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Perspective

Getting real with retirement benefits

By John Betts

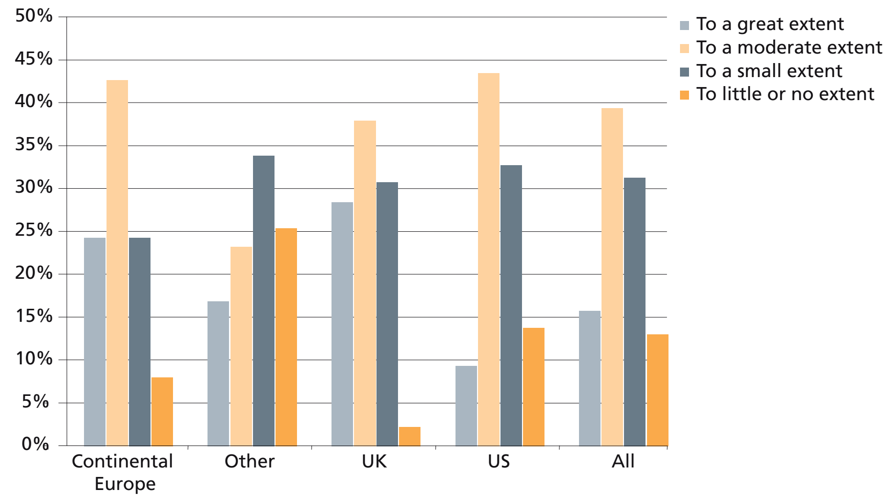
For those responsible for financing retirement liabilities, 2006 has been another year of concern. Despite rising equity markets, rising interest rates and the lack of any specific bad news on pensions, the financial burdens on corporate sponsors do not seem to be lifting.

After significant stock market rises in most parts of the world during 2004 and 2005, and no new pension problems – after all, we already know about more transparent accounting standards and people living longer – you will be forgiven for thinking that retirement plan problems should be ebbing a bit. In reality, 2006 has shown that pensions are even higher on companies' financial agenda, and resolving pension woes has become more difficult. In response to these pressures, Mercer recently surveyed a representative group of multinational companies on their thoughts and intentions about some key pension issues. The answers uncovered some very specific trends and opinions.

Background counts

Well over half the respondents surveyed thought that pension plans represent a "moderate" to "great" financial risk to their companies. This hardly suggests that financial officers see pension problems as resolved. Rather, evidence seems to indicate that companies have initially looked at pension issues and made some preliminary decisions, realising that the scope and difficulty of the underlying problem are more severe than originally envisioned.

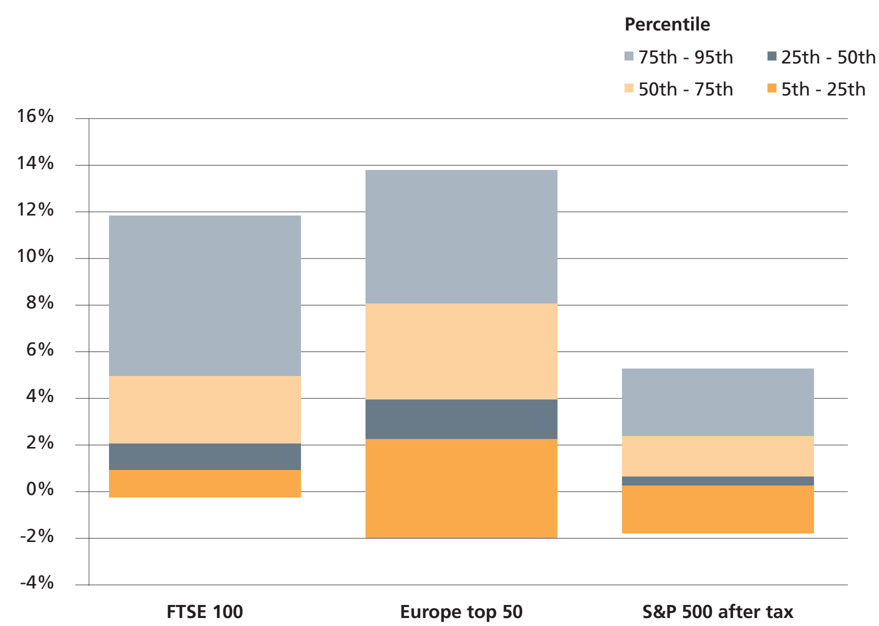
Financial risk of pension plan



The preceding graph shows there are some significant geographic differences among companies that said pension plans represent a great financial risk. The UK leads, with around 28 percent of respondents, with the rest of Europe not far behind, whereas in the US, the proportion of companies that have serious pension concerns is less than 10 percent.

