



Risk with everything? Pension cost and variability

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Finance Director: Morning.

Consultant: Morning.

Finance Director: What have you got, then?

Consultant: Well there's DB and DC; DB, pension and DC; DB and risk; DB, DC and risk; DB, DC, pension and risk; risk, DC, pension and risk; risk, DB, risk, risk, DC and risk; risk, risk, risk, DB and risk; risk, risk, risk, risk, risk, risk, FRS17, risk, risk, risk and risk; or longevity thermidor aux postcode, with a LDI sauce garnished with enhanced transfer value, bulk annuity buyout and a PPF levy on top and risk.

Trustee: Have you got anything without risk in it?

[With apologies to Monty Python]

The topic in pension discussion has become the identification and elimination of risks; de-risking is the zeitgeist. Risk is now epidemic, and has spawned a very long list of remedies.

An exchange between Frank Knight, whose 1921 *Risk, Uncertainty and Profit* is considered one of the most important economics monographs of the twentieth century, and a medical historian at the University of Chicago is cautionary. To the question as to when doctors began curing more people than they killed, he received the response “*Well, I think that will be in another generation or so*”.

There is just one risk truly matters in defined benefit pension provision: protection against sponsor insolvency. Sponsor insolvency is paramount because it is the only way that members can receive less than full pension. Whatever the outcome of a scheme's investment strategy or the population's longevity, members will receive their full entitlement if the sponsoring company is solvent. However, it is a risk that is more often than not absent from risk analysis.



Perhaps this is because the Pension Protection Fund was intended to protect against sponsor failure. But its design, the product of hastily drafted legislation, only provides partial protection and acts to increase the cost of pensions. Many hope that the PPF levy will stabilise; some even expect it. They will all be disappointed; the PPF levy will rise inexorably over time (for why, see “And pigs might fly” at www.BrightonRockGroup.co.uk).

The correct design provides complete protection (no 10% reduction, no £27,770 cap) through the mechanism of indemnity assurance rather than compensation fund. Assurance premiums reflect the marginal cost of risk that the insured presents; PPF levies reflect the cost of failed companies spread across the surviving. Such assurance serves to lower the total cost of financing pensions while making contributions more predictable and less variable. Company contributions can be limited to the cost of benefits accruing. Point-in-time estimates of deficit arising from market volatility can be ignored without jeopardising member security.

Every Finance Director sees the likelihood of their company’s failure as remote, and quite rightly so. However, Trustees, tasked with ensuring benefits are paid, should investigate the consequences of insolvency from the immediate to the remote. Over-funding is the obvious risk remedy as it reduces the consequence of insolvency, though usually increasing its likelihood - a treatment which can kill in excess.

The question is one of economic efficiency, and indemnity assurance is far superior to over-funding. This is the corporate equivalent to life assurance and is neither irrational nor undesirable; over-funding a scheme is simply a form of self-insurance. Sponsors need only contribute to target full-funding, freeing cash for use in the company; in practice this means 90-100% FRS17. Cash in the business is more powerful than cash in the pension scheme, not least because its use is far less restricted; it reduces the likelihood of sponsor insolvency (strengthens balance sheet, boost profits, etc) while cash in the scheme only reduces the severity at the time of sponsor insolvency.

Purchasing protection is certainly better than paying to eliminate risk through the purchase of annuities replicating pension benefits. DB pension schemes are part of the long-term capital structure of the sponsoring company: liabilities are created for discharge many years later. Funding acts as collateral and while traditionally referred to as scheme assets, these are, economically, retained profits of the company (under control of trustees). In this light any decision to extinguish these liabilities, part of corporate finances, is far from trivial, even before consideration of the hefty cost (the barrier to exit). For these reasons, despite the headlines, bulk pension annuity should be



limited to use at times of major corporate restructuring. Risk elimination here is expensive and poor value for money.

Accounting treats pensions harshly. The liability and collateral assets must be marked to market, or, absent that, to a market parameterised model. This treatment is at odds with the accounting for other forms of company finance. The funding level variability, transient in nature, manifests as a surplus or, more often, as a deficit on the sponsor's balance sheet. The spotlight shines on the deficit figure, but its characteristics, in particular its variability, are primarily those of the accounting construct used for measurement (being a difference statistic, linked to market prices) rather than reflections of real pension happenings. By their nature the naïve use of deficits as the basis for decision making – contributions, investment strategy and so on – will lead to unnecessarily large cost and/or variability.

Liabilities drive contributions and many assumptions are needed to set a fair contribution rate for a specific pension scheme's benefit structure. If these are to result in unbiased evaluations, they must be best estimates. When an assumption is biased away from best estimate, intentionally or not, the contribution cost is also biased. This bias is error not risk. Risk is variation from the estimate while error is variation of the estimate. This is important because errors add while risk diversifies. Revision to the longevity assumption is error, and justifies additional contributions over an appropriate timeframe; equity market volatility is risk (deliberately assumed for return) and does not.

A re-evaluation of defined benefit pensions is needed; the orthodoxy is not serving us well. There are operational risks needing correct management and secular trends requiring proper budgeting. But as a source of finance pensions are a friend of the company, and with all the focus on "risk" it is easy to overlook this "return" aspect. Moreover, as this is pension provision for the suppliers of finance, the workforce and ex-workforce, security is required beyond that afforded to debt and equity holders.

Insolvency risk was reduced by the debt on employer legislation to a question of ability to pay; willingness to pay became irrelevant and a material barrier to exit from voluntary provision was introduced. The regulators would do well to recognise that pensions were provided willingly by companies and that the private sector can provide efficient ways to manage them. With indemnity assurance pension cost, security and variability are manageable. Waiting a generation is not an option; the willingness to provide DB pensions at all is now being tested to destruction.