

# DECISIONS

PENSIONS AND EMPLOYEE BENEFITS

December 2008



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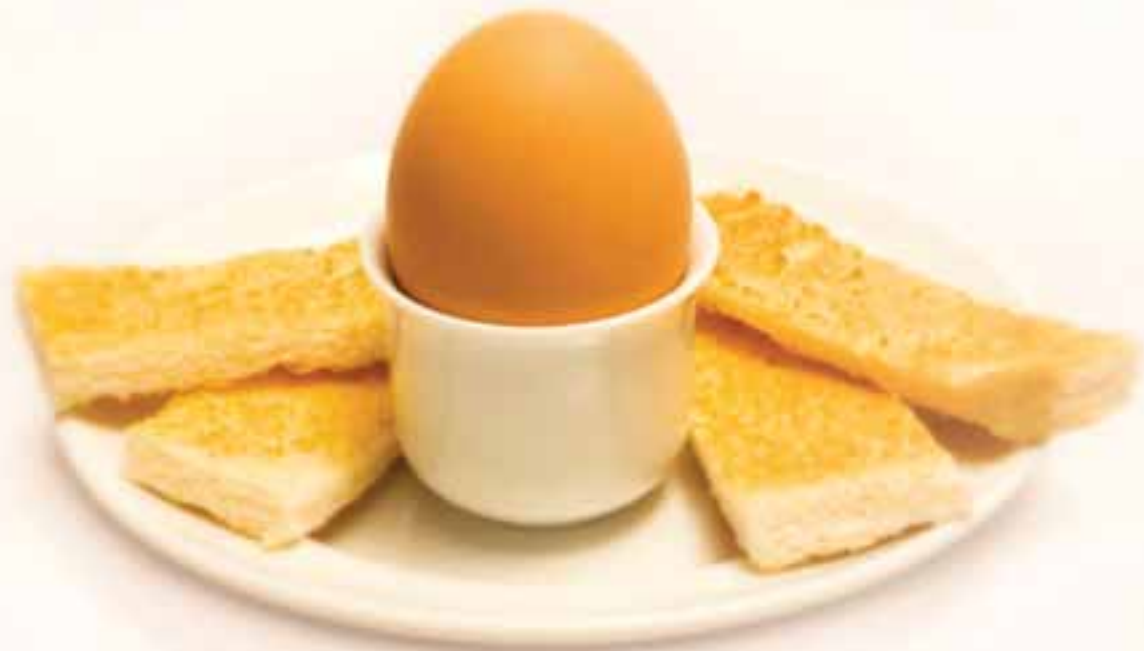
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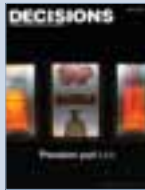
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**Pension schemes** are feeling a lot like a slot machine these days. The whole environment is so crazy, with the failure of counterparties to deals that were supposed to

reduce risk. The returns from gilts goes down, the value of equities goes down and the present value of the liabilities in the balance sheet goes down.

And as for the asset classes that were supposed to have been uncorrelated in portfolio risk terms, well, you know what's happened to private equity and hedge funds. Never mind: if you've got shot of your final salary scheme and switched your people into DC, then you're safe, right? Think again.

All these issues and more feature in our supplement this month. Charlotte Moore looks in particular at the problem of volatility (page 5), while Anthony Harrington works overtime to inform us about the litigation threats from DC-scheme employees (page 9) and against actuaries (page 3). Maybe, just maybe, you can pay for the whole problem to go away (page 16). Or maybe it's cheaper to persuade your employees to take up smoking as a hobby (page 13).

Andrew Sawers

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FINANCIAL DIRECTOR



# NOT AN OPTION

Personal accounts will be a step forward, but compelling companies to contribute may have unintended consequences

**At the time of going to press**, the pensions bill was nearing the end of its passage through the House of Lords. As David Robbins, public policy adviser at Watson Wyatt observes, despite many minor amendments at committee stage, the two most important features of the bill are likely to sail through relatively unscathed. These are (a) the introduction of auto-enrolment of members into pension plans and (b) the framework for the 'personal account' (the government's latest wheeze to ensure the lower-paid get some pension from the private sector).

Both auto-enrolment and personal accounts will come into play from 2012; both constitute fundamental changes in the pensions landscape, for two reasons. First, until now, employees have had to decide to opt in to company schemes. Auto-enrolment (with an option to opt out) has a proven record of greatly increasing the number of people in pension schemes. So this about-face fits well with the government's long-term aim of shifting the pensions burden as much as possible from the state to the individual.

Second, the ground-breaking novelty that the introduction of personal accounts bring with them is a compulsion on employers to contribute. This has always been optional for employers. Even with the introduction of stakeholder pensions in April 2001, the company was not required to contribute – all it had to do was to set up the mechanism for employees to opt in to a scheme.

Personal accounts, on the other hand, rewrite

the rules. Employers will have to contribute 3% on top of the employee's 4%, with around 1% coming from the government in tax relief.

The Delivery Authority (DA) was created by the 2007 Pensions Act to deliver the personal accounts system as a functioning entity by 2012. Having consulted on the charging structure for personal accounts, the next step for the DA is to issue a consultation on the 'default fund' that will constitute the heart of the personal accounts system. The default fund will be there for employees who have no taste for actively managing their own portfolio.


Sweeping as the changes in the pensions bill are, they are not expected to derail proceedings. As Robbins puts it, "No one has said that personal accounts are rubbish. The basic shape of the thing looks right and, although there are all kinds of details around the edges to be sorted out, personal accounts will get a reasonable reception."