To try and understand these differences, we looked at the UK's most recent annual surveys of retirement plan exposure against those in the US and across Europe. Below we take a look at the data comparing the S&P 500 with that of the FTSE 100. These survey results give us a view on the proportionate level of pension fund deficits and compare both the overall pension liabilities and pension deficits as a proportion of the market value of the companies themselves.

Deficit/surplus as % of market cap



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The relative sizes of the median plan deficits on either side of the Atlantic, after allowing for the after-tax effects above, are not that great. Although they demonstrate some difference in favour of the US on this measure, they do not seem to explain fully the differences in company concerns. We need to look elsewhere, and two or three factors may be at work. One could be the risk profile in terms of the volatility that flows from holding assets that are not matched with liabilities. This view carries some weight, especially in parts of Europe where historic defined benefit (DB) plans may have been closed for some time.

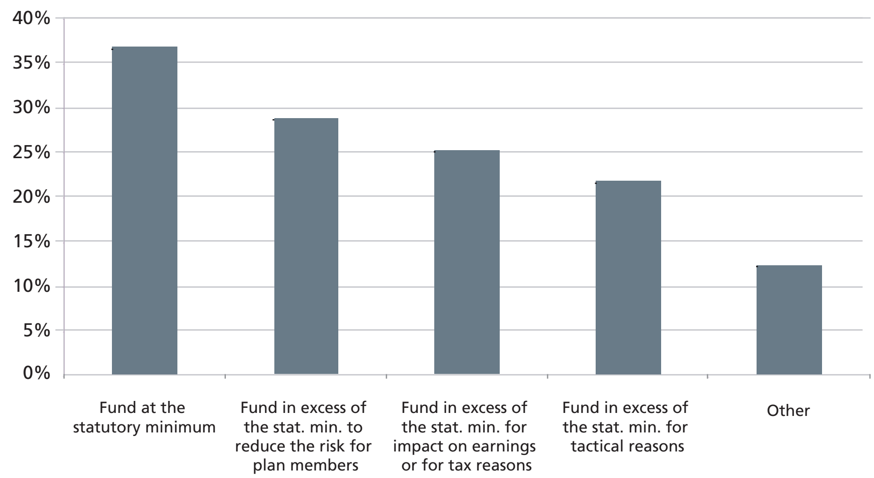
But there could be two other important factors relevant to the UK position. The UK may have a bias towards some specific companies that are affected to a higher degree by pension liabilities than the average. Or it might just be the introduction of a new regulatory environment – which has brought pension issues to top of mind. While it is hard to be certain about causes, it would seem that the introduction of the new Pension Protection Fund in the UK and the associated framework for funding has alerted companies to underfunding, requiring them to more openly "own" pension deficits and to resolve the problem. Extrapolating from the UK environment, we could conclude that US concerns over pension integrity might rise over the next 12 months with the introduction of the US Pension Protection Act and the new FAS 158 accounting standard.

A real problem: Tell me where it hurts

Financial effects of pension plans are felt either through cash contributions or through the impact of pension accounting numbers on the sponsor's accounts. The move toward transparent accounting standards, which recognise total liabilities, has been well-documented. The survey found that over 70 percent of the respondents indicated an acceptance of the mark-to-market approach, which reflects pension liabilities on the sponsoring company's balance sheet. This view was the same, irrespective of geography, although more respondents in the US would prefer a continuation of smoothing mechanisms in relation to profit and loss figures.

What's clear is that the thrust of recent legislation in the UK and the US is another driver. On top of that, the actions of plan sponsors in other countries, such as Germany, demonstrate that companies are facing up to the need to provide more security for plan participants. We asked survey respondents in the major countries in which their companies sponsor pension plans how much above the statutory minimum they fund their plans.

