The security behind the benefit promise.

Is it worth the paper it's written on?

Anthony P Cunningham, MA FIA

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Abstract

The Pensions Actuary makes his living out of providing guidance as to what the cost or value of the provision of a pension benefit might be. This suggests that there is some doubt about the real value of the benefit. Where does this doubt come from, who or what causes it and what can be done about it?

This paper looks at the nature of benefit promise security in a number of countries, considers why the UK has such a different approach, and asks what, if any, the correct or optimum solution might be.

Contact Address

Anthony P Cunningham, Lane Clark & Peacock, St Paul's House, St Paul's Hill, Winchester, Hampshire SO22 5AB, UK; Tel: +44 (0)1962 870060; Fax: +44 (0)1962 849802; e-mail: tony.cunningham@lcp-actuaries.co.uk.


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The security behind the benefit promise. Is it worth the paper it's written on?

The pensions actuary makes his living out of providing guidance as to what the cost or value of the provision of a pension benefit might be. This suggests that there is some doubt about the real value of the benefit. Where does this doubt come from, who or what causes it and what can be done about it?

1. The benefit

For the purpose of this discussion, let us assume we are dealing with a typical final pay related defined benefit pension plan, providing a pension of “final covered pay x service x accrual rate”.

At any point in time, the member knows exactly what his/her benefit is. They are not concerned about what might happen in the future. However the actuary is grappling with predictions of future pay levels, when the member may withdraw from service, what might inflation be, might the member be terminated, or even die. All these concerns can serve to cloud the actuary’s sight of what the benefit actually is.

In the UK, this complexity has been taken one stage further. In considering the question “what is the benefit?”, the UK has, uniquely in my experience, brought into the equation the issue of how a company is likely to choose to fund that benefit and how it is likely to invest those funds. This different perspective on the nature of the benefit is, in my view, behind some of the unique legislative features that can be found backing a UK defined benefit promise, as well as explaining why UK companies are often surprised at the structure found in other countries.

2. The UK perspective

In the UK, final pay defined benefit plan trusts have, for many years, held a very significant proportion of their funds in equities. Even where there was a significant current pensioner liability, it was not uncommon to see 90% of a fund invested in equities. This is because, for many years, UK pension fund sponsors and the trustees carrying the fiduciary responsibility of looking after the member’s interests, have been convinced that over the longer term equities will outperform any other asset class. Throughout my working life this expectation has been fully met by experience. This has led management, trustees and actuaries to value defined benefit plans by implicitly capitalising an element of the equity risk premium in advance, thereby attributing a lower value to the accrued benefit from time to time than would be borne out if one tried to secure that benefit with an insurance company.

This concept has manifested itself in two areas in the operation of UK plans, both of which are currently under review. They are the UK accounting standard (SSAP24) and the UK minimum funding requirement (MFR). It is the latter that I wish to focus on here, but both currently allow for the capitalisation of the future expected equity risk premium.

3. The Minimum Funding Requirement.

What’s in a name? In this case quite a lot. For those not familiar with UK legislative development, let me give you a little history.
Prior to 1978, if a company promised a pension to an employee, there was no statutory obligation to pre-finance that benefit. The company could, if it wished, fund it on a pay as you go basis. This changed marginally in 1978, when the government introduced an earnings related state benefit, which a company could opt out of if they provided an adequate level of replacement benefit promise. However, to qualify to opt out, they had to fund, at a level decided by the actuary to be adequate, at least the benefit that the member would have otherwise got from the state plan.

This carried on until Robert Maxwell decided he was going to be more adventurous than most pension funds with his investment strategy, and lost a significant part of the assets. This event stimulated a wide ranging review of the provision of pension benefits, culminating in, amongst many other things, a proposal designed to protect the security of the members’ benefits.

The proposal was for a minimum solvency requirement. However, this sparked off a heated discussion about what exactly was meant by solvency and what, in reality, was the nature of the benefit promise. The final legislation seemed to accept the concept that a defined benefit promise was only really a defined benefit promise for so long as the employer wanted it to be. Until the member retired, the promise was considered to be no more than: “we will fund at a rate that we think will be enough, on a 50:50 basis, allowing for the equity risk premium, to secure your pension benefit when you reach retirement, unless we are a large pension fund, in which case we will continue to allow for some of the equity risk premium in retirement, as we can pass the investment risk down the generations”. Consequently, the name was changed to Minimum Funding Requirement.