The big fear, however, is that instead of being a benefit for the lower-paid, the exercise will lead to a raft of employers lowering their contributions to employee schemes to the 3% level espoused by the personal accounts system.

If that happens, it will devastate private pensions and the law of unintended consequences will once again have been visited on the UK pensions sector. ■

**Anthony Harrington**

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# LOVE ACTUARY?

The actuarial profession is likely to fall out of favour as pension schemes launch more and more litigation against their advisers

**Three years ago**, at the height of the bull market, American actuaries were coming under fire. In 2005, Charles Bryan, a former president of the American Academy of Actuaries, wrote an article warning that, although “at first glance it appears that we have reached actuarial nirvana – lots of work, great value placed on actuarial estimates and good pay – the whole position could unravel.”

He pointed out there were more lawsuits – real and threatened – against actuaries. What was particularly troubling was that these lawsuits were for enormous sums relative to the fees that actuaries were receiving for their calculations. Bryan used an example from the insurance world, pointing out that an actuary’s fee for a loss reserve opinion could be around \$50,000, while the loss reserve estimate itself might be as much as \$100m – 2,000 times as much as the fee. An alleged error in the loss reserve, he said, could easily generate a claim for \$15m – or 300 times the fee.

Similarly, in an M&A deal where the actuary is asked to provide an opinion on the target company’s final salary scheme, damages claims could dwarf the fee if the scheme in question turns out to be in deeper distress than the actuary indicated.

Actuaries on this side of the pond will breathe a sigh of relief that the UK approach is not yet quite

so geared to encouraging swingeing damages claims. Yet according to Biggart Baillie pensions litigator, Brent Haywood, who has been involved in several actions over the past few years, there are clear signs of a marked upward trend in actions against actuaries here as well.

## Professional negligence

The odds do not particularly favour litigants, however, unless the actuaries have been disciplined by their own profession for professional negligence in the case in question. This is not unheard of, since it is all too easy for actuaries to find themselves in a conflict of interest having drifted into a position where they are offering advice to both the company and the trustees.

“As a litigator you need a ‘nugget’ – some solid piece of evidence that you can work from – and if you can find one, then it makes an action so much easier,” Haywood says. The disadvantage that scheme trustees have in pursuing actuaries is one of scale. Say, for example, they find themselves with a fund that is massively short of achieving a match between its assets and its liabilities to members and they feel that the actuary (and, often, the scheme’s investment advisors as well) are to blame in some way. To fund their action they will have to look to the assets of the scheme, depleting

them even further. The actuary, on the other hand, will often either be part of a massive insurance company or will have professional indemnity insurance from a very large insurance company.

“The stand the indemnity insurance people take is simple: they are not going to roll over for any claim. They do not want to set precedents and they are going to make you work all the way up to the point where they would be incurring court expenses in what looks like a losing action for them,” Haywood says. “That is a hard road to go down, but people are increasingly willing to contemplate it.”

## Blame game

David Robertson, a partner in Mercer’s financial strategy group, says while he has not seen much sign of a build up of actions against actuaries in the UK, the blame game that is sure to follow the present debacle in global equities is bound to generate some activity.

“One area where actuaries might be vulnerable is with certain scheme rules, particularly involving contributions. Some schemes leave the setting of the contribution rate solely with the actuary and there are probably a few actuaries sitting rather uncomfortably right now,” he says.

Haywood points out the problem with going after actuaries is that you have to prove they acted in a way that no reasonable actuary, standing in their shoes would have acted, and that is a high hurdle to jump.

David Knox, pensions partner with law firm Dundas & Wilson, says in many instances it will come down to exactly what the actuary was asked to do. “Trustees’ advisers are now advised to hire expert advice in writing, with a clear written record of what it is that the expert is being asked to do. The second duty, if you want to litigate and win, is to look at the extent to which you can show that the expert has failed to do this. The third and final task is to connect that failure with real, quantifiable loss,” he says. “Scheme de-risking strategies and the statutory funding regime are focusing more attention on actuaries. The *Cornwell* and *Allied Domecq* cases show the courts’ increasing interest. Recent stock market movements and the FRS17 rules increase scheme deficits and could set up claims against actuaries that set contribution rates that now look too low.”

If all that sounds as if bringing a winning action against actuaries is still difficult, it is. Nevertheless, Biggart Baillie’s Haywood says he gets the feeling that the actuarial profession has something of the “rabbit in the headlights” look about it at present. The next year or two should be interesting. ■

**Anthony Harrington**

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**It was the collapse of Lehman Brothers**

that really changed things. Up to that point, company pension schemes had experienced turbulence from the credit crunch, but the demise of this one Wall Street institution flung them into the path of a force-ten gale. Suddenly, the prevailing wisdom that pension funds should attempt to manage their inflation and interest rate risk with swaps no longer looked such a great idea if their counterparties could go bankrupt overnight.

This sudden rise in swap counterparty risk is just one of a host of issues that finance directors and pension trustees have had to grapple with in recent months. Recessionary fears have crystallised and equity markets around the world have tumbled. Supposedly uncorrelated asset classes such as private equity and hedge funds saw their valuations plummet. And volatility has shot through the roof.

Many FDs must feel like they have fallen down Lewis Carroll's rabbit hole and are now in Wonderland where it is the norm to believe six impossible things before breakfast. But even in such volatile and unpredictable times, there are a few opportunities to be found.