Pension funding policy/approach in major countries of operation



As you can see, only a third now limit their funding to the statutory minimum, with several reasons given.

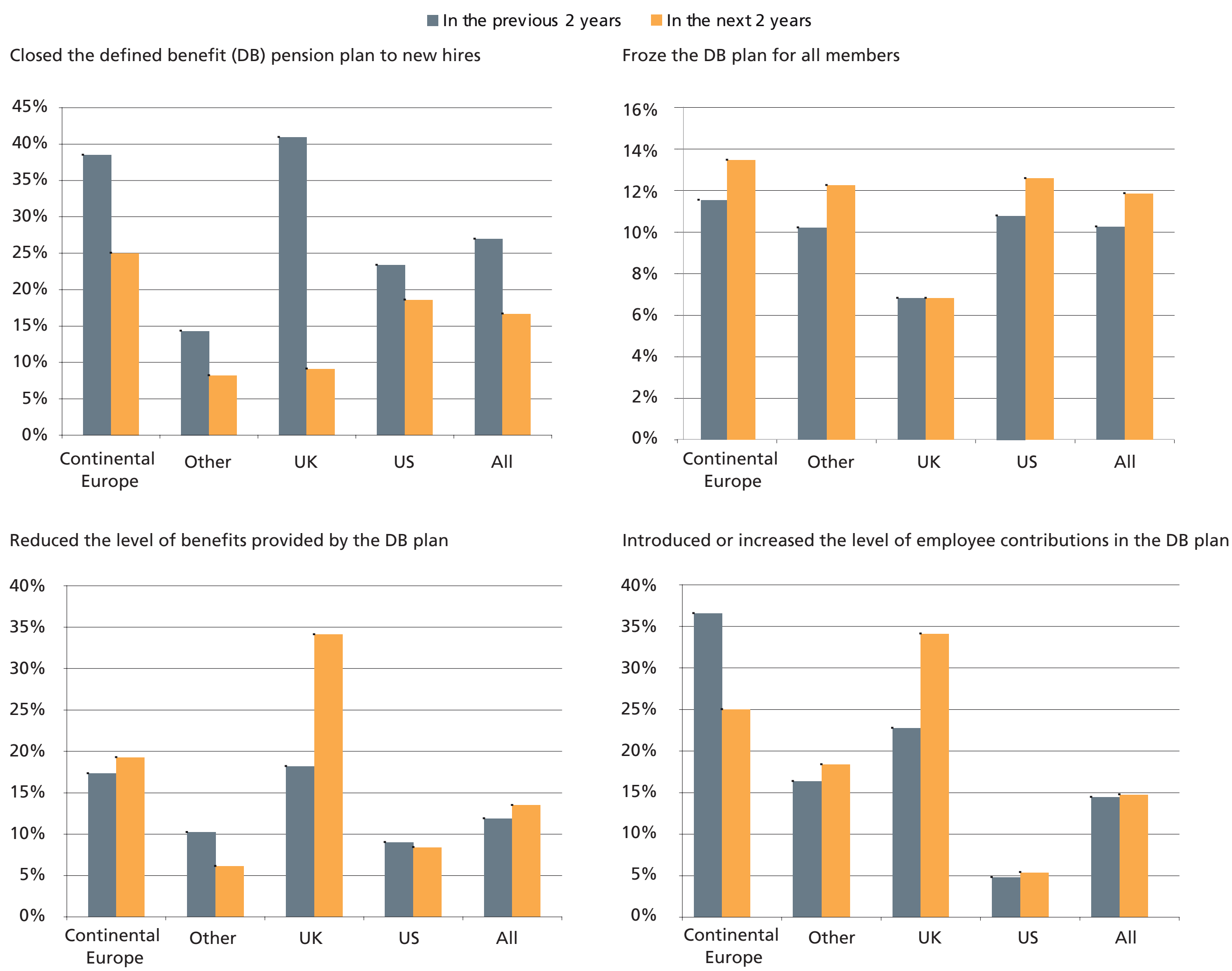
Increasing objectivity and transparency seems to be flowing into perceptions and actions on accounting and funding numbers. The strategies of smoothing the accounting numbers and ignoring the funding problem in the hope that it will go away do not seem to hold the appeal that they once had. Evidence underscores that pension sponsors are looking at the real questions and are seeking real solutions.

