



Misconceptions of risk, asset allocation and the death of pensions

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“Organisms inherently understand that there is risk in life. The idea that we can eliminate these risks would be selected against quickly in the natural world since any organism that tried to do so would not have enough resources left for reproduction, or feeding itself.”

Raphael Sagarin, Duke University

In October, the PPF is due to issue a consultation covering the question of scheme asset allocation, and the risk thereof, in the levy setting process – we have already seen press articles promoting its adoption. Hopefully, this consultation will be more perceptive and accurate than the recent DWP paper¹ on risk sharing.

Both Partha Dasgupta and Lawrence Churchill from the PPF have stated on numerous occasions that they do not want to influence the asset allocation of schemes. This is admirable, but the introduction of differential levy pricing based upon asset allocations will inevitably have precisely this effect, intended or not. Perhaps they should both read Sunstein² and Thaler’s recent book “Nudge” where choice influences and decision architectures are discussed in depth.

Influence over asset allocation should be taken very seriously as it can have a dramatic effect on the quality and cost of pension provision – one recent study from the US National Institute on Retirement Security identified a value gain of 30% arising from the asset allocation advantages of DB over DC.

If we look at the stand-alone variability of bond and equity asset portfolios, obviously history tells us that the equity portfolios are more volatile than bond, but that same history also tells us that equities deliver higher average returns than bonds. To consider the risk or variability of assets without considering in similar fashion their returns has the logical consistency demonstrated all too often by bureaucracy.

The level of regulation and its associated costs for DB pension schemes is already far in excess of anything justified by the experienced costs of scheme failures; this is the relevant market failure justifying any regulation. The difference between DB and DC is simply a matter of where the risk is borne – and incidentally the tax incentives are virtually identical for the two forms of provision. The sole risk faced by a DB member is sponsor insolvency, whereas a DC member is exposed to all possible risks that affect pensions; risks they are ill equipped to deal with.

It is insightful to turn the argument around: if the risks faced by a DB member were as high as the regulations imply, the question which should be asked is why is this Government content to let these risks be borne by the individual under DC arrangements? A cynic might be tempted to delve in to the political influence of organised groups versus individuals.

¹ A response to the DWP risk sharing consultation is available from www.BrightonRockGroup.co.uk

² Richard Thaler & Cass Sunstein, “Nudge – Improving Decisions about Health, Wealth and Happiness” Yale University Press 2008 – ISBN 978-0-300-12223-7



Even a cursory examination of the DB regulations in force makes obvious the fact that there is little or nothing which addresses the principal risk present, sponsor insolvency. Unless a sponsor fails, pensions must be paid on time and in full. In fact the total risk faced by a scheme member is the product of the likelihood of sponsor insolvency and the consequence of that event, the level of deficit at insolvency. There is a genuine difficulty here as prior to insolvency correct corporate finance tells us that no liability should be funded at greater than 100% of its value. Whereas post insolvency the now orphaned scheme is faced by considerable uncertainty and risk through the term of its run-off - it requires funding in excess of 100%. The bulk annuity market suggests this excess should be 25-30%.

Scheme specific funding rules, by their own scheme-centric limitation, operate on the consequence of the event, the deficit. However, they are inefficient in the sense that this is only relevant at a particular point in time – sponsor insolvency. It is obviously grossly inefficient to impose such rules for all schemes at all times.

The PPF levy structure is itself rather strange. It is bound by legislation to be 80% or more risk based in aggregate, but with risk undefined. It has elaborate setting procedures which have led to a common misconception. The costs faced by a scheme under the PPF arrangements are not those of its own insolvency but, as the PPF is a mutual compensation fund, a proportion of those of all others. This proportion is determined by the contribution of a particular scheme's estimated risk to a year's total estimated risk. This is inimical to the strongest schemes, which pay far more than equitable. Sound insurance risk theory tells us that the correct form would be pricing, of the marginal contribution of a sponsor and scheme to the overall portfolio, **of their own risk.**

The PPF risk-based levy is already based upon deficits. If a scheme is largely invested in bonds, its deficit will be quite stable since the variability of liabilities is dominated by variation in interest rates. This is actually variation in the measure, not a reflection of any change of risk to pension payment; it is just the application of a particular financial model, the discounted, present value model. If a scheme is largely invested in equities, its deficit will tend to be volatile. This arises because we are comparing equities valued at market prices with interest rate discounted liabilities. The accountants refer to this as mixed attribute accounting, but every schoolchild knows it as comparing apples to pears.

The PPF levy is assessed annually. Combine this with the formulaic link to deficits and a scheme's asset allocation is already allowed for. A risky (read equity) asset allocation will create volatile deficits which in turn will lead to higher levies over time than an otherwise identical but less risky (read fixed income) asset allocation. The reason is exactly the same as for volatility acting as a drag on average realised (geometric) return. The only situation where an explicit allowance for scheme asset allocation is justifiable is when the levy is a once-and-for-all payment. To include it in an annual formula is double jeopardy for the levy payer.