

Current Funding Issues for Defined Benefit Pension Schemes

Introduction

1. According to the latest figures published by the Pensions Board, approximately 232,000 employees, or 33% of the total membership of occupational pension schemes, are included in funded defined benefit pension schemes.
2. A defined benefit pension scheme provides a pension that is defined, typically, by reference to the salary and service of the employee. The employee's contribution, if any, is also typically defined as a percentage of salary and the employer undertakes to meet the balance of the cost of the promised pension. In other words, the benefits are underwritten by the employer and, other than for certain public service employees, are funded through the pension scheme on a long term basis.
3. This briefing note considers the funding issues that are currently facing defined benefit pension schemes. There are also challenging accounting issues for defined benefit schemes, but these are beyond the scope of this note.

Background

4. Traditionally, defined benefit pension schemes in Ireland have invested a substantial proportion of their assets in equities, with a view to delivering the investment returns needed to enable the employer to fund the benefits at an affordable cost. Over the long term, this strategy has met its objective, as is illustrated by Table 1 in the Appendix to this note.
5. However, the extra return from equity investment comes at a price – the price being far greater risk and, in particular, volatility of returns. This is illustrated in Tables 2 and 3, which show the volatility of returns from equities and bonds over the past 30 years.

6. This investment volatility increases the likelihood that, from time to time, the value of the funds' assets will fall short of its liabilities. While there is no asset which is a perfect match for the liabilities of a defined benefit pension scheme, the volatility of the funding level can be reduced by investing to a greater extent in other asset classes, including bonds. However, Table 1 shows that investing in bonds is likely to result in lower investment returns over the long term with, as a consequence, a higher cost to the employer of funding the promised pension benefits.

Many schemes currently in deficit

7. Over the past year, concern has grown about the funding position of defined benefit pension schemes. It has become apparent that a significant proportion of schemes would be in deficit if they were to wind up i.e. the assets would not be sufficient to meet the full cost of members' benefit entitlements on wind up. How has this occurred?
8. The answer is twofold. On the one hand, the liabilities of defined benefit pension schemes have increased significantly, for a number of reasons which are outlined below. On the other hand, the value of the assets held by pension schemes has been affected by falls in equity markets in recent years.

Increases in liabilities

- If a scheme winds up, the cost of buying out its liabilities is linked to prevailing yields on long term bonds; as these yields have fallen in recent years, buy out costs have risen significantly.
- Life expectancy for current and future generations of pensioners has been increasing, so that pensions have to be paid over a longer period. In the event of a scheme winding up, this is reflected in the cost of purchasing annuities from an insurance company.
- Changes in legislation over the past fifteen years have incrementally increased the liabilities of defined benefit schemes, particularly in relation to early leavers.

- The level of salary increases in recent years will also have contributed to the increase in liabilities.

Impact of investment returns

9. Over the past ten years, the average investment returns achieved by most pension schemes were satisfactory, as can be seen in Table 1. However, this ten year period had two very different parts. Over the first seven years, average investment returns were approximately 20% per annum, whilst over the past three years, fund values fell by more than 20% in total.
10. During the late 1980s and the 1990s when investment returns were high, most schemes built up substantial investment surpluses. These surpluses were generally used in one or both of the following ways:
 - to reduce the employer's contribution rate, or, in a minority of cases, to facilitate a "contribution holiday"
 - to provide enhanced benefits to members generally or to augment benefits for members retiring or leaving service.
11. When fund values subsequently suffered substantial falls, the surpluses built up in prior years had already been utilised and were not available to cushion schemes against the adverse experience of a three year bear market.
12. A contributory factor in this is that tax regulations limit the amount of surplus that can be held within a pension scheme, requiring measures to be taken to reduce surplus during periods of high investment returns.

Impact of the statutory funding standard

13. The falls in asset values over the past three years are not unique. Similar falls have occurred in the past, for example in the early 1970s. These had relatively little impact on pension funds, as markets subsequently recovered and so long term funding was unaffected. A short term deficit was only relevant if a scheme had to wind up and the employer was unwilling or unable to make good the deficit.

14. Since 1990, however, the statutory funding standard requires schemes to demonstrate on a regular basis that their assets are at least as great as the liabilities that would occur in the event of the scheme winding up. In the current environment, many defined benefit schemes will not be able to satisfy the funding standard. As a consequence the trustees will be required to submit a funding proposal to the Pensions Board outlining a course of action which will enable the scheme to satisfy the standard before the due date of the next Actuarial Funding Certificate i.e. three and a half years later. The Pensions Board has indicated that it will consider applications from trustees for an extension of this period generally up to a maximum of ten years.

The future

Higher contributions required

15. It is now generally considered unlikely that the favourable investment conditions of the 1990s will re-emerge in the foreseeable future. Therefore, it is likely that most schemes will require higher contribution rates over a sustained period in the future to fund the underlying benefits. The level of increase will be higher for those schemes that are currently in deficit. Some employers may not be able to afford the increase in contributions and may seek to share the burden with members; alternatively, they may seek to reduce benefit levels or even reconsider the continued operation of the scheme.

Switching to defined contributions is not necessarily the answer

16. Employers faced with funding difficulties may consider closing defined benefit pension schemes to new employees and replacing them with defined contribution schemes where the employer contribution rate is fixed and is not dependent on investment performance. However, it will be many years before the decision to close a defined benefit scheme will have any material impact on the financial risk being borne by the employer.
17. It is also important to note that, whilst both defined benefit and defined contribution schemes have advantages and disadvantages, ultimately the cost of pension provision is not any lower on a defined contribution basis than on a

defined benefit basis. The Society's briefing statement of February 2003 outlined our concerns about the adequacy of current levels of contributions to defined contribution pension arrangements.