Pension consultants and investment managers acknowledge that the collapse of Lehmans has not only focused minds on the risk of the swap counterparty, heightening concerns that their interest rate insurance could disappear in a puff of blue smoke. It also calls into question the viability of a so-called liability-driven investment (LDI) strategy.

But the sudden collapse in interest rates underlines exactly why it is so important to try to manage a pension scheme's interest rate risk. As Nick Evans, principal consultant in investment advisory at KPMG, puts it: "This is not the death of LDI." It is still possible, he says, to use swaps to give protection from interest rate

movements and manage the counterparty risk.

"We are still seeing a lot of pension funds going down the LDI route," says Mike O'Brien, head of European distribution for Barclays Global Investors. "But they are now setting more demanding terms. Swap positions are now being collateralised on a daily basis rather than weekly or monthly. That collateral also needs to be of high quality; only government debt is really acceptable." This ensures that if the counterparty fails then the pension scheme has cash readily to hand to set up another swap with another counterparty.

**Physical bond**

This is not the only way that pension schemes can get some protection, as KPMG's Evans explains: "LDI means different things to different people. You don't have to use swaps to implement an LDI strategy; you can also use physical bonds."

Evans believes it makes a lot of sense for pension schemes to switch



out of swaps and into bonds. "One of the distortions of the current market environment is that there is better yield on government bonds than there is on swaps," he says. "And there is no counterparty risk."

Another distortion that has arisen from the global financial crisis has come to the aid of the FD as he stares down the barrel of the annual reporting season: the yield on AA-rated corporate bonds. Plunging asset values from equities to hedge funds means there will be a sea of red on the asset side of the balance sheet when annual reports hit investors' desks at the start of next year. Things, however, are looking brighter on the liabilities side. This is because accounting standards currently stipulate that a company uses an AA corporate loan rate as the discount factor to value its future liabilities.

The credit crunch has seen the spread of AA corporate bond yields relative to government bonds widen to historical highs. "What that means is that a higher discount rate is being used to value the liabilities side of the balance sheet so the value of the liabilities has fallen," explains O'Brien. "This has given finance directors a bit of wiggle room. Yes, pensions deficits have got worse, but it's not as bad as it could have been," he adds.

**Potential risk**

But there's no room for complacency, warns Robert Hayes, head of BlackRock's strategic advice services team. "This presents a big potential risk. We cannot assume that the valuations of different asset classes will continue to move in the same direction. If corporate spreads correct before the equity market recovers, then the pension deficit will widen further," explains Hayes. "Both pension trustees and FDs need to be very aware of potential risks and do what they can to minimise them."

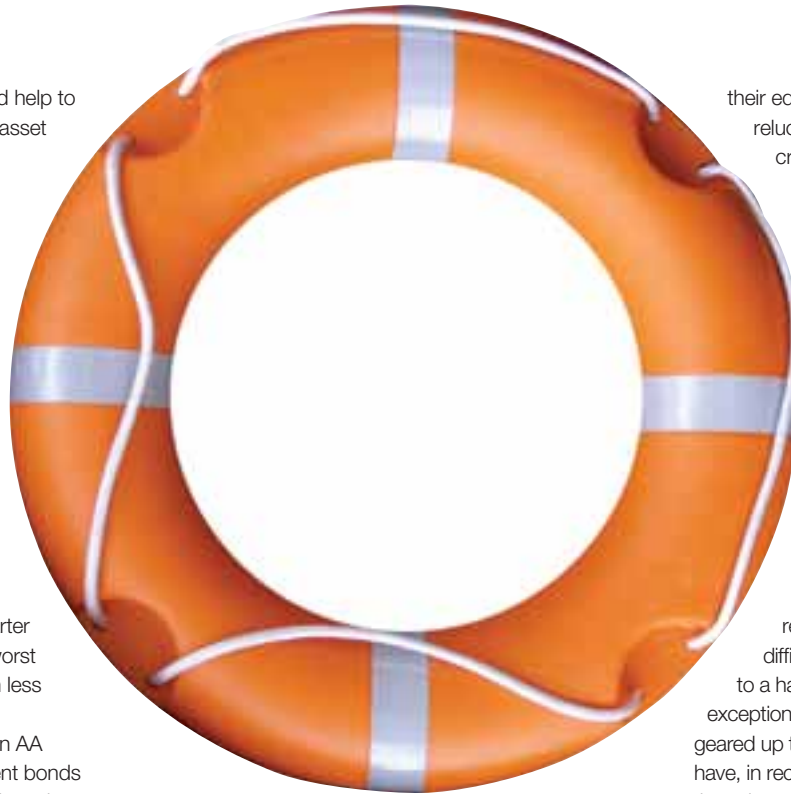
Increasing the proportion of assets invested in corporate bonds would help pension schemes ▶

# SAFE HAVEN

The collapse of Lehmans brings a new danger to pension funds: the risk that counterparties in swap deals could go under overnight. Is there a safe way to do liability-driven investment?

to manage this risk as this would help to align the movement in both the asset and liability side of the balance sheet, says Hayes. Investment managers and pension consultants are unanimous that buying corporate bonds makes sound investment sense as well as being a good way to protect against narrowing of spreads relative to government bonds. "AA corporate bonds currently have a spread of nearly 300 basis points above government bonds. That represents a default risk of 23%, or an assumption that nearly one-quarter of companies will default. The worst over a ten-year period has been less than 10%," says Hayes.

