

RIP RPI

By far the biggest story of the month and certainly the one to have caused the most confusion and consternation was Pensions Minister Steve Webb's announcement of the change in the basis for index linking private sector defined benefit (DB) scheme deferred benefits and pensions in payment. Following the government's decision in the June Emergency Budget to increase all state pensions and public sector pensions by the Consumer Prices Index (CPI), it was announced that from April 2011 the CPI would replace the venerable Retail Prices Index (RPI) as the measure of inflation applying to all private sector DB schemes, including those administered by the Financial Assistance Scheme and Pension Protection Fund.

The CPI is considered a more appropriate measure of inflation for pensioners given that the RPI excludes pensioners from its monthly household spending survey and includes those housing costs, which for those pensioners that own their own homes, are largely irrelevant. That said, the change is expected to wipe off anything between five and ten per cent from the collective value of DB scheme liabilities and reduce member benefits by around 15 per cent, given that annual CPI increases have historically been 0.7 per cent less on average than that for the RPI. Given this, The Pensions Regulator (TPR) has expressed a desire to see reduced recovery plan periods rather than reduced employer contributions. However, according to Aon Consulting three out of every five DB schemes will not be able to implement the new rules unless the Pensions Act 1995 is amended, as these schemes are required by their rules to increase pensions that are already in payment in line with RPI. In addition, 15 per cent have the same restrictions for deferred pensions. In fact, only a fifth of DB schemes currently link increases to RPI but have the flexibility to use an alternative measure.

Once implemented, accurately hedging inflation risk within DB schemes could become a problem owing to the fact that inflation swaps, the index-linked bond markets that underpin them and other inflation matching assets have always been based on the RPI. That said, in an attempt to minimise this "basis risk", the swap market has established a facility by which to exchange RPI for CPI inflation swaps whilst the Debt Management Office has said it would take feedback over the next few weeks on whether pension indexation changes mean it should start issuing gilts linked to the CPI.

True cost of "gold plated" pensions revealed

The Public Sector Pensions Commission (PSPC), set up by the Institute of Economic Affairs and the Institute of Directors, not to be confused with the government commission chaired by John Hutton, revealed some quite startling numbers in their call to reform public sector pensions. The PSPC's inaugural report suggests that a typical public sector worker requires the equivalent

of 48% of annual salary to be "paid" into their unfunded public pension scheme to provide their eventual benefits. However, this varies from scheme to scheme, with the average male teacher's pensions pot requiring an annual equivalent of 34.7% of salary whereas for a policewoman, it's an eye watering 71.8%. In order to bring this average down to 20% of salary, options such as moving to an unfunded notional defined contribution (DC) scheme or a hybrid DB/DC scheme are suggested.

BBC presses the red button

In a bid to address its £2bn deficit, the 60,000-member BBC DB pension scheme is to close to new members from December. Based on career average earnings to new joiners since 2006, the scheme will also restrict pensionable pay increases to 1 per cent for its near-20,000 existing active members from April 2011. Possible industrial action has been threatened to force key events, such as Last Night at the Proms, off the air. At the top of the BBC, director general Mark Thompson together with eight executive board members are understood to have access to a multi-million pound pension fund, with one of them expected to receive a £400,000 pension: one of the highest in the public sector.

USS

The Universities Superannuation Scheme (USS) – the UK's second largest DB scheme after BT and the largest for around 130,000 university and college lecturers – is to move from final salary to career average earnings, raise its normal retirement age to 65 and increase employee contributions from 6.35 per cent of salary to 7.5 per cent. Whilst consultation over the changes is due to take place between September and December, opposition to the proposal has been voiced by the Universities and Colleges Union, which last month threatened the "greatest industrial dispute" ever if the changes are forced through.

Longevity risk overstated

We reported in the May edition of Pensions Watch that the longevity risk market had attracted a significant number of new entrants and was geared up for a bumper year. However, this may all be about to change as Risk Management Solutions (RMS) has launched a longevity risk model that captures advances in medical science and assesses the impact on mortality rates. The model suggests that whilst longevity improvements should continue, the rate at which they do so will slow from that of the past 30 years. Separately, analysis from Hymans Robertson's Club Vita suggests that UK DB schemes have collectively overstated the potential lifespan of their members in monetary terms by £30bn.

Filling its funding gap

Readers might recall from April's Pensions Watch that Uniq, the former Unigate business and now Marks and Spencer's biggest sandwich supplier, with a stock market capitalisation of £25m and 2009 profits of £4m, sought to apply a 50 year recovery plan to its now £477m buyout deficit. TPR, who risked setting a dangerous precedent in accepting such an extraordinarily long time period by which to fully fund the scheme, rejected the proposal along with that for a three year contribution holiday. The company has now proposed a debt-for-equity recapitalisation of the business, which would require the pension scheme, the company's biggest creditor, to hold more than 5 per cent of the sponsoring employer's share capital in contravention of the Pensions Acts.

