Submission on the relationship between pension assets and liabilities

John Hill

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Introduction

I was a member of a Working Party set up by the actuarial profession's Myners/Sandler Steering Group following the publication of the Myners' report on Institutional investment. Responsibility for the Working Party subsequently passed to the Pensions Board. The final report is published as *Note on the relationship between pension assets and liabilities* and is being presented to the SIAS meeting on 6 May 2003. I was unable to agree this report and have produced this separate submission.

Background

As a member of the working party I attended its meetings and took part in drafting some parts of the main report.

I believe that the concept of the Liability Benchmark Portfolio (LBP) that the main report promotes is a useful tool, albeit that it has some shortcomings. However, in my view the report is too prescriptive, fails to fulfil the working party's brief and, if adopted by the profession, would be contrary to the best interests of pension stakeholders in the UK (principally sponsors, trustees and members).

I therefore make this submission, which I hope will be considered alongside the main report.

The working party's brief

The brief of the working party was:

> " To produce a briefing document for pension fund trustees and sponsors on the relationship between fund assets and liabilities. This work is in response to the recommendation in Paragraph 3.58 of the Myners' report that trustees should:
>
> - set out explicitly an overall investment objective for the fund which represents their best judgement of what is necessary to meet the fund's liabilities; and
>
> - set objectives for their fund managers that are coherent with the fund's investment objective."

My concerns in summary

The thrust of the report appears to derive largely from the view of its chief authors that the overriding concern of trustees of defined benefit pension arrangements should be the short term solvency position measured as the ability to secure the accrued scale benefits on winding-up. For example, paragraph 2.2 of the Summary states that:

> *When considering the relationship between assets and liabilities, Trustees should (in most cases) focus on the accrued liabilities that represent the pension promises made to the members to date. These represent the entitlements that members have in the event that they leave the scheme or the scheme is immediately terminated.*

It is not clear to me whether this was the primary reason for the direction of the report, and it may be that a more fundamental one was the chief authors' view that defined benefit pension obligations should be treated as if they are tradable financial instruments that can and should be 'marked to market'. Neither starting point reflects the current reality on scheme termination that scale accrued benefits are not usually guaranteed. Either starting point gives rise to a strong presumption that bonds should back such liabilities and that there is little or no place for equity investment. As a consequence the report takes an extremely narrow viewpoint and in my view it falls a long way short of addressing the working party's remit from the perspective of those practitioners who do not share the above view of the report's chief authors.

I am also aware that the replacement of the MFR is currently under review by Government and I am concerned that the report's prescriptive line ignores and may cut across the Government's preferred way forward.

More specific comment

The report introduces the concept of a Liability Benchmark Portfolio (LBP). This is a pure bond portfolio matched to the accrued scale benefits arising on discontinuance; it would more accurately be called the Termination Liability Benchmark Bond Portfolio. The LBP is central to the report which states that "Asset allocation should start from the LBP" and seeks to impose a 3 year maximum on the time frame over which risk relative to the LBP is considered.

In my view, the LBP is too narrow a concept. Rather than helping trustees and sponsors to understand the investment issues, the central role given to the LBP in the report seeks to prejudge those issues. Identifying the LBP in detail would be a worthwhile exercise if, but only if, the trustees were seriously contemplating investing in the LBP or a proximate portfolio. In other cases it adds little useful information to the reporting likely to be required under GN9 on the discontinuance position. It should also be appreciated that the LBP will in many cases not be capable of being constructed from gilts and for smaller funds approximating to the LBP by use of derivatives would be impractical.

Moreover, the LBP would be seen as a guide to securing the accrued scale benefits on winding up, and may materially mislead since the cost of buying-out with non-profit deferred and immediate annuities (which are the true match to those benefits, not the LBP) may significantly exceed the cost of the LBP. Furthermore, the cost of the LBP and that of the buy-out annuities will vary in different ways.

There is an implicit assumption in the main report that the LBP is comprised solely of bonds. However, no evidence is presented that this is a valid assumption. Indeed, analysis suggests that in the absence of suitable matching instruments, minimum risk portfolios are ordinarily not entirely bond-based.

I also believe that a number of statements in the report, which derive from perfect markets financial economics theory, need to be subject to detailed empirical scrutiny. A number of assumptions behind this theory break down quite severely in the context of long term defined benefit pension provision. In particular I believe that such pension provision operates in the context of investment markets that are neither complete nor, from the perspective of a long-term investor, efficient.

Information about the performance of the actual portfolio of investments relative to a portfolio of bonds which is a reasonably close match to the accrued liabilities may be useful and should not be difficult to obtain in most cases. I must stress that I am all in favour of trustees and sponsors being given proper information about the likely position of their scheme on winding-up and about the implications for that of the asset allocation. However, they should also be given proper information about longer term issues, including the contributions that the employer is likely to be called on to pay over time, and about the implications for that of the asset allocation. It should also be remembered that the sponsor's legal liability is to pay contributions in accordance with the trust deed and rules and any statutory requirements such as the MFR, a point which this report appears to entirely ignore.

