

A watershed year for pensions

By John O'Connell and Neville Galloway

The performance of global stock markets in 2008 has shocked almost everybody.

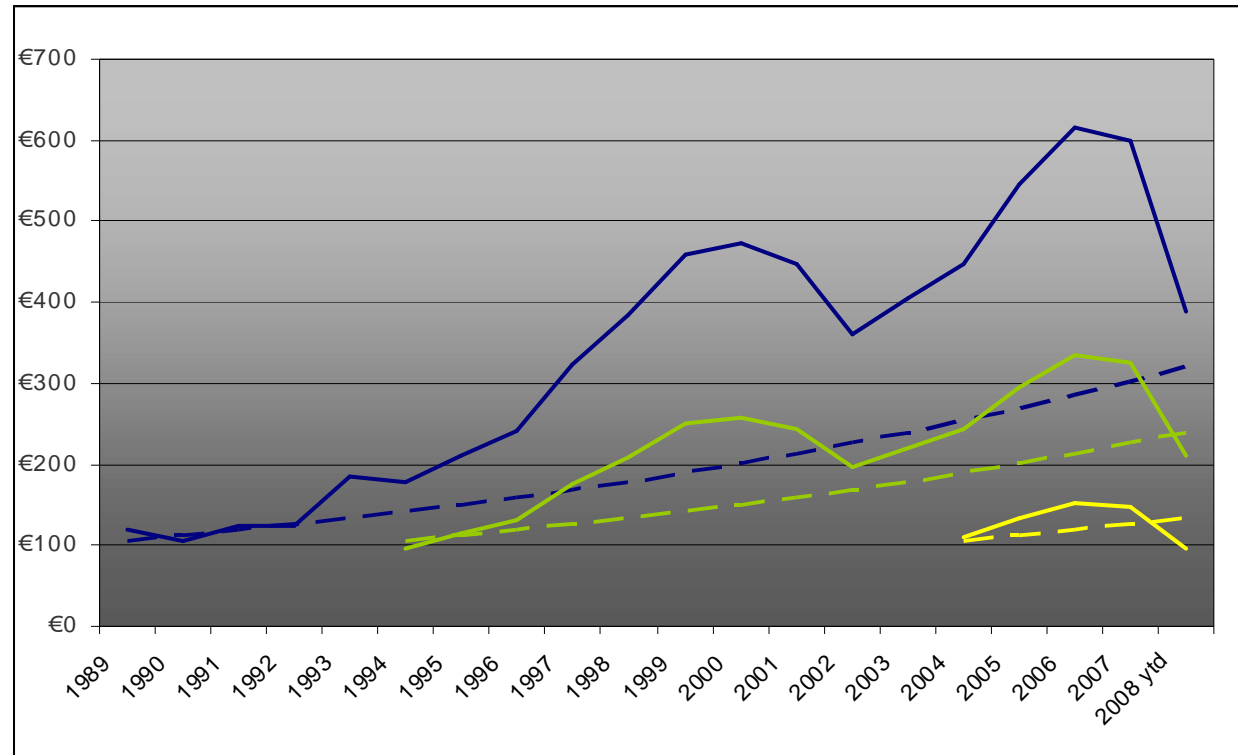
This performance has not only reduced portfolio values for pension fund and other long term investors, the scale and the persistence of the downturn has rocked the confidence of many investors that stock markets can deliver long-term returns in excess of inflation within an acceptable level of risk.

During October 2008, Irish pension managed funds lost 16% of their value on average, depressing the average 5 year and 10 year returns to close to zero. Both returns are of course well below inflation. As these are managed fund returns, including some Government bond exposure, it is clear that the underlying equity returns are now negative for both periods.

No return over these periods compares to inflation of 19% in total over 5 years and 45% over 10 years.

Worse still, if an actuary 10 and 5 years ago anticipated an investment return of say 6% p.a. (at the lower end of typical assumptions), the expectation was that €100 would grow to €134 after 5 years and €179 after 10 years. If these returns are not achieved, a deficit will emerge relative to the actuary's calculations.

Traditionally, it was said that the stock market ups and downs average out over the long-term, but increasingly people are wondering what exactly is meant by long-term.



Average Irish pension fund managed returns 1989-2008 per Rubicon Investment Consulting and ILIM (2008). Solid lines: Actual values of €100 invested 20, 15 and 5 years ago; dotted lines: expected values.

This chart shows that only over a 20 year period has a return of at least 6 % p.a. been attained. In each other period, had the actuary assumed 6%, a lower return was achieved.

