

Flexible Response Needed to the Pensions Crisis

By John Feely

It seems that we are turning a corner, slowly but surely. 'Green shoots' have begun to emerge and the prospect of entering an economic ice-age seems to have passed.

The changes we can expect over the next few years will affect the nature of pension provision in Ireland – employers looking to eliminate pension risk from their businesses and to reduce (or at least contain) future costs; the Government looking to change tax rules to claw-back reliefs and reduce the perceived cost of tax incentives; pension savers reducing contributions to pension schemes because of concern over their ability to deliver decent investment returns; and The Pensions Board encouraging trustees and employers to focus increasingly on minimising risk.

One of the main problems seems to be that the system is too rigid to deal with current financial conditions.

Employers with defined benefit schemes are facing 'mark to market' pressure from two main sources:

- Accounting rules based on current valuations of assets and liabilities introduce a high degree of volatility in the financial results of companies.
- Minimum funding standard rules and requirements for funding proposals require increased short term funding at a time when companies are already strapped for cash.

Both of these measures are somewhat artificial, based as they are on assumed valuations of liabilities, and asset values determined at a particular point in time. Nevertheless they are important drivers of long term financial decisions now being taken by companies.

During the late 1990's the strong financial position of defined benefit (DB) pension schemes encouraged many employers to use surpluses to increase benefits and allow early retirements on enhanced terms. By contrast, the currently weak financial position of DB schemes is encouraging employers to cut future service benefits, and even to consider cutting accrued benefits or winding up altogether.

Arguably in most situations, such reactions to surplus or deficit are both flawed. There is a real need to step back from the brink if we are to avoid making inappropriate long term decisions in response to current market conditions.

Solutions Needed

More sophisticated solutions are needed for employers, rather than the blunt instruments being contemplated in some cases. Hybrid arrangements, though complicated, are designed to achieve a balance between benefits and cost. The payment of a portion of benefit entitlements on a discretionary basis directly links benefits with available funds. A change such as increasing retirement age, while still an effective reduction in benefit entitlement, reflects the reality that pension benefits are expected to be paid for longer.

Regulators across the world are responding to the current crisis by encouraging more prudent management of financial institutions, including pension schemes. Fine in theory, but this approach potentially consigns pensions to long term under-performance compared to what could be achieved in a more risk tolerant framework. Adopting too prudent an approach is likely to lead to higher costs, lower benefits and even more dissatisfaction with the ability of pension schemes to deliver over the long term.

More flexibility needs to be introduced in the area of regulation also. Dynamic, risk-adjusted regulatory solvency measures are required – for example, holding higher reserves when investment markets have performed well or using some form of smoothed asset values, to provide a cushion against a fall; or having minimum benefits heavily protected with less protection for benefits above minimum levels. Scope must be retained within the regulatory system to allow a reasonable level of risk in pursuit of the optimum outcome.

In relation to the Government, it seems completely counter-productive to reduce tax incentives – this is certainly so in the

long run if we are to avoid a crippling burden on the social welfare system and future taxpayers. If the State needs money now, why not issue 'index linked bonds' and 'annuity bonds' to pension schemes? There is a real opportunity for a 'win-win' here for Ireland. Depending on how this is done there could be a significant benefit for pension schemes in being able to match liabilities more effectively, while providing much needed funds to the State.

A Harder Sell

Encouraging pension savers back into pension schemes or to make additional voluntary contributions is a harder sell than it has been. Pension providers have much work to do. Fundamentally this will mean a more sophisticated approach to managing investment risk and return to ensure that reasonable returns are achieved and acceptable risk tolerance levels are not breached.

What this all adds up to is the need for greater sophistication as we move on from here. Trustee boards will need to boost their levels of expertise and experience, more creativity will be needed from the providers of services to pension schemes to come up with solutions that meet the needs of clients.

Government has the ultimate challenge of building a sustainable long term pension system.

We need to get back to thinking about our collective long term futures. It is time for the Government to issue the long overdue White Paper on pensions. ©

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