As I am sure you have guessed, this was designed 100% by actuaries. However, it is also true to say that it probably was a fair reflection of the perspective of many sponsoring employers. In reality, this capitalisation of the future equity risk premium may work against the employer, as it may be understating the true risk adjusted future cost of provision (a concept being highlighted by the debate currently surrounding a new accounting standard). However, it has been the basis underpinning most UK pension provision. It is even enshrined in the maximum tax deductible funding level (which is calculated on a basis specified by the government actuary).

So, the employer knows what’s happening, the government knows what’s happening, the actuary knows what’s happening, but nobody told the member.

4. Is a UK pension promise secure?

It depends on what you mean by the promise and what you mean by secure. The promise that if equities continue to outperform bonds and give a higher real return than indexed linked bonds, then you will have enough to buy your pension, is probably true. However, if your employer decided to wind up the plan and pay out the bare minimum under legislation, this would typically only secure a fraction of the accrued benefit promise as a deferred annuity. The main problem in the UK is that the most significant group that are probably unaware of the true level of security is the members.
5. How does this compare with other countries?

It is interesting to observe how other countries have tackled the security of pensions issue. To give a cross section of solutions, I have considered the US, Germany and the Netherlands. Hopefully others will share their country’s solutions with us at the conference, and those from the countries mentioned below will hopefully comment on how effective they have been and how well they are understood by the potential beneficiaries.

5.1. United States

The US got off to a relatively early start in terms of extensive protective legislation through the introduction of ERISA (Employee Retirement Income Security Act) in 1974. As was the case in many countries, the US had the problems of inadequate pension funding highlighted by a well-publicised event, which in their case was, I understand, when Studebaker went bankrupt. This was one of the catalysts for ERISA and the other member protections introduced.

The US addressed the issue of benefit security in a dual way. Firstly, they established a minimum pace of funding, which involved funding towards the value of accrued benefits using a generally conservative long-term investment assumption. Secondly, they established a central body, to which all plan sponsors must contribute (if they wanted the tax breaks), known as the PBGC (Pension Benefit Guarantee Corporation). Did this work, and were members’ accrued rights secure?

The US minimum funding requirement was generally a higher target than the UK minimum funding requirement, but the amortisation of deficits meant that at any point in time, the fund assets could be quite some way below the minimum target, although the rules for determining the Deficit Reduction Contribution have been changed such that the bigger the deficit, the faster the payoff of the unfunded liability. When a plan was wound up, the first call would be on the net worth of the plan sponsor. If that was not enough then the PBGC stepped in and secured the accrued vested benefit of the member, financing the rescue by collecting contributions from all those employers who hadn’t become insolvent. From the members’ perspective, their accrued benefit was secure, but from the employers’ perspective, the prudent employers with well funded plans were bailing out the profligate. This is clearly not equitable, and hardly encouraged well funded plans. This was partly addressed by introducing solvency related PBGC premiums, but the structure still seems to me to be encouraging minimum funding. The current PBGC premium is $19 per participant plus 0.6% of the unfunded Accrued Benefit Obligation, calculated based on approximately 85% of the 30-year Treasury bond rate.

To me, the system seems to work for the member, but maybe at too big a cost to the prudent employer.
5.2. Germany

In Germany it is necessary to recognise that the State is a major provider of pensions, in addition to anything provided by the employer, as Germany has a comprehensive social security system providing a far higher level of state pension than is available in the UK, the US or the Netherlands. Consequently, the security of company pension benefits may possibly be less significant in Germany.

Perhaps reflecting this, Germany has adopted a very different approach to benefit security for occupational pensions than that found in the UK and the US. Typically, the benefit is not funded at all, but simply falls to be met on a pay as you go basis out of the emerging cash flow from the business.