The current yield gap between AA corporate bonds and government bonds reflects the lack of market liquidity rather than an accurate reflection of corporate default risk, says Hayes. As pension funds invest over the long term, they can afford to invest in a more illiquid asset class. KPMG's Evans agrees: "A pension fund is a long-term



close the pension deficit over a ten-year period, trustees like to narrow the gap as quickly as possible, explains Evans. Falling interest rates and lower investment returns mean that trustees

their equity portfolio plummet and they are reluctant to sell their equities as that would crystallise the losses. "Over a five to 10-year view, they expect the value of equities to rebound quite strongly. I think that's the right view," says Evans.

Before the credit crunch took hold, many pension schemes were in the process of trying to reduce the risk of their portfolios while maximising their returns. They did this by investing in alternative assets such as private equity and hedge funds. But both fund managers in both those asset classes were avid users of debt, which helped them to amplify their returns, but now makes life a lot more difficult. Private equity deals have to come to a halt and hedge funds are going through an exceptionally tough time. Many hedge funds that geared up to exploit the mispricing of two assets have, in recent months, seen a large number of those bets not work out. Not only have hedge funds had to pay back the debts by selling off their assets – almost invariably much depleted in value – they are now also seeing a significant number of investors getting cold feet, queuing up to redeem their funds and putting yet more pressure on hedge funds to sell even more assets.

The level of uncertainty surrounding the alternative asset universe means most pension schemes will have to put these schemes on hold. As McLaughlin says, "It's going to be very difficult at the moment to put more money into various alternative asset classes, particularly given the immense difficulty that hedge funds are facing. This industry needs to work through the difficult issues first. Similar problems may face the private equity industry as deleveraging continues."

McLaughlin says that pension schemes have limited options available to them to prevent further devaluation of their asset portfolio. "It's extremely difficult because many asset classes have been highly correlated in the recent downturn and all have seen their valuations move downwards together, with the exception of government bonds. The only real choices available are to invest in corporate bonds or to take some risk out of the equity portfolio by using options."

Hayes says that both FDs and pension trustees need to ensure they remain open to new possibilities as they arise: "They must ensure that their operations are flexible enough to take advantage of any investment opportunities." ■

**Charlotte Moore**

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## If corporate spreads correct before the equity market recovers, then the pension deficit will widen further

investor that does not need to sell its bonds next week, next month or next year. The pension fund can afford this illiquidity premium especially for assets that will give good returns at an acceptable level of risk."

The use of AA-rated corporate bonds to value the liabilities from an accountancy perspective has helped the FD when it comes to facing investors, but there are problems when it comes to dealing with the pension trustees. The accountancy rules stipulate that a company uses AA corporate bond yields to value its liabilities (though that is currently being reviewed by the standard setters), pension trustees are required to use the government bond rate. This has fallen dramatically as interest rates around the world have been slashed and the tumbling value of assets like equities mean that pension trustees see their deficits ballooning.

"Up until now, the relationship between government and AA corporate bonds has held quite steady," says Evans. "But that has now changed and creates a potential conflict between FDs and pension trustees." From the trustee perspective, the pension deficit is much larger than from the FD perspective.

Moreover, while the company is required to

believe the only way to remedy this situation is to ask FDs for more lumps of cash to put into the pension fund.

### Stash the cash

But the crisis in liquidity and the arrival of recession means FDs are trying to preserve as much cash as possible to protect the future of the underlying business and are extremely reluctant to put any additional funds into the pension scheme.

While there are still options open to companies to manage their liabilities, the asset side of the equation is trickier. The current volatility in all financial markets makes it incredibly difficult to devise an investment strategy that will satisfy the claims on the fund.

Kevin McLaughlin, senior investment consultant at Mercer's financial strategy group, says, "Some of those schemes that had a large proportion of their assets invested in equities decided to protect against any downside using options." As equity volatility is still so high, schemes could get good value by selling call options and using this to fund downside protection. In effect, they are giving up the chance of some upside in return for some downside protection.

Many pension funds have seen the value of



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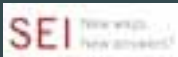
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### 22 October How can businesses cope with change?

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# YOU HAVE BEEN WARNED

Transferring from DB to DC schemes may help shed the financial risk of final salary, but it will not absolve companies from their responsibility to tell employees what they are getting into



**With stock markets around the world** getting into the habit of losing 5% to 10% of their value in one day and sometimes making most of it back the next, it's hardly surprising to find employees worried about the impact of all this thrashing around on their pensions.

Now, in other words, is the time for companies to really examine and improve the way they communicate to employees about their occupational pension plan.

There are at least three major, self-interested reasons for doing so, quite apart from the fact that it is the right and proper thing to do. First, companies do not gain by having their staff in an anxious and concerned frame of mind. Second, companies provide a pension at a very substantial cost to themselves: if it is going to invest in a benefit on that scale, then it is in its own interests to see that the benefit is recognised and valued by the staff.

Third – and this is the really interesting one – there is a storm brewing, in the shape of litigation

to come. Companies that say the right things in print and do the right things in practice will have a better defence to fall back on than companies that do not.

Ironically, the litigation risk arises from the defined contribution schemes that employers have turned to as a way of shedding their final salary financial risks.

### Individual responsibility

The nub of the problem lies in the fact that, with DC schemes, each individual is responsible, in effect, for defining the investment strategy for their particular pot of money. As David Robbins, public policy adviser with Watson Wyatt points out, this might look as if the company is home free, irrespective of how the investment performs. However, the reality could be very different.