Although not impacting with the same speed and surprise, another key driver of pension cost – longevity – has pushed up the cost of pension provision significantly.

For over a century, 65 has been considered the right age to retire despite the fact that 65 year olds are now living three times as long on average as 65 year olds were a century ago.

Many defined benefit pension schemes were established when the outlook for investment markets and longevity was radically different to today. Pension schemes also face much more regular measurement of their liabilities on prescribed bases with the result that bad news has an immediate impact on contribution requirements and on the sponsoring employer's company accounts.

A key point is that there is a lot we don't know about stock markets and longevity.

Is it really safe to assume that stockmarkets will generate high returns over the next 10 or 20 years? And is it reasonable for expensive pension

benefits to be promised on the basis of this assumption?

What will happen in the area of medical science? A small number of illnesses account for a high proportion of deaths. What probability should be assigned to some or all of these illnesses being cured over the next twenty years?

When we know so little about the future, how confident are we that existing defined benefit schemes are viable?

When we review a pension scheme which is part of a dispute, it is striking how defined benefit pension schemes are built on the basis of optimism rather than scenario planning. Most pension schemes have an insufficient safety valve which acts when the scheme is under pressure. Of course, over the last few years, schemes with discretionary pension increases have appeared to have a safety valve but in some cases the employers and trustees have little practical discretion as the pension increases are all but guaranteed.

In some schemes, the only moveable part is the contribution rate. As there is invariably a limit to the extent to which the contribution rate can be changed, these 'defined everything' schemes are not robust. There is a point at which a 'defined everything' scheme will fail – and some are close to that point already (or past it).

Our work in the review of pension schemes therefore has led us to the conclusion that many pension schemes are flawed due to the level of inherent risk and the inability often to move the contribution rate sufficiently to make up for experience losses.

The most important issues which threaten the viability of pension schemes (and possible solutions) are:

1. **Final salary** – basing pensions on a final salary is risky. A lengthy averaging period or an overall cap on pensionable salary growth (regardless of actual salary growth) is a key risk limiter.
2. **Overall salary cap** – a number of defined benefit schemes have introduced an overall salary cap above which the employer makes a contribution to a DC scheme. These hybrid schemes reduce risk making the core DB scheme affordable.
3. **Balance of cost** – many schemes were set up with the members paying a modest cost and the employer paying the balance. Given the much higher cost of pension schemes, some schemes will need a realignment of costs.
4. **Defined everything** – if there are no safety valves, the probability of the scheme failing through being unaffordable increases. A discretionary layer of benefit can help to make a scheme sustainable even if experience is worse than expected.

Of course, members and their representatives may read these suggestions and aim to 'hold what we have'. In some cases, that will be possible.

In other cases, some flexibility will be needed to make a scheme sustainable.

The immediate task given the stock market falls in 2008 has been to quantify the level of deficit in schemes and to calculate the contributions required under a funding proposal to restore solvency.

Looking into 2009, the focus will shift to benefit modifications and cost realignments if the defined benefit schemes that are still in existence are to survive.

Looking further ahead, the underfunding of DC schemes is largely underreported. We believe that the basis on which DC schemes are established will be reviewed as otherwise employers will in practical terms end up with employees who cannot afford to retire.

Clearly given the increased cost of pension provision and the scale of uncertainty, for many schemes change will be necessary. Our collaborative approach to change has yielded results. Change is often hard to accept but adopting the right structure leads to a greater acceptance of change.

While any change can be hard to achieve, pension changes are particularly difficult because (1) many people do not understand (or choose not to) the ins and outs of pension schemes and (2) pension schemes by their nature relate to a vulnerable stage of people's lives and people are naturally emotive about changes affecting their retirement.

This has led us to believe that pension issues are quite unique in the area of industrial relations and a collaborative approach involving pensions and IR expertise is needed to deliver change constructively (i.e. minimising any negative residual feeling after the change).

This collaborative approach is endorsed by union leaders and IR professionals, some of whom are quoted on our website www.pensionsolutions.ie.

The collaborative approach

Objectives

- understanding reasons for change
- achieving buy-in
- change

Process

- bring parties together
- facilitated by pension and IR expertise
- structured approach to problem
 - o broad discussion of issue
 - o appreciation of perspectives
 - o mapping alternatives
 - o achieving buy-in
 - o decision

In summary, the pension scene needs to change in order to survive. However, the way in which change is achieved is vitally important.

John O'Connell and Neville Galloway are the principals of Pension Solutions, a company that facilitates pension disputes in the workplace. Pension Solutions is a trading name of Trident Benefit Consulting Limited.