The Funding Crisis
Will 2004 Bring Relief?

BY JILL KERBY

It would be wonderful to think that the 12.6% recovery in managed pension fund investment returns in 2003 – after the frightening losses for 2000, 2001 and 2002 – would be sufficient to ease the fears about funding standards that so many Irish pension managers are now experiencing.

Welcome as these positive end of year figures are, fund performance is only one part of a much wider problem that is plaguing pension trustees, fund managers and administrators all over the western world: low interest rates and longevity being the other causes for worry.

The Irish experience in 2003 reflects this growing concern. More and more companies with defined benefit schemes experienced funding difficulties, with varying levels of deficit and, under the new funding standard rules that were brought in a couple of years ago, unable to comply with the legislation's requirements.

These effectively required that trustees of defined benefit schemes are required to

Sympathetic to the difficulties that so many companies (around the world, not just in Ireland) were having in meeting this funding standard, there is now more leeway than before, time-wise, in meeting the standard.

certify, at three and a half year intervals that the assets in their scheme are sufficient at a specified date to meet the liabilities of the scheme if it was wound up at the date.

Sympathetic to the difficulties that so many companies (around the world, not just in Ireland) were having in meeting this funding standard, there is now more leeway than before, time-wise, in meeting the standard. In early December, after considerable lobbying from the IAPF and other interested parties for greater flexibility from the Pensions Board over meeting funding standards the IAPF's Chairman, Gerry Ryan welcomed the decision of the Pensions Board to introduce greater flexibility for pension schemes which found themselves in funding difficulties. The concern of the IAPF and others was that too short a catch-up period might force some companies to reduce benefits or even close down their DB schemes altogether. Having already indicated that its policy was to only consider extensions for periods up to ten years, by December the Board indicated it would now consider applications for longer extensions in exceptional circumstances. Any extensions would be confined to schemes whose funding difficulties related wholly or mainly to investment market falls.

"The problem with setting a short time frame for funding deficits in some pension schemes is that sponsoring employers may be fully committed to maintaining the pension benefits proposed for employees but unable to increase contributions to the levels necessitated by short term funding requirements," said Mr Ryan.

"Some pension schemes have been spared the need for a reduction in benefit entitlements which might have been required had the Pensions Board not shown this level of flexibility. It is clear from the guidelines issued by the Pensions Board that employers will still be required to fund their pension schemes prudently and that trustees will

APPLYING FOR THE FUNDING EXTENSION

Trustees who apply for a longer than specified extension (of three and half years) to their funding standard requirements under Section 49 (3) of Part IV of the Pensions Acts 1990-2003 will be considered on a case by case basis, says the Pensions Board.

The sort of information being sought by the Board from the trustees only (and not agents of the trustees) when considering the application is now available on its website www.pensionsboard.ie The guidelines note the following information to be included:

- Reasons as to why the later date is necessary or appropriate and not contrary to the interests of the members of the scheme. Trustees also have to confirm that the members will be made fully aware of funding position of the scheme on a discontinuance basis by category of beneficiary.

- The applications should be made within such reasonable timescale as to ensure that time limits for submission of actuarial funding certificates and proposals specified in the Acts can be met.

- The application must enclose a certifying statement by the actuary for the scheme that the failure of the scheme to satisfy the funding standard relates wholly or mainly to the performance of relevant markets in relation to investments made with the resources of the scheme and that the performance of those markets in relation to those investments is not inconsistent with the performance generally of relevant markets for investment in the same period. (A pro-forma certificate is also available from the Board.) It also requires detailed actuarial information and documentation (as laid out by the Board in its guidance note), plus a copy of the Actuarial Valuation Report relevant to the funding proposal being prepared plus a breakdown of the percentage of assets of the scheme invested in various sectors.

The Board's decision regarding the extension will take into account, says the Guidance note, the interests of the members of the scheme and the certification provided by the actuary. Its policy is to "only consider granting a later effective date no longer than ten years from that of the funding proposal," but it has the discretion to consider a longer period, though this would only happen "in exceptional circumstances and in no circumstances could the extended period be longer than the average working life of the active members."

The Board also makes clear that the proposed contribution rate would have to be the equivalent of the ongoing contribution rate plus the contribution rate "necessary to fund any deficiency in the scheme over the working life of its active members" and would have to be made spread evenly over the period.

The Funding Crisis

be obliged to keep members informed of solvency issues. It is also clear that extensions will only be granted where a strong case can be made that any such extension is necessary or appropriate and not contrary to the interests of members."

