Company pensions

**Bitten More than Can Be Chewed?**

Probably each of us would like to have a nice retirement. Probably most of us will need some sort of money for realization of that desire. And this consequently requires (again, for most of us) to create some form of saving during our productive age. One form of such saving can represent the occupational pension which is provided by our employer.

Occupational (also called company) pension is a fund to which both employees and employers contribute and as explained e.g. by Peter Howells and Keith Bain in their book Financial Markets and Institutions, chapter 4.2, such fund can be basically of two types. First one is called "defined contribution" arrangement (DC) (also money purchase) and is based on a system upon which each employee makes a fixed contribution into the scheme and accumulated fund is invested. The later pension payments are determined by what happens to the fund's investments. This causes an uncertainty for employees and less pressure on company and the trustee board which runs the company pensions. The second type of arrangement called "defined benefit" (DB) (also final salary) scheme is more favourable for employees, less then for the employer. The basic distinction compared to DC lies on fact that DB scheme specifies at the outset what a pensioner can expect to receive, provided he or she maintained the contributions. The company is then obliged to pay to pensioners their pension regardless the performance of the underlying fund.

However, in an effort to allure new workforce and provide them with a "luxury" certainty after retirement in form of DB, the companies themselves see them trap in a problem. As a recent survey carried out by National Association of Pension Funds points out, in 2003 there were 46% of the 255 significant UK companies operating a DB scheme. During the same year, however, 41% of those companies had to close their funds to new members and offer mostly DC scheme as alternative, 7% had close to future accrual for existing members, 5% had to increase contributions and 33% companies' DB schemes were reviewing.

The major reason causing those inevitable steps was widening deficit between pension funds' liabilities and underlying assets. After a decade of a strong rise of stock markets, during which some employers could even afford to take "pension holidays" (they temporarily stopped making contributions ), came a sharp decline of equities in 2000 which continued to 2003. This, among other things, meant that pension funds' asset allocation changed as a lot of DB pension scheme moved towards a less risky and more stable form of investment.

Table 1 Weighted Average Asset Allocation of Large UK DB Funds

| | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| UK Equities | 50.4 | 48.3 | 45.9 | 39.8 | 39.6 |
| Overseas Equities | 24.7 | 22.7 | 23.7 | 23.4 | 26.6 |
| UK Bonds | 8.4 | 9.6 | 10.0 | 13.0 | 12.5 |
| Overseas Bonds | 3.9 | 4.0 | 3.9 | 4.0 | 3.2 |
| Index-Linked | 5.9 | 6.3 | 7.0 | 9.5 | 8.8 |
| Property | 4.3 | 5.1 | 5.7 | 6.3 | 5.6 |
| Cash/Other | 2.4 | 4.0 | 3.8 | 4.0 | 3.7 |
| | 100 | 100 | 100 | 100 | 100 |

Source: WM Performance Services: Better Information for Better Investment Decisions

When looking at the weighted average asset allocation of large UK DB funds in Table 1 (which was used in State Street Global Advisors' survey called The Changing Face of UK Pension Fund Asset Allocation) the move from equities to fixed income products is visible. However, the strong demand for bonds in fact only pushed real yields

lower making the investment of that kind less profitable. With conjunction with falling real interest rates pushing up the net present value o f funds' liabilities the most companies see their DB scheme in deep deficit. The article from the recent edition of The Economist (January 28th-February 3rd 2006, p.13) estimates the collective black hole in Britain is anything between £40 and £300 billion depending on the measure.

Valuation of liabilities is another factor that plays an important role in DB scheme because it provides another feedback implication on asset allocation . As the report of UK Pension Fund Management points out, meanwhile few would now justify valuing assets on anything other than a market basis, there are three official valuation bases for pension liabilities in the UK. The concepts ("Minimum Funding Requirement" – MFR, "statutory" concept and currently the most used – accountancy concept FRS17) significantly differ from each other in accessing the basis for not only valuation of liabilities but also the discount rate. This causes problems for pension -fund trustees how to set the portfolio to raise appropriate expected return and therefore to meet all liabilities. The report naturally suggests that moves should be made to develop a single valuation ba sis which would not therefore distort pension fund asset allocations.

If we add other significant factor, namely an unprecedented increase in longevity of people, no wonder many companies developed an aversion to DB's. After all, the high deficit can put each company in danger – facing the insolvency. So what should companies experiencing pension fund deficit do? As the article from Economist (once mentioned) reveals, the latest solution is focusing on risk connected with liabilities ( mainly inflation and interest rates) and hedge them away using a method called "Liability Driven Investing". The thought lies in fact that pension fund should be able to meet its cashflow by using financial instruments like interest rate and inflation swaps and derivatives that allows hedging the two biggest threats for value of liabilities and securing the asset in this way as well. As was pointed in the article, such a radical way was chosen by WS Smith, a British retailer, when selling all of its shares and bonds and investin g in swaps and equity options. Another rational changes can be (and in most cases must be) made in relation to contributions. This was applied in the case of Sainsbury's reform of its pension fund ( see report of BBC News from February 24 th). Sainsbury's currently faces £582m deficit in its two DB schemes (already closed to new members) which according to new agreement will be eliminated by injection of £350 m and increasing annual contributions from the employer's side. In addition each member of those DB sc hemes has a choice: either they increase contributions thereby keep ing projected pension payments after retirement or sustain their contributions at current level but their projected pension payments will not be based on final salary but only on their aver age career salary.

After all, even though the lucky members of DB schemes will be given their pensions in proper instalments and will probably have a nice time after retirement, the price for it was not in most cases worth it. The question is whether the final salary scheme will ever be widely used and run again. Yes, perhaps. When the mathematical methods will be unified and reliable and investments secure and highly predicted. Till then though, the people running DB will be under pressure and in doubt about investment performance and will be most likely looking forward to one thing … pension.