If adopted by the profession in its current form the report would intrude on the existing relationships between actuaries, investment advisers and their clients and on the relationship between sponsors and trustees. It would appear to give advice in areas which are for the actuary/investment adviser appointed by that client, and would change the currently accepted approach to pension fund investment and funding to a short term point of view. A fundamental question is whether the shift to a strictly short-term point of view is correct and justified. In my view it is not, because the correct context has to be taken from the political and legal framework in which UK pension funds operate. The report misses the context: it is well intentioned but too simplistic.

It is interesting to consider the short term bond dominated approach of the working party report in the context of the quotation from J M Keynes and the Forward by Gordon Brown which preface the Myners' Report. Keynes refers to "….the long term investor, he who most promotes the public interest …." And Gordon Brown says "I regard our strong funded pensions system, our highly developed equity culture and the professionalism of investment in the UK as key national assets".

The political and legal framework is that pensions are an act of voluntary provision by employers, now subject to many statutory constraints, but not yet to the extent that pensions are 100% guaranteed. This is most clearly seen in the discussions which have taken place between the Institute/Faculty of Actuaries and Government ministers about the introduction and amendment of the MFR. It was always made clear by ministers that the context for setting the MFR is one in which the pension promise is not fully guaranteed. We see the same feature in legislation pertaining to winding up of pension funds (despite some strengthening of the debt on the employer regulations last year). We see the same philosophy reflected in the Myners' Report. Indisputably there is a tension between the Treasury/Myners camp and the DWP interests in safeguarding company pension promises. But a balance has to be struck, just as the market price of an investment is settled by balancing the tensions between supply and demand.

In short, the current political consensus and legal framework about company pensions in this country is:

- they are to be encouraged
- member protection should not be legislated to the point where employers discontinue the provision of such pensions and
- as Pickering said in his recent report: "absolute guarantees are absolutely unaffordable".

Therefore the premise of the report, namely that pensions should be 100% guaranteed, is at variance with the political consensus as things stand. If legislation were introduced to make this premise correct, it would undoubtedly hasten and confirm the demise of employer guaranteed pensions. Ironically, a statutory requirement to ensure that defined benefit pension schemes are 100% solvent on a wind-up in which members are entitled to full accrued scale benefits may precipitate the insolvent winding-up of schemes that such a requirement seeks to avoid.

Much of the content of the working party's report is useful material which can and should form part of an actuary's toolkit when advising clients, but viewed as a full response to paragraph 3.58 of the Myners' report it falls significantly short.

Trustees' objectives in relation to the investment of a defined benefit pension scheme will usually be complex. They will usually have regard to the sponsor's wishes (the report largely fails to address investment issues from the sponsor's perspective) because if the trustees ignore the sponsor's wishes, the sponsor may well cease to support the scheme. Such objectives will normally cover the long-term as well as the short-term, risks of underfunding by reference to various criteria and the emerging contribution requirement.

As regards the funding criteria which the trustees and sponsors have regard to, the list may include:

1. Ongoing funding target
2. Discontinuance (closed fund approach)
3. Buy out
4. FRS17 / FAS87 / IAS19 (not directly relevant to funding)
5. MFR

Summary

I believe that the concept of a minimum risk portfolio, defined as the portfolio which minimises the risk of underfunding, given the contributions available, is a useful one. However, in my view the funding criteria to be adopted and the timescale over which the underfunding risk is assessed should be for the individual adviser to agree with the client. The report seeks to prescribe that the funding criterion should be 2 or 3 above and the time period a maximum of 3 years. Such an approach virtually excludes any evidence that would support investment other than in bonds.

My understanding is that Government policy is to replace the MFR with:

1. A scheme-specific long-term funding standard

2. Voluntary wind-up liabilities of buy-out for pensioners and scheme-specific cash equivalent transfer values (CETVs) for others determined on a "basis that is fair for all" and presumably linked to the new long-term funding basis.

Such a policy avoids a buy-out solvency standard for non-pensioners, and is consistent with a recognition that (1) such a solvency standard would place an excessive burden on employers and (2) would be unachievable in practice unless the Government is prepared to underwrite the guarantees somehow, eg by issuing sufficient gilts with the right characteristics, to render buy-out solvency more than an illusion, and (3) that accrued scale benefits are not guaranteed

The wider definition of a minimum risk portfolio which I propose would allow proper consideration to be given by trustees to the investment policy best suited to the long term funding standard, whilst having regard to the risks for wind-up liabilities (to be redefined by Government) and to the sponsor's objectives.