PENSIONS IN 2004: CHALLENGING THE STATUS QUO

BY AISLING KENNEDY

The environment for pension provision has become particularly challenging in recent times, both in Ireland and internationally. A Society of Actuaries' seminar on 25 March considered some of the key issues for Irish pension schemes.

WHERE NOW FOR THE DEFINED BENEFIT MODEL?

According to Eamonn Heffernan, a past President of the Society, defined benefit pensions are likely to remain the preferred choice of the majority of employees.

In the traditional defined benefit scheme, all of the risk – in relation to investment returns, salary inflation and longevity - is borne by the employer, while in defined contribution schemes, all of the risk is transferred to the individual employee. Eamonn emphasised that risk cannot be removed from the equation but suggested that alternative benefit structures need to be considered for the future, with a view to sharing the risk between the employer and employee. Some possible options include:

- Defined contribution up to a certain age, with a defined benefit thereafter.
- A lower level of defined benefit (for example, 1/100th salary per year of service, instead of the traditional 1/60th) together with a defined contribution top-up - or a "target benefit" based on 60ths with a guarantee of 100ths.
- Defined benefits based on average earnings over the course of an employee's career (revalued in line with price inflation), instead of the traditional "final salary" formula.

Eamonn also discussed the funding of defined benefit schemes and the impact of the statutory funding standard (which is currently under review by the Pensions Board). The current standard is based on the liabilities that a scheme would have if it wound up. However, if schemes have to be fully funded on a wind-up basis at all times, they may have to invest in less volatile assets, resulting in lower investment returns in the long-term, with implications for the affordability of benefits.

The alternative is to adopt a "going concern" approach, where contribution rates are based on a scheme's long-term benefit commitments, with the funding level being allowed to vary as a result of short-term investment volatility. This would mean that schemes could continue to invest in equities, with a view to achieving higher long-term investment returns to help meet the cost of benefits. However, this approach would mean that if a scheme did actually wind up it could potentially have insufficient assets to meet its obligations; some mechanism would be needed to deal with such situations and Eamonn outlined a number of options that could be considered.

INVESTMENT STRATEGY FOR DEFINED BENEFIT SCHEMES

The seminar also included a lively debate on the appropriate investment strategy for defined benefit schemes. Steve Cooper, a Managing Director at UBS Investment Bank in London, told the audience that defined benefit schemes should invest in bonds. He argued that:

- The value of equity investment is less than often thought when allowance is made for higher risk as well as higher return.
- A pension scheme should be seen as, effectively, assets and liabilities of the sponsoring company; therefore, equity investment on the part of the pension scheme merely leverages the position of the company's shareholders.

However, Tim Gardener, Mercer Investment Consulting's Global Practice Leader, made the case for pension schemes continuing to invest in equities. He noted that investors who can tolerate short-term volatility will benefit from the higher expected returns from equity investment over the long term. In his view, long-term investors can reduce the cost of pension provision by investing in equities.

INVESTMENT STRATEGY FOR MEMBERS OF DEFINED CONTRIBUTION SCHEMES

Brendan Kennedy, Chairman of the Society's PRSA Committee, noted that over half a million members of defined contribution (DC) schemes and personal pensions have to make their own investment choices, with most not being equipped to make informed choices. Most defined contribution scheme members also have a very high exposure to equities and may not realise the risks involved, while many have a relatively low capacity for investment risk. In his view, defined contribution schemes should be required to have a "default investment strategy" (similar to that required for PRSAs) for those members unwilling or unable to make their own investment choice.

The speakers' presentations are available on the Society's website: www.actuaries.ie