

Trustee Tutor Solving Britain's Pensions Crisis

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The debate seems endless but the right mix of ingredients could produce a recipe which finally puts the crisis to bed

Anyone perusing the headlines of either the tabloids or the broadsheets in recent months, couldn't have failed to notice the extent to which the debate surrounding pension provision and pensions crises has moved centre stage. Whilst the Government's recent Pensions White Paper has tackled the state pensions crisis head on, there is still the issue of how several hundred billion pounds of unfunded public sector pension liabilities will be met and an increasing focus on how the gaping hole plaguing Britain's occupational defined benefit (DB) schemes will be plugged. In fact, such is the topicality of the latter crisis and the responses by DB scheme sponsors to date, that the Daily Mail recently gave equal prominence on its front page to Arcadia and the Co-op diluting the benefits of their DB schemes as it did to the latest wayward antics of a certain Mr Doherty and Miss Moss.

Although the focus of attention has moved away from rationalising the DB pensions black hole to how we return schemes to a healthy funding position, knowing a little more about how we arrived at this juncture certainly helps in formulating viable solutions to the crisis.

DB scheme deficits are principally the result of a number of factors. There was the introduction of accounting standard FRS17. The Chancellor abolished the tax credit that had accompanied UK equity dividend payments to pension schemes – which would have compounded to possibly £140bn today. There were compulsory and voluntary uplifts in scheme benefits, and unmanaged exposures to the many and various risks faced by pension schemes. People are living longer. Finally, scheme sponsors took contribution holidays, largely on the back of the late 1990s 'bull' stock markets.

FRS17, which applies a transparent market valuation to scheme assets and liabilities, in stark contrast to the opaque actuarial "smoothing" of the previous regime, has, amongst other things, highlighted the extent to which risk has been inappropriately assumed within most DB schemes. On the liabilities side, an unmanaged exposure to unexpected changes in interest rates and inflation, which largely works against schemes in the long run, while on the assets side, over-reliance on UK equities as a means to maximise total return, has been the undoing of most schemes. Although equities have bounced back with a vengeance from their 2003 lows, they have failed to offset the dramatic increase in liabilities resulting from falling interest rates, robust wage inflation and, perhaps most importantly of all, the rising life expectancy of scheme members. Not that this should come as any great surprise, given the absence of any economic rationale linking stock market returns to changes in scheme liability values. Basically, stocks and shares are not a good "match" for scheme liabilities.



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The task at hand

To date, the response to the deterioration in scheme funding positions has been equally dramatic. After all, short of something like a 40% re-rating of the equity market and a 1% rise in interest rates, which translates into a significant bond market correction, restoring DB schemes to a position of rude health requires considerable intervention on the part of scheme sponsors and trustees alike. Indeed, sponsor contributions have, in many cases, risen several fold, and in some instances have been used as a quid pro quo for scheme members to up their contributions, accept reduced scheme benefits or shoulder an element of the scheme's longevity risk. In addition, a considerable number of sponsors have closed their DB schemes to new members and, in a limited number of cases, existing members, whilst others have moved from final salary to career average earnings as the basis for the calculation of scheme benefits.

Scheme investment policy has also been the subject of a renewed focus, with risk management superseding the outmoded goal of maximising return. Quite refreshingly, this has not only materialised into a progressive move away from domestic stocks, towards a more diversified asset mix that increasingly emphasises alternatives, such as commercial property, hedge funds, private equities, commodities and infrastructure assets, but also the implementation of measures to guard against, or hedge, unexpected changes in interest rates and inflation. Traditionally, the hedging of these risks has been achieved by moving away from shares and into bonds, notably index-linked bonds. However, whilst this minimises the volatility of the scheme's funding position, it also constrains the scheme's asset allocation policy and, in so doing, effectively crystallises the scheme's deficit.

By using derivative contracts known as swaps, rather than bonds, to hedge these risks means that the risk reduction decision can be made independently of the asset allocation decision, so freeing up the scheme's ability to capture the most appropriate mix of risk and prospective return to ultimately fund the scheme's pension promises.

So, short of significant movements in stock and bond markets, solving Britain's DB pension crisis really comes down to a mixture of increased sponsor contributions, the use of swaps to hedge out undesirable interest rate and inflation risks combined with a more innovative and well diversified asset allocation policy, notably one not wholly reliant on the returns from traditional asset classes. In other words, a reversal of all those factors that contributed to the current crisis. Let's hope that, unlike the headline grabbing escapades of our wayward "celebrities", the pensions deficits crisis has had its 15 minutes of fame.

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