Consider a very probable future in which DC scheme members find that their pot of money is manifestly not enough to provide them with

anything other than miserably skint old age. Will they accept that under the logic of the shift from DB to DC schemes, the responsibility for the scheme's failure to produce a sufficient pot of money lies with them?

Some might, more might not. They will take the matter to their lawyers who will cast around for a way of attaching blame to the company. Taking as their starting point the employee's claim that they were "mised" about the probable size of their ultimate pension, the lawyers may want to attack the company on the grounds that it failed to adequately inform its members of the nature of the transfer of risk entailed when the company moved from DB to DC.

The starting point for any judge in an action like this will be an aggrieved plaintiff who really is – no question about it – staring at stark poverty and who has a multitude of similarly-aggrieved scheme members waiting in the wings for their actions to begin. The judge, one might respectfully suggest, ▶

is not going to be disposed to regard the company, whose actions without question initiated the sequence of events that led to this state of affairs, as entirely blameless. In fact, as Chris Noon, a partner with Hymans Robertson notes, any company which finds itself in this position is going to want to be able to put before the court a really strong history of excellent communications with its employees on the subject of DC schemes.

### Communication strategies

So far, however, all is not well on this front. The problem, Noon says, is that while a number of finance directors in larger companies have got rid of their risky DB schemes, they have so far failed to make the necessary investment in their DC scheme. By this he is not referring to the employer's contribution to such schemes – which, indeed, is often too low for the scheme to produce a decent pension – but to the fact that they are not investing enough in communications strategies to arm employees to cope with the new responsibilities they are taking on.

“The point about DB schemes was that, from an organisational standpoint, the employer did not have to worry about them. The trustees and the trust framework provided a coherent infrastructure for these schemes. With a DC scheme on the other hand, the employee is pitched into the fray and courts may well decide in future that the employer had a duty to explain what this shift of responsibility entails,” he suggests.

At present, neither the recruitment process, nor the induction process, nor the line manager support function, is geared up to alert a new employee to the perils of making the wrong investment decisions in a DC scheme.

How is Noon so sure that not enough is being done? He points to the statistics. “In many companies where there used to be 100 % of employees signing up to the DB scheme, there are less than 10% signing up for the DC plan. And in many instances this is not because the plan is bad or not generous, but because the company is not supporting the employees coming into the DC option,” he says.

Noon offers the analogy of a mythical corporation that has a long history of sending chauffeur-driven vehicles to ferry staff to and from work. If it suddenly switched to providing them with their own cars, without ensuring they had any driver training, there would be a spate of crashes. “With our car example, the crash happens pretty soon after the switch. With pensions, the crash comes 40 years later,” he says.

The moral of the story is that companies need to add comprehensive DC “instruction” to their induction process for new recruits. And yet, they cannot, of course, offer financial advice, just general advice, such as the importance of “life-styling” the investment policy.

“Having joined the DC scheme, the new recruit

becomes, in effect, their own fund manager, so they need the skills to select the appropriate funds from the often opaque list of funds that they can choose from,” he says.

Dave Robertson, a partner within Mercer's financial strategy group, takes up the theme of DC schemes and the current market turmoil. He argues that where a DC scheme has been designed to give due consideration to risk, and there are developed strategies in place to ensure, for example, that members are progressively moved out of equities as they near retirement, any communications from the company to the members right now could be fairly reassuring. “You would be saying that while these are difficult times the DC plan has structures in place to enable the members to manage their way through the problem,” he says.

The ideal position here is where members have been sufficiently educated in the notion of risk and reward and in assessing their own appetite for risk. “Clearly, choosing the investment strategy is

## One cannot rule out some legal challenges based around the idea of misleading communications from the company about the defined contribution scheme

ultimately in the hands of the member. If they have opted for some exotic investments, there are going to be fund options in the menu they can choose from which would create difficulties for them in the current downturn,” he says.

### Member confidence

Similarly, in a DB scheme, where there is a strong employer covenant, to the point where the membership can be confident that the employer will be able to ride out any downturn, the message to the scheme members is likely to be quite positive even if the scheme has quite a high equity exposure. After all, buying equities when they are cheap makes excellent sense if you take a long-term view and are reasonably confident that equity markets will recover. (This is less certain than it might seem – Japanese equities are still well below the values they enjoyed before their bubble burst more than 18 years ago.)

However, where a DB scheme has a high equity content and an employer who is being buffeted by the present conditions, then soothing words from the trustees to the members could be extremely difficult to do right now. But the trustees cannot shirk the responsibility to report to the members: “They have a duty to communicate, but the messages that go out will be quite negative,” Robertson says.

Back to DC schemes and Robertson agrees there is definitely potential for future legal action around poorly performing funds. “Where these schemes have been badly deflated by the crash in

equity values, and where members have colleagues and friends who are with the company's DB scheme, there is the potential for members of the DC scheme to feel particularly exposed and concerned,” he says.

Initially, Robertson suggests, this is more likely to take the form of calls from the unions and from members for employers to step up and help members of DC schemes. However, one cannot rule out some legal challenges based around the idea of misleading communications from the company about the DC scheme.

“It is far from obvious to me how such legal action would play out in the courts,” Robertson says. “There is no doubt the DC scheme puts the risk on the members. But might the courts decide that, nevertheless, the risk somehow returns to the company? The only grounds for such an action would seem to be miscommunication, so the defence must lie in the company making sure that the members are fully apprised of all the risks involved in various investment strategies.”