Talking telephone numbers

Trustees for the BT pension scheme, the UK's largest DB scheme, with 336,000 members with total pension entitlements of £40.2bn, have submitted papers to the High Court asking the court to rule on the scope of the Crown Guarantee. This was granted to the pension scheme upon the company's privatisation in 1984, should the company, currently valued at £10.6bn, become insolvent. If the High Court rules that the guarantee only applies to those pension benefits accrued before privatisation, then in the event of liquidation the liability to the taxpayer, rather than the industry-funded Pension Protection Fund (PPF), would be £7.3bn. However, if the liability additionally extends to benefits earned by employees who joined the pension scheme post-privatisation then the taxpayer could be on the hook for an eye-popping £22.8bn. Interestingly, 20 other companies enjoy Crown Guarantee status. A decision is expected in October.

Meanwhile, Ofcom has put paid to BT's plans to raise the prices it charges its wholesale customers, who rent the company's landlines to sell phone and broadband services to consumers, by up to 4% per annum, in an attempt to supplement the annual £525m contributions the company currently makes to plug the pension scheme's £9bn deficit. All of this comes at a time when Rod Kent, chair of trustees for the scheme, has seen his remuneration rise 60% from £110,000 to £175,000, whilst the pay of three other trustees has risen between 38% and 66%. Mr. Kent, who is also the chairman of a property investment firm, attended 22 trustee meetings in 2009.

Having your cake and eating it

Rothsay Life, the insurance company arm of Goldman Sachs, completed a buy-in for the £6.1bn Airways Pension Scheme – the smaller of British Airways two DB schemes. The deal covered £1.3bn, or 20%, of the scheme's pensions in payment and was unusual in two respects. The trustees specified the target price for the deal at the outset, putting the onus on Rothsay Life to time the underlying transactions when market movements allowed.

The deal also provided the scheme with additional security by allowing the scheme to retain the assets covering the insured liabilities. The deal simply requires the trustees to pay the asset returns to Rothsay Life in return for meeting the pensions in payment.

Trustees suspended

In his 2009/2010 Report and Accounts, TPR suspended trustees from over 100 DC schemes, resulting in, amongst other things, the recovery of £35m of misappropriated scheme funds.

Consultation on annuity rule

The Treasury has announced an eight week consultation on its plans to abolish the requirement to purchase a pension annuity by age 75. It is proposed that pensioners should be able to draw down their pension pots within specified limits, subject to them being able to demonstrate that they can meet a Minimum Income Requirement (MIR) and not be reliant on state mean-tested benefits at any time in the future. In addition, the residual fund on death would be taxed at 55% rather than the current 82%.

Turning to events outside of the UK...

EU Pensions Green Paper

Three EU Commissioners have thrown their weight behind an EU Green Paper entitled: Towards adequate, sustainable and safe European pension systems which is widely expected to become a White Paper and lead to a review of EU pensions legislation. Meanwhile, during the four month consultation period, ending on 15 November, the paper's key debating points will be considered. These include the introduction of a new pensions solvency regime, an EU-wide pensions benefit guarantee system, the need for DB scheme risk sharing and hybrid schemes if a wholesale shift to DC is to be avoided, cross-border portability of pensions and the strengthening of state pension provision.

That sinking feeling

According to consultant Mercer, the aggregate DB pension scheme deficit of the top 1,500 US companies reached a near-record US\$451bn (£293bn) in June, with the collective value of scheme assets being 26% lower than their respective total liabilities.

MySuper pension

With reports of up to 90 per cent of Australian workers having become disengaged from their pension funds, fundamental change is on the way for the Australian compulsory retirement saving system. One of the 174 recommendations for Australia's

superannuation industry to have surfaced from the all encompassing Cooper Review is the introduction of a new universal fund, which will provide a simple, low cost route to saving for retirement. MySuper, as it will be known, is to adopt a single default fund and levy fees that significantly undercut the current average of one per cent, meaning that a typical 30 year old Australian will save around A\$40,000 (£23,000) on fees by the time they retire at age 65. Interesting, despite compulsory retirement saving having been introduced in 1992, Australia's total retirement savings only account for 1.7% of worldwide pension assets of \$27tn (£17.6tn), which collectively are only equivalent to about half the annual output of the world economy.

Pension fund assets still credit crunched

According to the Organisation for Economic Co-operation and Development (OECD), the Paris-based club of middle to high income countries, OECD country pension funds in 2009 recouped \$1.5tn of the \$3.5tn asset value lost during the depths of the financial crisis in 2008. Some countries, such as Austria, Chile, Hungary, Iceland, New Zealand, Norway and Poland, have already recouped their losses. In addition, the OECD weighted average asset-to-GDP ratio for pension funds increased from 60.3% in 2008 to 67.1% in 2009.

Turning Japanese

The demographic time bomb in Japan is now being played out through an increasing number of Japanese pension funds paying out more in benefits than in contributions received. Indeed, in 2008, 40 per cent of Japanese DB schemes faced this predicament. As a consequence, Japan's public pension funds were, for the first time in a nearly a decade, net sellers of Japanese government bonds (JGBs) in the year to March.

And finally...

Purely medicinal

Diageo, the drinks conglomerate, has come up with a novel idea to solve its DB funding deficit. Rather than making additional cash contributions or pledging property as collateral or putting a guarantee in place, it is handing over 2.5 million barrels of whisky to the scheme's Trustees. At the end of 15 years, the scheme must sell this back to Diageo for an amount expected to be "no greater than the deficit at that time", which is estimated to be up to a maximum of £430m. In the meantime, the deal will generate an income to the scheme of around £25m each year over the 15 years and will, no doubt, help make the Trustees meetings go with a swing!

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