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Risk in DB Pensions: A Jobsworth Box

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"Why were you so blunt?" was the most frequent question raised by the peer reviewers of our response to the DWP's recent consultation on risk sharing. One answer to this lies in a perceptive and considered article, "*Accounting rules for public duty and private failure*" written since by John Kay, published in the Financial Times. In this he states: "*Governments, like private sector companies, are anxious to promote flattering reports of their affairs….. A true and fair view is even more important to the operation of democracy than the functioning of markets.*" Our full response to the consultation is freely available from www.BrightonRockGroup.co.uk.

Trust is a central concern in financial affairs, from money to pensions; in this context the stated Government objective of ensuring confidence in pensions is to be applauded. However, the majority of actions of this Government do not accord with that objective. The relevant economic concept is known as signalling, and for a signal to be credible, it must be costly to the sender; in the vernacular, talk is cheap. The litany of Government actions which have imposed costs on the sponsors of voluntary DB schemes is long; ACT, the contracted-out rebate, the PPF, scheme specific funding, and on. Any comparable list of actions imposing costs on Government is very, very short.

It is evident that the volumes of regulation now imposed on pension schemes carry costs far in excess of any market failure that might justify their introduction. This is a strong assertion, deliberately so, but this article will provide support and evidence for it.

DB is superior to DC in many regards for the employee and pensioner: risks faced by the pensioner and employee in DC are borne by the sponsor in DB. The incentives for a sponsor to assume these risks of provision are both central and complex.

First though it is necessary to consider the extent of these risks. Service contribution rates, the cost of pension accrual, are set to reflect best estimates of a range of uncertain assumptions in order to provide the benefits promised. Risk then is limited to adverse developments around these estimates. If the best estimates are distorted,

for whatever reason, this is reflected in the service cost; this, however, is not risk but error. This is an important distinction to which we will return.

The sponsor in considering whether to provide a DB or DC arrangement has to consider the extent of these risks together with the associated incentives; the cost-benefit trade-off. The DC option effectively sets a floor for DB, that which can be achieved by the employee individually. The tax concessions are fundamentally the same. The incentives for the sponsor now arise from just two sources; firstly the signalling value of DB provision to employees and secondly the operating efficiency of a collective arrangement such as DB.

The first is largely intangible and surveys often suggest that DB provision is not highly valued by employees; this suggests that little value should be ascribed to this element by employers. The second is concerned with both economies of scale and scope in fund management and administration (a form of cost reduction) and also with the time diversity of a collective scheme, which may be described as risk sharing.

A pension scheme typically has little requirement for liquidity; the pensions payable in any year are usually less than 5% of the value of the scheme's fund. This dependence is in marked contrast with an individual needing to liquidate his entire pension savings portfolio to buy an annuity on retirement. This time diversity is one facet of the risk sharing within a DB scheme. Another form arises from the commonplace fixed accrual for each year of service regardless of the age of the employee. These serve to reduce the risk faced by the sponsor employer but nevertheless the sponsor still faces some level of uncertainty and risk, which has a cost. It really is doubtful that this cost is less than the savings achievable through the economies of scale and scope, and therefore in such a situation there is an explicit disincentive to the provision of DB pensions by a company.

Before the introduction of asset concentration and scheme specific funding rules, there used to be another significant advantage to DB pensions provision as a long-term liability of the sponsor: it could be a very attractive form of financing for the business. Contrary to the widely held view, such financing is not free; it effectively pays the cost of the earnings of the assets which could have been purchased. Such book entry arrangements are much frowned upon now, but it is worth remembering that this was the principal form of financing for industry in post-war Germany, the era of the Wirtschaftswunder.

The sole risk now faced by a member of a DB scheme is sponsor insolvency. The 2003 Debt on Employer legislation made the pension liability explicitly enforceable; the covenant concern was reduced, from ability and willingness to pay, to simple ability to pay. It also had an effect which has passed largely unnoticed – it rendered redundant all of the prior and much of the subsequent regulation of the scheme and its funding. This is the most important point in this article so we shall repeat it. The introduction of legislation to assure the enforceability of the sponsor liability, the debt on the employer, reduced the risks faced by a scheme member to just one risk, the sponsor's ability to pay. Any regulation which increases the cost of provision of the pension benefit, the sponsor's liability, increases the quantum of the risk. For completeness we should add that reducing uncertainty, or equivalently enhancing the member's security, will inevitably increase the cost of provision for the ongoing employer.

