLOW-BASED APPROACH. The single most important feature of a pension scheme's investment strategy is the asset allocation – ie, what proportions of the assets are invested in equities and bonds. Asset allocation is all about finding a suitable balance between risk and reward. Cashflow based investment strategies help trustees and employers to find the right balance between risk and reward within a framework constructed around the new characteristics of their closed DB schemes.

- The strategy automatically tracks the ageing process of the closed scheme and proactively manages a transition from equities to bonds. As the scheme membership matures, the proportion of assets held in bonds will increase in a way dictated by the scheme's own benefit payments.
- The cash and bond holdings provide comfort that benefit payments can be met for a number of years as they fall due, reducing the likelihood that it will be necessary to sell equities at inopportune times to provide the necessary cash.
- The rebalancing process can be used to reduce the likelihood of having to sell equities at a time of depressed market values.
- Closure shortens the expected lifetime of the scheme, and yet a cashflow-based strategy shows how equity risk can be kept where it belongs – in the long term.
- A cashflow-based strategy introduces a new and intuitive way of understanding the level of investment risk taken. If equities out-perform gilts over the horizon period, then the strategy pays off. For example, if a horizon period of 15 years is adopted, the scheme's managers are effectively taking a bet that equities will out-perform over 15 years.

NEW RISKS, NEW APPROACH. Closing a DB pension scheme to new members does not reduce pension costs and risks overnight. Instead, it creates a set of different risks that need to be understood and managed. Those responsible for risk control, including the treasurer and advisers alike, must consider whether the approach to setting asset allocation for the scheme should be changed following closure.

With the government's announcements on pension reform still fresh in the mind, it is clear that the price of failing to manage the risks successfully can be high.

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Note: David and Tony were speakers at the ACT's 2003 Pensions Conference, sponsored by Lane Clark & Peacock, held on 23 October. A write-up of the conference will appear in the December issue of The Treasurer.
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