"...pension sponsors are looking at the real questions and are seeking real solutions."

Simple solution 1: Stop the plan

Many a decisive CEO of a multinational would take one look at pension issues and come up with a simple solution: Let's stop the DB plan and go DC. When we look at the actions multinationals have actually taken over the last couple of years, that initial reaction rings true.

Design changes made or expected to be made



There are still many large multinationals that are continuing to offer DB plans to new employees, finding that they help in recruiting and retention efforts and far outweigh the risks involved. But a majority of multinationals have tried to ease the pension problem by changing the nature of benefits for new staff and, in many cases, reducing its value for existing employees. The survey shows that while closing DB plans to new entrants in the UK was significant over the last two years, it is anticipated that it will diminish in the near future. Evidence indicates this is because most companies have already travelled this route. Survey findings tell us that the US is on the same track. A significant number of DB plans in the US are expected to close to new employees or to freeze future benefits over the next couple of years.

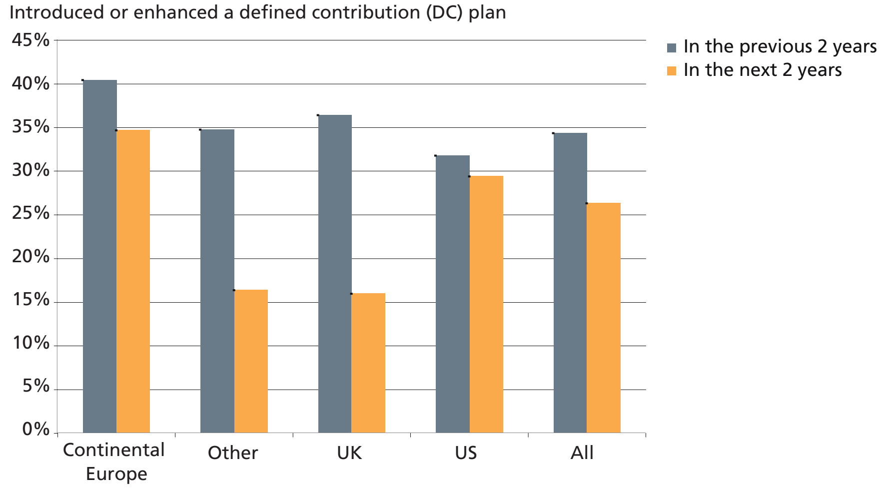
We can also see from the charts intentions for plan design over the next two years. There is a significant proportion of companies that are seriously considering changes to existing DB plans – either a total freeze or reduced benefits within the next couple of years. This is greatly significant in the history of global retirement provision. These decisions will, undoubtedly, trigger an array of thorny issues, including judgements about balancing retirement plans themselves, their impact on the workforce and other employment objectives, as well as communication and administrative challenges. What is clear is the extent to which multinational companies are now committed to finding the right benefits for their existing workforces.

"...a significant proportion of companies that are seriously considering changes to existing DB plans."

We also asked questions about attitudes toward defined contribution (DC) arrangements, and whether companies had any intentions to implement or improve these plans.

Design changes made or expected to be made

Introduced or enhanced a defined contribution (DC) plan



The number of organisations expecting to introduce an enhanced DC plan in place of an existing DB arrangement was high. Effectively, most companies are looking to implement, review or improve their DC arrangements.

In many ways, this is not that surprising. The effectiveness of a DC plan becomes much more important when it is ‘the only game in town,’ and employees’ interest in pensions becomes much greater when these plans are in the public eye. Also, DC plans are designed to be more attuned to the career patterns of today’s workers who move from job to job rather than building a career at one company.