It may be that some companies will decide that the simplest forms of DC schemes – those that leave it all up to the member – are not appropriate, after all, and that they should engage in a degree of risk-sharing with members. The government is currently exploring the possibility of such hybrid schemes.

Watson Wyatt's Robbins points out that even DC schemes that have a default ‘life-styling option’ that moves members out of equities and into low-risk bonds as they approach retirement could have a problem: members who do not take the default (and so who end up exposed to too much volatility risk just prior to retirement) might argue that the virtues of the default scheme were never properly explained to them.

Robbins also argues that companies with DC schemes should be telling their members that the money stays in a protected pot and is not reliant on the strength of the employer. This can be a crucial point in a deep economic downturn.

The main lesson for finance directors to take from all of this is that DC schemes are not just a way of bailing out of expensive DB schemes. They impact people's quality of life in retirement and if you short-change your staff on this, expect trouble later. ■

**Anthony Harrington**

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# What more can we say?

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<b>YTD</b>	<b>6.0</b>	<b>-29.8</b>	<b>2.7</b>	<b>-14.4</b>	<b>4.9</b>
<b>1 Year</b>	<b>5.3</b>	<b>-32.3</b>	<b>6.2</b>	<b>-20.5</b>	<b>6.0</b>
<b>*3 Years</b>	<b>8.5</b>	<b>-2.9</b>	<b>3.8</b>	<b>0.0</b>	<b>5.5</b>

\*Absolute Insight Plus UK Equity Market Neutral Fund annualised

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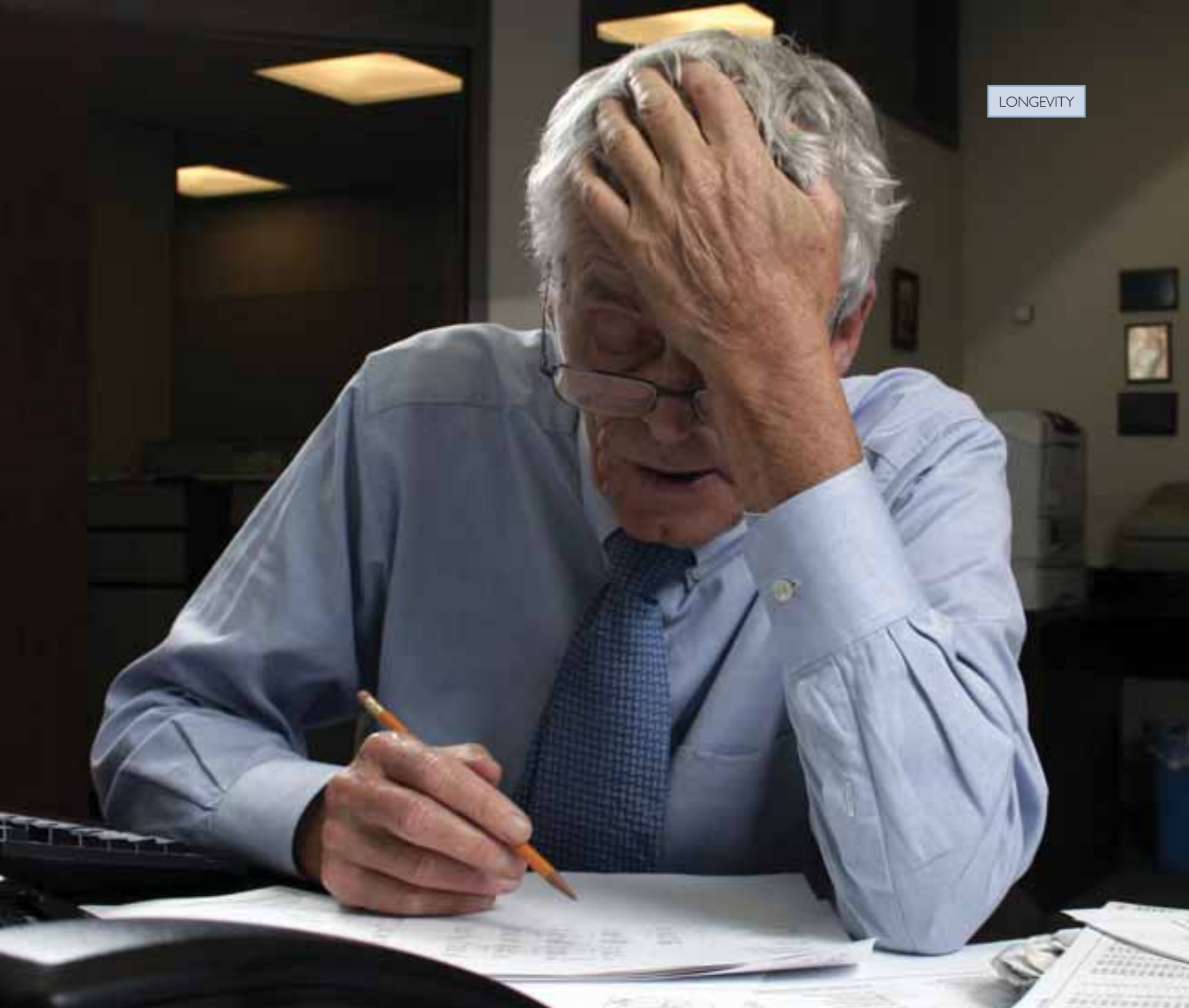
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The fact we are all living longer is a good thing. But increasing longevity is putting a strain on investment strategy, forcing trustees to look at their schemes' mortality risks in more detail

# WORK TO LIVE

**By now we are all getting rather familiar** with the risks that the increase in longevity of life poses to final salary (defined benefit) pension funds. But being familiar with the risks is one thing; solving the problems is another, requiring a total overhaul of pension practice.