Alan Broxson
Irish Pensions Trust

The funding issue very much came to a head last October at the IAPF Trustee Forum in October in which Alan Broxson, Irish Pensions Trust, described the pension funding crisis as "a pensions hurricane" caused by a combination of occurrences which has left some beyond repair.

The minimum funding standard at the time – before it was liberalized a couple of months later by the Pensions Board - "has significantly increased the hole in any fund already paying pensions," he told the meeting. "The problem has been exacerbated by the fact that the regulator requires such shortfalls to be made up over a maximum of 10 years.

"The size of the problem is too big for many employers to fix over that timescale and they are being forced to cut back on the pension promise. It is ironic that legislation designed to protect members is being applied in such a way as to have the opposite effect," he added.

Allowing for exception extensions even longer than 10 years will provide "breathing space" for those companies who could need "14, 15 or even 20 years to get their funding deficit cleared

> *"It is wrong to focus on equity markets alone for this shortfall problem. Equally problematic has been the collapse of interest rates in recent years. This may be very good for someone with a mortgage, but the effect is devastating for capital markets that need to build up their surpluses to meet pension holder's requirements."*

up," he told *Irish Pensions* recently. "Just because a company has a hole in their pension doesn't of course mean that the company is in trouble. It just means it has a hole to fill. But to ask a company to double their pension contributions over three years is not realistic," he says, and this is what the Pensions Board, thankfully, has recognized.

Asked whether the equity markets recovery will also help fill the hole, Mr Broxson said he "doubted" it would have much impact at all for companies that were in serious deficit trouble; these were probably still likely to reduce benefits or close their DB schemes.

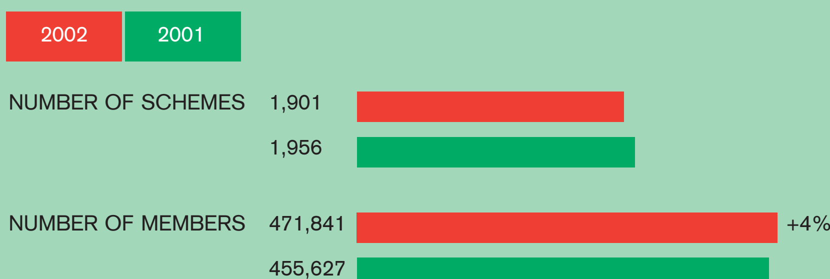
However, for those companies with more typical deficits – a category he suggests that at least half of all Irish companies with DB schemes are now in ("some of them very big firms") – the rise in investment markets, especially if it is sustained, "will be a help".

"It is wrong to focus on equity markets alone for this shortfall problem. Equally problematic has been the collapse of interest rates in recent years. This may be very good for someone with a mortgage, but the effect is devastating for capital markets that need to build up their surpluses to meet pension holder's requirements.

Two other problems are not going to go away just because markets are back up either, he said: our propensity to live longer and the contentious issue of benchmarking in public service companies "that could spill over into the private sector".

He also repeated the point he made at last autumn's seminar: that while public sector pension funds were exempt from the full requirements of the funding regulations, "their current financing arrangements are unsustainable. This is a problem that has to be addressed,

CURRENT DEFINED BENEFIT SCHEMES AND ACTIVE MEMBERS



The Funding Crisis

especially if it spills over to the private sector."

The growing fear is that the funding problems will drive more and more companies to abandon defined benefit cover for the less financially onerous defined contribution system. "It's happening already for many new entrants to companies," says Mr Broxson. "The Pension Board's statistics show the movement away from DB to DC coverage, but it doesn't break down how much of that movement is attributed to dual schemes – the DB scheme for existing workers and the DC one for new entrants." He thinks this kind of data needs identifiying.

As the Pension Board's figures for 2002 show, there is no evidence of any widespread closures of DB schemes (see table), but Alan thinks the 2003 figures "will be the ones to watch".

Back in October, David Jones of UK pension consultants Lane Clark & Peacock suggested that some sponsoring Irish employers may follow the trend evident in the UK towards the closure of their defined benefit pension schemes to new entrants.

"The last few years has seen an unprecedented shift in the UK occupational pensions landscape, with the majority of defined benefit pension schemes closing their doors to new entrants. Most schemes were closed to reduce pension costs and risks.

"But closure does not solve things overnight - rather it creates a different set of problems. Employers and trustees need to understand the new features of their closed schemes to help them manage the new risks they face."

Plenty of blame is being thrown around in the UK. Senior fund manager such as Alan Brown, the chief investment officer of State Street Global Advisors, and PwC pension partner John Shuttleworth both produced a litany of so-called "villains" who have caused such chaos in the industry there.