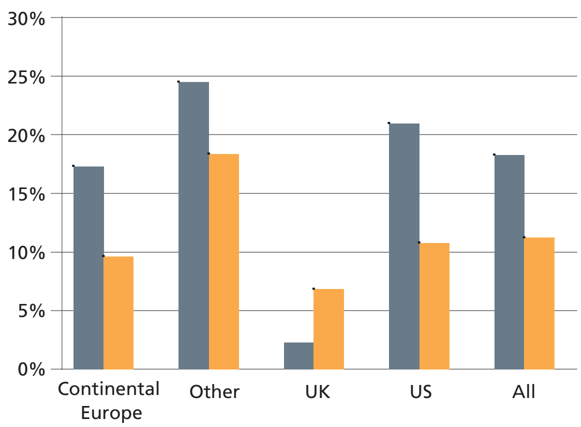
Simple solution 2: Match the assets

We also asked multinationals what actions they had already taken or were planning to take with respect to their pension plan investments. The questions were intentionally broad as we hoped to capture any major investment trends linked to pension risks.

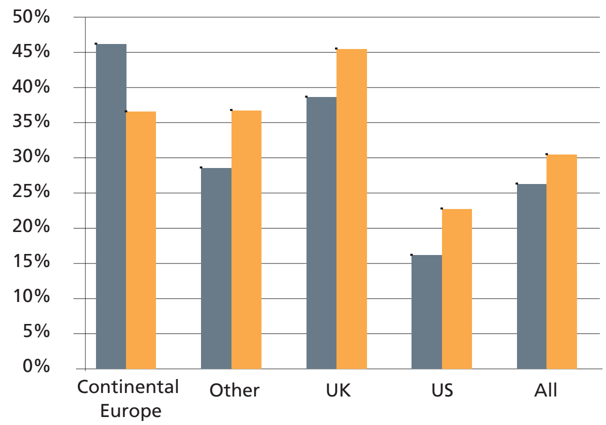
Investment actions taken in the past two years, or expected to take in the next to years

■ In the previous 2 years ■ In the next 2 years

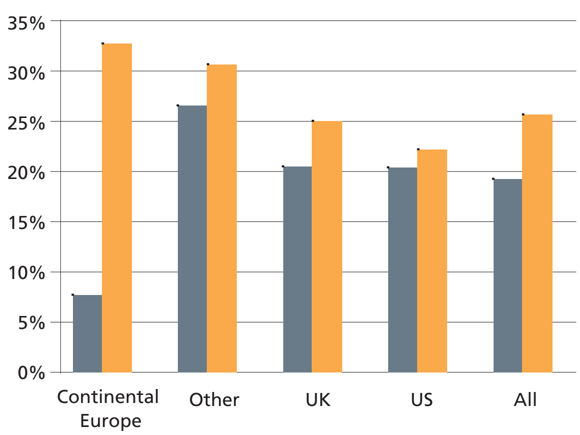
Increase allocation to equity investments



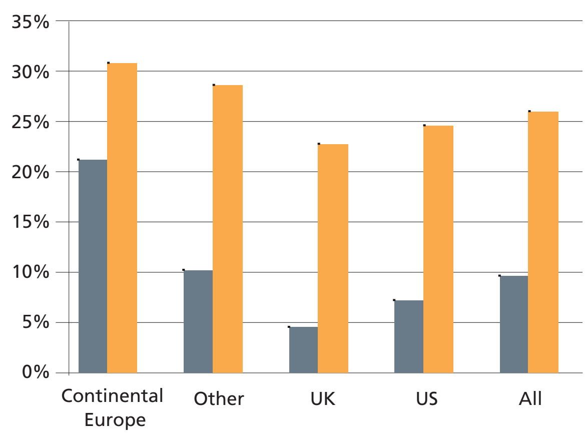
Increase allocation to fixed income investments



increase allocation to hedge funds / private equity / infrastructure investments



Increase interest rate hedging v ia fixed income investments and/or derivatives



One conclusion from the survey is that strategic changes on asset allocation are pretty much a given. A significant number of companies expect to make changes in each of four areas of investment choice we queried: more equity, more bonds, more interest risk hedging, and more other classes. There is also a strong move away from increased equity allocation toward increased fixed income investments – a trend showing no sign of abating.

