

Pension deficits are artificially inflated due to misconceived regulation

By Dennis Leech

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Many DB pension schemes are in deficit. At the end of November, according to Mercer, the combined deficits of the pension schemes sponsored by the FTSE350 companies (about half the total) were £61 billion, an increase of £6 billion in the month.

These figures lead many people to wrongly to believe that such schemes are unaffordable, and companies to close them. Few commentators, including many experts who ought to know better, question whether in fact these deficits are real, or based on artificial figures.

Many believe that the issue is longevity. But that has not increased pension liabilities by £10 billion in *one month!* Nor is it poor investment performance: in fact asset values have grown by £4 billion largely due to low interest rates and quantitative easing.

No, the liabilities figures are artificial and almost certainly misleading as a guide to policy. The calculated liabilities are discounted present values of future payments to pensioners, which, the regulations say must be based on a so-called risk-free market discount rate. They vary inversely with interest rates, so that when they are low as at present, a result of monetary policy aimed at combating the recession, they are very high.

But these discount rates have nothing to do with liabilities in *reality!*

The *real* liabilities for a final salary scheme are defined in the scheme rules and depend on (simplifying only slightly): the member's final salary on retirement, the years of service, the expected inflation going forward and the expected number of years the member will live in retirement. These sums (the so-called technical provisions) are a flow of cash payments that have to be met annually.

Market interest rates have nothing to do with these payments. (They might indirectly affect salaries and inflation through macroeconomic monetary policy but that is another matter.) Whether the scheme is thus solvent is simply a matter of whether there is projected to be enough money coming in - as a return on investments as dividends, interest, rent etc, as well as contributions from members and employers - to cover these payments when they arise today and in the future.

But under the 2004 Pensions Act the law does not allow pension scheme accounting to be done in this – apparently common sense – way. Instead it poses one question: what would happen if the sponsoring company fails and all contribution income ceases. It requires assets and liabilities to be converted to hypothetical balance sheet items. It ignores the actual income and instead uses an untested economic

theory – the efficient markets hypothesis - that says that market prices embody all information about future earnings and are all we need to know. Liabilities are calculated as the capital sum that would be sufficient if invested at the so-called risk-free market interest rate to yield enough to pay all the actual liabilities.

The problem with this market fundamentalist approach is that both the assets and liabilities figures turn out to be highly volatile, and fluctuate wildly from year to year even when there are no changes to the underlying health of the scheme. The assets value is volatile because, for example, equity prices are very much more volatile than company dividends. The liabilities figure is volatile because the so-called risk-free discount rate varies with the state of the economy.

In his Autumn Statement the Chancellor George Osborne acknowledged the problem exists and announced there would be a consultation by the DWP on the desirability of moving away from the mark-to-market approach and returning to the smoothing methods that actuaries used to use in the past.