

CSFI

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The future of company pension schemes: A round-table with David Ellis (Mercer), Mark Wood (Paternoster) and Stephen Delo (Pensions Management Institute) held on Tuesday, May 20, 2008, at Innholders' Hall, 30 College Street, London EC4R 2RH from 12:30-2:15pm.

Any doubt about the current state of company defined benefit (DB) pensions schemes was laid to rest by a stark statistic. The market for buy-outs of such schemes in the UK is the fastest growing segment within the long-term life sector...in the whole world. The first speaker said that 2007 saw £3bn worth of deals under which assets and liabilities of closed schemes transferred to financial institutions. The first quarter of this year had seen £2.5bn with £10-£12bn seen as a cautious forecast. Even three years ago it was a relatively dormant market with the Pru and L&G sharing a market mainly made up of small company schemes in distress. Now there are 12 competitors, made up of existing insurers and new entrants often backed by private equity. This has forced down prices for companies looking to shed their pension risk. That in turn has created more demand among employers to go down this route. The second speaker confirmed this, saying that costs had fallen 10% in the first three months of the year alone. This has led to 15 requests to his company for an estimated price covering £9bn of liabilities in the last few days. Some 10 FTSE-100 companies were looking at the possibility.

However buy-outs represent less than 0.5% of the £1 trillion of current DB pension's assets. The DB scheme is not dead: there would always be firms that continue to run their own pension scheme. Those most likely to go down the buy-out route tended to have a scheme larger than the company itself; be mature; and closed to new members. There is £400bn worth of assets under such schemes and they are fuelling the acceleration towards buy-outs. Why do employers want to do it? Effectively the company is swapping a longevity risk for a counterparty risk. From an investor's point of view longevity risk is uncorrelated with asset prices. That raises an issue of what would happen if a buy-out company went bust. The answer seemed a little vague – pensioners would be paid by the as-yet unfunded Financial Services Compensation Scheme. However if that were to fail to meet the full liabilities pensioners expected, the employer might come under reputational pressure to meet the shortfall. So perhaps the risk never goes away 100%.

What has changed this market so drastically? The second speaker focused on three factors. The Pensions Act 2004 that put in place regulation for companies altering their pension schemes; accountancy standards removing ambiguities over rates of return and liabilities; and a realisation that mortality rates were lower than had been priced in by actuaries. He highlighted four recent cases: EMAP, a buyout as part of a company break-up; LASMO, where the price was set by electronic auction; P&O, which was a buy-in after a three-way auction; and Lonmin, a financially robust company that broke the pattern for the three pre-conditions for a buy-out that the first speaker had outlined. P&O had dominated

the figures for last year, which, as one member put it, made the market very lumpy and hard to analyse. One troubling issue was the rise in buy-outs by unregulated companies. The second speaker warned that aggressive selling patterns might be a new mis-selling scandal waiting to happen.

The third speaker challenged this backward-looking obsession with closed schemes. Perhaps there was a future for DB schemes. He took the round-table through a history of the –isms and –ations of the DB scheme. Beginning with voluntarism and paternalism of the mid-century employers that set up pension schemes, it moved to commercialisation as finance companies structured the final salary idea. Then came protectionism as regulators ensured workers kept these benefits for life followed by moves to guard against inflationisation and then more competition as the 1980s government removed the obligation to join a scheme. Commercialisation Pt II came along in the form of mis-selling of direct contribution (DC) schemes to DB pensioners; crime prevention post-Maxwell; opportunism in the form of the Gordon Brown's pensions levy; heavy regulation; diversification and innovation; and finally termination for DB schemes!

If there is a future for DB, it might be in the form of a return to the past as problems with DC schemes start to emerge. They schemes might seem "easy" as they remove the worry over longevity. But if they fail to deliver for pensioners there could be outbreaks of litigation while the admin, legal and practical issues may weigh down on employers. One member said the taxation regime of the mid-20th century favoured final salary schemes and there was no reason why the tax system could not be altered – especially if the Government wanted to support DB schemes. Another member said a way of squaring the circle might be for employers to buy a deferred-start annuity for employees once a year that would mature on their retirement. The second speaker said this was hard to price efficiently.

Wrapping up, the second speaker said the peak in the buy-out market had not yet been seen. Companies would come under pressure to hive off the risk both for stock market analysts who struggled to price them, and private equity companies who increasingly shunned companies with open DB schemes. The DB scheme was not dead but needs some intervention to resuscitate it.