Reassessing investment strategy

18. Most defined benefit pension schemes have tended to pursue a broadly similar investment policy that is substantially biased towards equities. However, the last three years have reminded everyone that the prospective equity premium is a reward for the risk borne by equity investors. For the future, trustees and employers need to consider the particular circumstances of their scheme and their capacity to tolerate risk, in particular the exposure to equities. In deciding on an asset allocation strategy to suit a particular scheme, issues such as the following need to be taken into account:
 - the nature of the pension liabilities
 - the available asset classes, the level of risk implied by different investment strategies and the potential to reduce risk through asset diversification
 - the maturity of the fund (i.e. the percentage of its liabilities that relates to pensioners)
 - the size of the scheme relative to the size of the sponsoring employer
 - the strength of the employer covenant (i.e. the employer's ability and commitment to sustaining the scheme in the longer term) and
 - the current level of funding relative to the statutory funding standard
 - the cost implications of alternative strategies and the timing of change.
19. The Society currently has a working party examining the issue of investment risk for defined benefit pension schemes. It is considering the question of appropriate investment strategies for defined benefit schemes, having regard to the liability profile and other factors such as those outlined above, and its report will be of interest to trustees and sponsoring employers.
20. It should also be noted that, in order to cope with investment volatility, defined benefit pension schemes need to be able to maintain significant levels of

investment surplus during bull markets and the tax regime needs to facilitate this.

Communication and partnership are key to the way forward

21. The benefits promised under a defined benefit pension scheme are not guaranteed absolutely. Moreover, if current levels of benefit were to be guaranteed absolutely, the cost would be unaffordable for the majority of employers. However, scheme members rely on the future benefits that they expect to receive from defined benefit schemes. It is vital to ensure that the nature of the benefits and the basis on which they are funded are clearly communicated to scheme members.
22. Such communication - and a partnership approach between employees and employers - is key in finding a way forward for defined benefit pension schemes. Changes to current benefit structures may be needed. For example, in some circumstances, a lower level of benefit with a higher level of guarantee may be preferable.

Change to the statutory funding standard may be needed

23. Some changes to the current statutory funding standard may also be appropriate. The Pensions Board is currently engaged in reviewing the standard and the Society has made an input to this process. It is essential that the funding position on a discontinuance basis is communicated clearly to members. However, with a view to ensuring the future viability of defined benefit schemes and having regard to the impact of investment volatility, it may not be practicable to require a scheme to be fully funded on a discontinuance basis at all times.
24. This would, however, increase the probability that some schemes will wind-up without being able to meet their accumulated liabilities in full (clearly many schemes would be in this position if they were to wind up now). Current pensions legislation gives priority to pensioners when the available assets in a pension scheme are being distributed on wind-up. This means that the possible adverse consequences of wind-up are largely (perhaps excessively) borne by

employee members. Legislative change to provide for a more equitable distribution of the available resources would be appropriate and this is currently being considered by the Pensions Board as part of the review of the Funding Standard.

25. It should also be noted that the current legislation does not require employers to make good any deficit when a defined benefit pension scheme is wound up, even if they have the resources to do so. If the statutory funding standard is changed such that schemes are not required to be fully funded on a discontinuance basis, then it may be appropriate to consider whether a deficit in the event of a scheme winding up should become a debt on the employer.

Retirement ages may need to be reviewed

26. A normal retirement age of 65 is typical for the majority of Irish pension schemes. However, in recent years, the trend has been towards earlier retirement, with those retiring receiving augmented pensions, in many cases financed from fund surpluses built up during the bull markets of the 1980s and 1990s. The financial strain now being experienced by the majority of Irish pension scheme means that this practice will be much less affordable into the future. Indeed, given the projected improvements in life expectancy, many employers may see a later retirement age as a necessary step in order to provide current pension levels at an affordable cost.

Appendix

Table 1

Period	Return to an Irish Investor over a period from investing in:		Increase in CPI
	Equities* % per annum	Bonds % per annum	% per annum
1973 to 1982	12.1%	10.8%	15.8%
1983 to 1992	17.9%	14.5%	4.4%
1993 to 2002	11.8%	10.6%	2.9%
1973 to 2002	13.9%	12.0%	7.5%

**40% Irish, 60% Global*

Table 2

Period	Average equity return % per annum	Range of yearly returns
1973 to 1982	12.1%	-44.6% to +107.8%
1983 to 1992	17.9%	-21.6% to +61.4%
1993 to 2002	11.8%	-30.1% to +52.7%
1973 to 2002	13.9%	-44.6% to +107.8%

Table 3

Period	Average bond return % per annum	Range of yearly returns
1973 to 1982	10.8%	-18.3% to +60.0%
1983 to 1992	14.5%	+0.9% to +37.3%
1993 to 2002	10.6%	-7.9% to +34.9%
1973 to 2002	12.0%	-18.3% to 60.0%

Data sources

Bonds:	Before 1999, the Riada over 5 year Irish Government index; since 1999: the Merrill Lynch over 5 year EMU Government index
Irish equities:	Before 1998, the Goodbody Irish equity index; since 1998, the ISEQ index
Global equities:	Before 1996, figures taken from Appendix II of Healy P., " <i>Pension Fund Investment: A liability-based approach</i> ", a paper presented to the Society of Actuaries in Ireland in 1996 (these figures represent a varying basket of UK, US, European, Pacific and Japanese equities; since 1996, the FTSE World index.
CPI:	Central Statistics Office

All returns are expressed in Irish pound/Euro terms and allow for the reinvestment of dividends.