The number of respondents planning to cover interest rate risk, say, with swaps or derivatives, was significant, and represents a healthy response toward tackling pension issues. A simple analysis of DB risks, particularly in a closed or frozen plan, demonstrates that dealing with interest rate risk is one of the least-costly interventions with the most potential impact on reducing financial volatility.

The propensity to consider hedge funds or other asset classes as an investment is a little less obvious. It may be just a step toward an important and sensible diversification, but expectations of stable returns on hedge funds have not always been realised.

We also considered whether the approaches to intended changes might be affected in any way by the existing asset allocation. The survey looked at asset allocation data for the top 50 European companies and the S&P 500 for the years ending in late 2005 or early 2006. Below are the results:

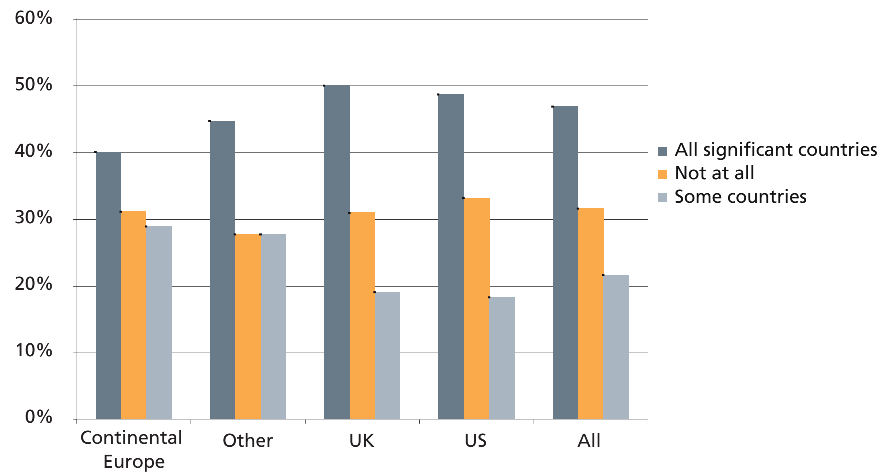
Country	Number of companies	Average funding level	Equity allocation
Switzerland	5	97%	32%
Netherlands	4	95%	38%
Finland	1	92%	no data
UK	17	90%	65%
Sweden	1	75%	no data
Germany	8	75%	44%
France	8	67%	52%
Spain	3	30%	no data
Italy	3	25%	no data
Total (Europe)	50	82%	55%
US	(S&P 500)	83%	64%

It is interesting to note from the above table that the UK and the US are virtually identical in their equity exposure in contrast to some European companies that have much lower equity exposure – and experience suggests that they have held this position for some time. The differences we noted above – particularly between the US and the UK in terms of their expected changes during the next two years – therefore cannot be derived from differences in the starting position but must be a reflection of their respective attitudes towards risk and the pace of decision making. While the survey is based on multinationals whose funds will cover many countries, we believe our conclusions would also be valid if based on local information.

Bearing in mind the significance of the investment issues for multinationals, one of the key questions is how asset allocation is managed within the company.

To what extent are you managing the following at a global level?

Pension fund investment policy



We asked participants the extent to which they managed investment issues globally. Replies may be indicative of general management style, but it is nonetheless interesting to note that in the sample, the degree of central management and monitoring is much stronger for companies based in the US than in other parts of the world. How these issues are managed will influence how HQs effectively control risk through the different interventions we have discussed.

On the horizon?

Overall, we think this survey gives us some important trends to look for over the next couple of years. We believe greater attention will be paid to changing benefits design for existing DB plan members. At the same time, moves from equities to fixed income assets will continue. Other investment interventions should become more prominent, in particular, the use of swaps and derivatives to hedge interest rates and as a low cost way to control pension risk, and it will be interesting to see whether many companies use them. Investing in other asset classes such as hedge funds or real estate and increasing exposure to fixed income assets are other considerations we found.

So, we are back where we started: employing real solutions – asset management and benefit design – for real problems. The pace of change will completely alter the retirement landscape over the next three to five years, so stay tuned.

John Betts is a senior actuary based in Leeds, UK and chairs our Editorial Board.

Other reading:

Pension deficits – up and down

How does your retirement plan stack up