Trustees are being blamed by Mr Brown for their "herd mentality" when making investment decisions. "Investment issues are complex and not readily understood by the layman," he is quoted as saying last month. "So it is difficult to get trustees to do anything different from their peer group."

He then turned his fire on accountants and actuaries who, he said, are wrong footed in the way they determine the rate at which the liabilities of a pension plan may be discounted, which is dependent on the fund's asset mix.

"A high equity content means that a higher rate of return can be assumed, and therefore your liabilities go down. This can mean that mature funds in a deficit position may not have the option of raising their bond content, because the impact on the liability side would be too great. What sense does that make?"

Admittedly, Alan Brown didn't have anything positive to say about fund managers either, who he claims have become too specialised. "Most of the solutions for better best practice involve multi-asset class mandates. Furthermore, this has affected the way they are internally organised, and it means that there are few track records of relevance to consider. That will discourage some clients."

Like Alan Broxson's dismissal of the turn-around in equity markets making all the difference to the funding crisis, Mr Brown produced a take on Oscar Wilde's much quoted line that 'Marriage is the triumph of optimism over experience'. "The equivalent in our world may well be, 'Equities are the triumph of optimism over experience.' The substantial rally in equities may cause a collective sigh of relief, and a hope that we are back in business as usual. We think that would be a mistake."

So is there a solution staring us in the face, but perhaps too obvious to be considered workable? Alan Broxson thinks so, though it would not suit shareholder's interests.

"If the Pensions Act, and everyone else agrees that pension funds are, in effect, deferred income, then why are pension fund liabilities not treated as a first charge when a company is wound up? Why cannot pension funds be put in the same category as unpaid wages, which are treated as a first charge?"

Back in October, David Jones of UK pension consultants Lane Clark & Peacock suggested that some sponsoring Irish employers may follow the trend evident in the UK towards the closure of their defined benefit pension schemes to new entrants.

The Funding Crisis

Promises, Promises:
DB Pension Schemes in a Cynical Age

(This is an excerpt from an article by Shane Whelan, Department of Statistics UCD and Acuvest Investment Advisors, which appeared in the latest edition of Irish Banking Review, the quarterly journal of the Irish Bankers Federation.)

Irish pension funds have experienced considerable financial strains since the start of the millennium. Asset values have reflected the dramatic decline in equity markets globally while, at the same time, liabilities have increased. Underlying forces are operating to bring the current structure of occupational pension provision to a crisis, with recent events only bringing forward its timing. If everything else remains the same, defined benefit pension schemes in Ireland will not recover with a recovery in equity markets. One of the forces inimical to defined benefit pension funds, and the one that is perhaps most easily altered, is the current regulatory structure for such schemes.

As the size of pension assets has grown, so too has the regulation exercised by the State. A landmark in this regard was the Pensions Act 1990 which, inter alia, reduced considerably the flexibility that employers and scheme trustees could exercise in the benefits paid to leavers before retirement age and also reduced the flexibility of the funding arrangements allowed to meet the promised benefits.

Three consecutive years of unusually poor returns from equity markets has focused on the financial risks borne by employers in promising the target pension. In itself, the poor equity market returns are bearable. However, when coupled with resilient bond markets, increasing life expectancy from a lately recognised "cohort effect", and unusually rapid salary escalation in Ireland, the line up produces a gloomy picture. Finally, stricter regulation has lessened the flexibility that pension schemes could previously have exercised to cope with the financial strains. It seems that we have reached a watershed for the defined benefit pension fund in Ireland.

The Funding Crisis

Irish capital markets in the past have not provided Irish pension funds with assets to match the nature and term of pension fund liabilities. While no category of asset matches the requirements of the investor seeking to provide wage-linked benefits over future decades, some asset types come closer than others. In particular, two key risks can be identified – reinvestment risk and inflation risk.

Reinvestment risk is where some of the future proceeds from investments currently made will have to be invested again in the future as such proceeds are not wanted until later. The terms on which this reinvestment can be made depend on future investment conditions, which are unknown. Hence the ultimate payoff depends on future unknown investment conditions. For instance, cash is an asset that leaves the investor most exposed to reinvestment risk. At the end of the short investment period of cash instruments, all the proceeds must be invested again at an unknown rate. Bonds are next in the order of exposure to reinvestment risk because of their higher running yield and generally shorter maturity, followed by property and equities.

Another significant risk for pension funds is unanticipated inflation. Trustees of pension funds ideally seek an investment that can generate a positive real return, irrespective of the actual inflation level. Long-term bonds are clearly most exposed as they give a nominal level income, irrespective of how inflation changes in the future. Next, in order of exposure to the risk of unanticipated inflation, are equities. The very short-term nature of cash investments means that the interest rate on cash can respond quickly and with little capital loss to a changing inflationary environment.