As Hymans Robertson partner Douglas Anderson observes, "The rate of increase in longevity has been so great that it is now effectively dragging back investment performance by half a percent a year, which is a terrifying figure for fund managers," he says.

The average lifespan is increasing at the equivalent of 12 minutes every hour, which is wonderful for individuals. But if you ponder Anderson's point about the impact on investment returns, it effectively means that in 10 years, a steady, continuous year-on-year investment return of 5% after inflation (which is not a bad rate) would be the equivalent of a zero real return by the tenth year – and every subsequent year the fund would actually lose value by 0.5% a year cumulatively, plus the rate of inflation.

Moreover, this disastrous scenario assumes that

there is no sudden upward leap in longevity caused by some new medical breakthrough such as a cure for cancer. Recently, a life sciences company started clinical trials of a genetic treatment that is expected to cause cancer cells to "commit suicide". Good news for mankind if the trials work; rotten news for annuity providers.

## War generation

To date, the generation that has been most favoured in the mortality statistics is the generation born between 1930 and 1945. "This generation saw a real step change in life expectancy, but about 40% of that change is thought to be due to the fact that it was the first generation to profit from the discovery of the link between smoking and lung cancer," says Anderson. The second factor is ▶

probably the dietary improvement brought about by rationing during the war years, which forced people to cut back on sugars and fats and to eat more balanced meals.

Danny Vassiliades, a principal at Punter Southall, makes the point that there is a built-in bias in developed societies for longevity to increase. "The plain fact is that mortality creep is going to be an enduring phenomenon for the pensions industry to deal with," he says. "You have a biosciences industry and a pharmaceutical industry hugely active in the area of keeping people alive. You have governments trying to attack behaviours that kill off people, such as obesity, dangerous driving and excessive alcohol consumption. And as the aged population expands you have a massive voting bloc very interested in seeing that public funds are spent promoting longevity. We are already seeing annuity providers adding hundreds of millions to their reserves to offset business they have written which under-estimated growing longevity."

Vassiliades argues that people's expectations

"On a high level, this is along the lines of using interest rate and inflation swaps to ensure the benefit payments from the scheme are matched by receipts from the assets," he says. The better you can match these two streams, the more resilient the financial base of the scheme will be to changes in financial conditions (see page 5).

Paul Kidson, a senior consultant with Watson Wyatt, says that the figures for increasing longevity make gloomy reading from the standpoint of annuity providers. But he adds that the current round of reserve adjustments being made by providers to deal with potential losses on this front could be being overdone.

### Mortality frisk

Until, and unless, something extraordinary happens, however, the main aim of the game is for trustees to get a lot closer to the mortality risks inside their own particular schemes. Kidson points out that Watson Wyatt has been helping trustees to analyse their schemes using a variety of tools. Postcode

the idea behind his scheme. "We work on a mutual concept, by creating a pool where smaller schemes can group all those scheme members who are high-benefit members and who might live for a long time. Life Trust dubs these people the scheme's 'idiosyncratic risk'. This risk, then, is taken by the mutual pool," he explains.

Consider a small scheme with several highly-paid members. The risk of those members living well beyond the average assumptions of the scheme, on which it bases its liability calculations, can skew the risks for the whole scheme. By "dumping" those members into the pool the "risk" is capped off at the cost of the premium paid to Life Trust.

Briscoe says that Life Trust is receiving a substantial number of enquiries from employee benefit consultants and advisers. The real appeal of the scheme, he says, is that unlike a scheme buyout or going to an insurance company for an annuity-based solution, there is no immediate large transfer of scheme assets to the insurance company.

"The assets continue to sit where they are and it

## How many 60-year-olds in the scheme are likely to die next year? How many 61-year-olds? 62-year-olds? The better that trustees understand their scheme, the more likely they are to make appropriate assumptions about longevity

about their standard of living at retirement will have to be managed downwards, or the retirement age will have to be pushed out substantially (BT is a very large and recent example of a company that has just raised its retirement age from 60 to 65). "Pension schemes will not be able to deliver a retirement income that gives you the freedom to do everything you want to do in retirement if everyone lives to 85 and beyond. So there is a macro-economic question of whether the nation's wealth should be used for retirement or whether we should keep the same proportion of that wealth allocated to retirement (without increasing it), and just keep walking the retirement age upwards," he says.

### Shifting the risk

For companies, the simplest way out of the dilemma has long been to shift from defined benefit to defined contribution, since this effectively shifts the longevity risk to the individual employee (but see our article on page 9).

Chris Tavener, a partner with Lane Clark & Peacock, says that actuaries and trustees need to keep a near-continuous eye on the interaction between any deficit in the scheme, the amount a company can afford and the strength of the company's covenant. "You can no longer afford to wait for the three-yearly scheme valuation report. These matters should be on the agenda for every trustee meeting," he says.

A sound response to increasing longevity is to deploy sophisticated liability matching techniques.

analysis is one of the more frequently used options.

The point here, Kidson says, is that trustees of smaller schemes are disadvantaged by comparison with trustees whose schemes have, say, 10,000 or more members. With that size of membership the law of large numbers comes into play and trustees can be reasonably confident that national mortality statistics for the population as a whole will apply to their scheme. However, in smaller schemes the figures can be skewed in all kinds of ways. Breaking down members of a smaller scheme to post codes and then using the population-wide post code mortality statistics provides a very good way of bringing the law of large numbers to bear on smaller schemes.