Elementary risk theory is helpful; risk is the product of the likelihood of the event, sponsor insolvency, and the consequence of the event, any scheme deficit at insolvency. Regulations which raise the cost of provision increase the risk to the member by increasing the likelihood of sponsor insolvency. Even those regulations where this cost is a benefit to the scheme security, such as a special contribution, reducing the consequence of insolvency, the scheme deficit, may (and usually do) also increase aggregate risk

However, there is still a real problem here. Prior to insolvency, when the firm is an ongoing concern, it should not fund any of its liabilities at greater than 100% of their accounting value. But, post insolvency, this is problematic for the orphaned pension scheme; it is fully funded but faces uncertainty over the residual life of the scheme. This uncertainly requires the scheme to possess additional capital buffers – and if the bulk annuity market is a fair guide, these should be of the order of 25%-30% of the scheme's total liabilities.

In essence this is the source of confusion in the debate over the application of the Solvency II regime to pension schemes in the UK. If the scheme is an orphan, it is rational that it should be funded to reflect the uncertainty and risks it faces, but there are very few ongoing orphaned schemes in the UK. If the scheme has ongoing recourse to its sponsor, as is the usual case, it should be required to be funded at no more than 100%.

Somewhat ironically this pension insolvency funding problem is well resolved by a form of insurance – indemnity assurance. This assures schemes against the insolvency

of their sponsor, indemnifying the scheme against both deficit and required risk provision. Note that this assurance, where the uncertainty is in timing rather than occurrence, is another form of time diversity. This is squarely in the domain of risk finance, where the distinction between error and risk is important.

Many assumptions are needed to set a fair contribution rate for a specific benefit structure. And if these are to result in unbiased evaluations, they must be best estimates, which are often referred to, with mathematical formalism, as expectations. If an assumption is biased, intentionally or not, then the contribution cost is also biased; this bias is error not risk. Risk is variation from the expectation while error is variation of the expectation. This is important in that errors add while risk diversifies. Mixtures of them are deeply problematic.

One of the major failings of the risk sharing consultation was the suggestion that the member should share in errors, or even accept them in full. This is a very poor idea as this then adds an incentive for the sponsor to insist upon aggressive assumptions, which reduce their contribution cost. This of course is a form of deception and profoundly inimical to any form of trust.

The strength of indemnity assurance is that it covers the insolvency contingency, a question of risk, but until insolvency occurs the cost of provision is borne by the sponsor (which with the passage of time tends to the true cost). As risk diversifies, the assuror faces less risk in aggregate than the total risks faced by its assured schemes individually and the solution is economically optimal.

Risk, in general, is bad in the sense that it lowers the current value of an asset; the more the risk the lower the current value. However, there is one situation where this generality is misleading and that is where an option is present. The effect of increasing the risk or volatility of an asset increases the value of an option written upon it. Conditional indexation of a pension scheme introduces optionality into the situation and this brings with it complications as to the precise form of the option. The form suggested in the consultation, which might be described as promise high but upon a contingency occurring pay less, is an option written by the member to the employer. This offers an incentive to the employer to engage in very risky strategies, a process which maximizes their value of the option, to the possible detriment of the member. A superior alternate would be to promise low but pay higher upon a contingency; now engaging in risky strategies increases the value of the option to the member.

Sponsor insolvency is the primary risk for DB pensions because it is the only way that members may receive benefits less than set out in the Trust Deed & Rules of the scheme. This is the risk that is strategic and inherent in DB provision in the UK; all other risks (funding level, asset allocation, longevity and so on) are operational. With the operational risks however they arise, however they are quantified, and however they are managed the membership will still receive full benefits. Put another way, the only risk that matters from a policy perspective is one that actually lies outside the pension scheme. All risks that lie inside the pension scheme, the operational risks, are of secondary importance.

In a world where indemnity assurance is available to schemes and their sponsors, it is clear that all of the redundant current scheme-centric regulation could be repealed; any constraints upon a scheme in this situation are rightly a matter of private sector commercial contract. The reduction of deadweight costs that results is a benefit to all, scheme member, sponsor employer and perhaps most importantly and most significantly the Exchequer.

Deregulation of pensions has been much talked about in recent years, but the fruits of all this talk have been meagre. It really is time to rethink the regulation of DB pensions radically to escape from the jobsworth box we're in; the alternate is to allow DB provision to continue to decline into oblivion.

In next month's article we shall examine in detail a selection of current regulations with a particular focus on the Pension Protection Fund.