German companies recognised in their corporate balance sheets that they had a liability associated with pensions, but the driving force behind this was to take advantage of available tax breaks, rather than any thoughts of member security. (This is borne out by the fact that most German companies recognised a liability on their balance sheet which was determined according to a basis and method laid down by the tax authorities as the maximum tax deductible amount, irrespective of whether or not this represented a realistic assessment of the liability). Clearly this represented very low member security, as the backing of the benefits was inextricably linked to the continuing fortunes of their employer.

However, in return for the tax breaks, the government encouraged employers to consider ways of providing member security as long ago as 1968. In 1974, coincidentally the same year as ERISA was introduced in the US, the German authorities introduced a centralised system not unlike the PBGC in the US. The German organisation, known as the PSV (Pensions Sicherungs Verein) works on the basis of collecting a percentage of all companies' tax deductible book reserves, with the percentage depending on how many organisations have become insolvent and have left unsecured vested benefit promises behind. (The significance of the word vested should not however be overlooked, as benefits typically cliff vest after ten years!). So, does this work?

From the members' perspective, their security is very low prior to vesting. Thereafter, their accrued pension is protected. The key thing however, is that most Germans understand what the security of their benefits are, so at least they are under no illusions (not something I think could be honestly said about the UK). From the employers' perspective, it again has the inequity of the successful bailing out the unsuccessful, but the cost has not, to date, generally been that high (0.12% of book reserves in 1998), although it did go up to 0.69% in 1982 following AEG's insolvency. At least Germany got their system in before their first major corporate collapse. What would happen if Germany suffered a major recession with widespread business closures remains to be seen, and must represent the biggest inadequacy of the German system, in that it could break down at the very time it was needed the most.
5.3. The Netherlands

The approach in the Netherlands has recently come under review, with proposals for a more sophisticated structure to ensure the security of members' benefits. In the past the Netherlands has adopted a different approach to benefit security than that found in the UK, the US or Germany, but it is one that is found in a number of other countries. Essentially, the Netherlands treats a pension fund rather like a small insurance company. As such it must hold assets that are secure (i.e. bonds), equal in value to the value of the liabilities determined on a discount rate which is conservative (4%) and has typically been well below the yield achievable on bonds.

Unlike in the UK, where the future higher return on equities is reflected in the liability value, the Netherlands goes in the other direction and says that if you hold equities, you must also hold an investment reserve to recognise the mismatch against the guaranteed liability. Has it worked?

Generally speaking, the system has delivered member security with no cross subsidy between the successful and unsuccessful. Most, if not all, arrangements would be able to secure members' accrued benefits with deferred annuities.

I look forward to hearing from our colleagues in the Netherlands as to the reasons behind their need to change and if there were any particular catalysts for their new, more sophisticated structure.

6. Why is the UK so different?

One big difference between the UK and the other countries is the requirement in the UK that accrued benefits are broadly index linked in both deferment and payment. This has a massive gearing effect on the value of accrued rights if secured using appropriate securities (index linked bonds in the case of the UK). It is this feature which so distorts the UK picture. Yes, the benefits are maybe only 50% or 60% secured if the employer should withdraw his support and funding was at the minimum level, but the value of the benefit being actually secured is typically more than 100% of the equivalent benefit in any of the above countries, because of the effect of statutory indexation. The UK probably allowed itself to grant such expensive benefits because it was pricing them using the equity risk premium to reduce the costs. Again, however, the problem is that nobody explained this to the members.

7. Which is best?

This depends on your perspective. In terms of member understanding and confidence, the US and the Netherlands probably have it. However, in terms of true benefit value, their UK counterpart is probably better off. I would rather have a UK style benefit and UK security, but that is with my actuarial understanding included. As a member communication challenge, the UK is in a league of its own.
The big question is whether or not there are other better solutions, either already in use or being formulated in people's minds. The UK has considered the idea of a central fund into which pension fund assets are transferred on wind up. Once again, this is the actuaries in search of their holy grail, namely the value of the equity risk premium. But the issue as yet to be resolved is who would pay if it turned out to be a myth.

I look forward to the ideas and observations of others as to the appropriate level and method for the delivery of the security of members' benefits.