"There is nothing magical about post codes, nor is there any direct causal link. But post codes are a very good proxy for the kinds of things that impact on longevity," Kidson explains. The analysis, then, is all about answering questions like: how many of the 60-year-olds in the scheme are likely to die through the course of the next year? How many 61-year-olds, 62-year-olds, and so on? What emerges from this is a better understanding of the liability structure of the scheme. "The better that trustees understand their scheme, the more likely they are to make appropriate assumptions about longevity," he says.

Another answer to longevity risk is to insure against it. There are an increasing number of products being introduced to the market which let trustees hand over their mortality risks to insurers. Andy Briscoe, chief executive of Life Trust, outlines

is only when the life cover for the individual ends that the assets are transferred to our pool," he says. In the present market conditions, where no scheme trustee wants to crystallise a loss on the equity markets for example, the idea of not having to hand over assets immediately is very appealing. Under the arrangement with Life Trust, when an individual in the scheme reaches, say, the age of 75, the insurer starts paying income into the pension scheme. The amount paid in rises each year that the individual remains alive. "This effectively caps the risk and makes predicting the assets and cash flow needed into the future far easier," Briscoe says.

Watson Wyatt's Kidson says that insurance-based solutions to the longevity issue are starting to attract real attention. However, Dave Robertson, a partner in Mercer's financial strategy group, argues that, in many instances, simply purchasing an annuity for these "idiosyncratic" scheme members will be a more attractive option for some schemes. "The problem with all the insurance-based longevity offerings out there at the moment is that they all need to get some momentum up. There is no shortage of ideas and capital starting to address the pensions market and we can expect some of these to succeed and some to fall away," he concludes. ■

### Anthony Harrington

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# EVERYONE'S A WINNER

Offering transfer packages to high-earning employees in order to reduce final salary pensions liabilities is dangerous. But get it right and it's a win-win situation for all involved

**One of the tactics** for reducing final salary pension scheme liabilities is to offer selected members (usually the more highly-paid ones) a package deal to transfer out of the final salary scheme.

There are some difficulties with this option, since companies want to achieve the transfer out of the final salary plan without leaving themselves open to any subsequent litigation from disgruntled employees. One obvious ground for legal action would be that the option they took had not been properly explained to them and that they were put at a disadvantage in comparison with the benefits they might have enjoyed had they stayed in the final salary scheme.

The usual technique for dealing with this problem is to ensure employees who are offered a transfer package are given access to a competent independent financial adviser to explain the merits of the deal on offer.

## Slimmed-down liability

For some time, a transfer-out deal was regarded as quite a good way of 'slimming down' the scheme's liabilities. However, as Clive Fortes, head of corporate consulting at Hymans Robertson, observes, companies are less enthusiastic about this option than they used to be. In part, this is because the yield on corporate bonds has been rising, reducing the value of the pension scheme liabilities. That has taken away some of the urgency for conducting transfer exercises.

A second point, Fortes says, is that in the past few years corporates have been able to offer enhanced transfer values, where the employee got more than they actually had in the pension scheme as an inducement to leave it. They could do this at less than the liability cost to the fund of keeping that member in the fund, as measured by IAS 19. Today, with rising bond yields, that is no longer possible.

Although companies have to proceed with care in this area, Fortes argues there are plenty of scenarios where a transfer can be a good decision for both parties. He cites the following example:

- A reasonable cost to a company of buying out a £10,000-a-year index-linked pension for some currently aged 45 would be around £200,000.
- If the member took that £200,000 and invested it in a way that generated a return 1% greater than government gilts, on retirement in 20 years they would *probably* end up with a higher pension than they would have had from the final salary scheme.



- If the company only offers 80p in the pound (ie, £160,000), then a return of 1% over gilts on that money would only match the original scheme benefit.

- If, however, the company offered just 50p in the pound (£100,000) – a level which is probably closer to what companies would actually offer – the member would need a hefty 3.5% a year more than gilts to match the final salary benefit.

"If the company can get rid of the liability at less than the full actuarial buyout cost an insurance company would demand, and the member can get a better pension from the transfer payment, then that is really a win-win for both sides. However, if the level of enhancement is more modest and is designed in a way to entice the employee to take the cash, then you need the member's IFA to be asleep at the wheel for the deal to go through," he says.

## Flexible benefits

There are other factors, though, for the employee and the IFA to consider over and above the sheer cash value of the transfer. First, Fortes points out that opting out of the scheme for a substantial payment gives the employee much more flexibility as to the timing of when they decide to retire, be it

early or late. Something else to think about is that if the company's future seems uncertain and its markets are potentially going against it, then crystallising the value of the pension and moving on makes excellent sense.

As a final point, the mathematics makes it much easier to make transfer options work for members in their early-40s than it does for older members. This is because younger scheme members have enough time before their statutory retirement date to replicate the benefits of the final salary scheme in their own private pensions vehicle. Very young members, however, such as those in their 20s, won't yet have built up enough value in the scheme to make a transfer worthwhile for them.

So, provided the company communicates the whole thing properly and has a decent quality of financial advice to hand for the employee to consult, then the company has a defensible position in law, says Fortes. This will give transfer values their proper place in the armoury when it comes to managing pension liabilities. ■

**Anthony Harrington**

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