Arguments such as those above have been used to justify the current high equity content of pension funds. In particular the risk of future inflation is material as it threatens to undermine the original rationale for pension schemes - to provide a decent standard of living to the retired. However, perhaps the primary reason that equities are favoured is their historically better performance over long periods in the past.

THE REGULATORY FRAMEWORK

The Irish State has sought to influence the evolution of the asset allocation of Irish pension funds over the last couple of decades, attempting to increase their exposure to Irish assets. However, regulations recently introduced for Irish pension funds, that are designed to provide greater security for beneficiaries, could indirectly have a significant impact on their future asset distribution.

First, the Pensions Act 1990 required that the early leaver be given a "preserved benefit" (defined in Part A of the Second Schedule to the Act) and that that part of the preserved benefit that could be deemed to have accrued after the year 1990 was to be revalued each year by the lesser of inflation or 4% (Section 33(5)) until the sooner of death or normal retirement age. The general effect of this provision was to increase the benefits payable from a scheme when a member left early, the amount varying from scheme to scheme but often the increase was equal to the total increase entailed by the revaluation.

Secondly, the Act introduced the requirement for Irish pension schemes to have an actuary (the "Scheme Actuary") undertake a periodic review to ensure that the assets of the scheme taken at market value exceed the liabilities on termination (as defined in the Act). If a shortfall were to be revealed, it must be disclosed to interested parties and a short-term funding plan agreed with the newly-established regulator, the Pensions Board, to make good the deficit.

In addition to the above provisions under the Pensions Acts, taxation acts and regulations also apply and, in particular, demand that action be taken to reduce the amount of surplus that can be maintained within a pension fund once it exceeds a certain level. Thus, Irish pension funds are faced with an unprecedented level of regulation, which poses an investment dilemma.

The decline in equity markets and the impact that it has had on occupational pension schemes in Ireland and elsewhere has been the subject of much public comment.

The fall in equity markets, when coupled with stable or strengthening bond markets has ensured that the fall in the value of the assets of pension schemes has not been matched by a fall in the value of liabilities on market-based valuation methodologies.

However, aside from the poor return on pension assets relative to the growth of the liabilities, there have been other developments detrimental to the finances of defined benefit pension schemes over the last three years. One less publicised factor has been the increasing realisation that mortality rates are improving faster than previously projected at the older ages, leading to increased reserves and funding for pensions to reflect the expected longer term of payment. A second factor, perhaps more material, is that there has been a significant change to the regulation of pension funds in Ireland with, as outlined earlier, the Pensions (Amendment) Act 2002 increasing the liabilities of Irish pension funds. Recent estimates put the proportion of Irish defined benefit pension funds failing this regulatory standard at 50%.

Finally, the whole investment backdrop for defined benefits schemes changed when the Irish pound became a founding member of the euro from 1999. From that time, Irish investors have access to the considerably deeper and more liquid euro markets to match Irish liabilities. This extended market of assets denominated in the domestic currency has allowed Irish pension funds to find an asset portfolio that matches their liabilities reasonably closely.

We have reached a watershed in the provision of occupational pensions in Ireland.

Recent changes to the regulation of occupational pension funds in Ireland have demanded that DB plans must demonstrate that the assets of the [regulated] scheme are sufficient at all times to meet the termination liabilities of the scheme. These regulations emphasise short-term mismatch risks and encourage a move to assets that most closely match the termination liabilities. This entails a move of Irish pension assets away from equities towards bonds.

The move towards bonds can be expected to increase the long-term costs of operating defined benefit plans as, if history is a guide, bonds lag the performance of equities in the long term. The consequence is that regulation designed to protect pension members has actually increased the long-term costs of running these schemes, by an unquantifiable but material amount. As the decision to establish such schemes, or to keep them open to new employees, or even to continue their operation is essentially a matter for the sponsoring employer, we can expect the increased cost burden (and its lack of transparency) to discourage new defined benefit schemes, close existing ones to new employees and, perhaps, even lead to the wind-up and conversion of existing schemes to the defined contribution type.

The underlying reason for the regulation of occupational pension schemes is protection of the members and other beneficiaries. Regulation is not attempting to ascertain whether the sponsoring employer is making reasonable and fair provision for the promise but demanding that the employer underwrites the risk that the trust's assets track the changing price the market puts on the future benefits. Perhaps, the level of guarantee now demanded is so high, and is such a financial burden on the employer, that it is unrealistic to expect companies to provide for defined pension benefits in the future.

Shane Whelan is with the Department of Statistics, UCD

The Funding Crisis