The Preventable Demise of Defined Benefit Pension Provision

Spring 2017

CONGRESS POLICY

As a society we need to talk about pensions. Not just older people or those on the verge of retirement, but everybody. The current crisis in private sector pensions – particularly in Defined Benefit schemes – has implications for workers in all sectors of the economy.

This issue is dealt with in greater depth in this latest policy paper from Congress.

Unless we tackle this problem as a matter of urgency, we will inevitably witness a sharp rise in levels of old age poverty as hundreds of thousands of people see the retirement they worked and saved for evaporate before their eyes.

This would have major implications for budgetary policy into the future, creating greater inequality and generating potentially deep social divisions.

Congress has warned for many years of the dangers inherent in failing to develop a proper national system of pension provision. It's not too late to do so and this document sets out how best to address the problem, but the government and policymakers must act immediately.

Patricia King,
General Secretary

The Preventable Demise of Defined Benefit Pension Provision

This paper examines the current crisis in Defined Benefit (DB) pension provision. Congress believes that, if present policy is not altered, a totally avoidable melt down of DB provision will occur with the real and substantial assets of these schemes being squandered. Our current Minimum Funding Standard overstates scheme liabilities and acts as an incentive for rogue employers to welch on their DB pension promise. The current situation requires emergency legislation providing for 'debt on the employer' legislation, as currently exists in the UK. Congress also calls for a high level Commission to examine how the substantial assets in DB schemes can be best protected in the interests of scheme members.

The Extent of the Current Crisis

One has to examine closely the latest (2015) Annual Report of the Pension Authority before it becomes clear that hundreds of thousands of people at work in Ireland today are likely to be far worse off in retirement than they had either planned or expected to be. Many will slide into poverty, while others may barely make ends meet. The people likely to be affected are those who throughout their working lives put aside significant amounts of their earnings to provide themselves with a fair income in retirement.

A survey published in 2016 by LCP Ireland shows that in relation to some of Ireland's largest DB funds, the deficit rose from €2.6 billion to €6.8 billion in the first 9 months of 2016.[1]

This paper will suggest that unless Irish officialdom can be shaken out of its current rigidity and complacency, an avoidable catastrophe may eviscerate what remains of our Defined Benefit pension assets.

As long as DB provision is regulated on the basis of the so called Minimum Funding Standard and liabilities are calculated on annuity prices, we will continue to make the survival of DB problematic.

Our DB pension deficits are calculated on a buy-out basis, which means that a scheme is deemed to be in deficit unless it has enough assets at any one time to purchase an annuity for each beneficiary. The UK Regulator, Andrew Warwick Thompson, regards such a calculation as "misleading" (based as it is on) "deficits calculated on a buy-out basis – reflecting exceptionally low bond yields and the cost of capital buffers and a profit margin for insurance companies."[2]

In the Canadian Province of New Brunswick the funding regime recognises that the adequacy of contributions to deliver benefits can only sensibly be measured over time, as opposed to at a given instant (as with Ireland's Minimum Funding Standard regime).[3]

Congress believes that the UK Regulator is right and that the New Brunswick approach is more sensible. It is not in the interests of the members of DB schemes to force them into a dysfunctional annuity market which will not provide a stable pension. Neither is it fair or equitable that active and deferred members will lose their entitlements unnecessarily because of assumptions that overstate and exaggerate liabilities.

1 LCP *8th Annual Survey* November p6

2 IPE *Investment & Pensions Europe* November 2016 p12

3 New Brunswick eliminates the volatility of solvency funding and instead requires annual going-concern valuations to determine benefit security levels. In addition, a 15-year open group forecast valuation is required every three years to determine if the going-concern funded ratio is below 100 percent. If this occurs in two successive valuations a "funding deficit recovery plan" is implemented. New Brunswick understands that the adequacy of the contributions to deliver the targeted benefits can only sensibly be measured over time, as opposed to at an instant, as solvency funding requires.

A Catastrophic Crisis

In recent years the Irish Defined Benefit pension system has been overtaken by a catastrophic crisis. The system is in decline internationally yet the scale of the losses suffered by Irish workers is far greater than elsewhere. A close examination of the Pension Authority's figures shows the scale of the unfolding calamity. From a peak of 1,500 healthy vibrant DB pension schemes a few years ago, which had nearly 300,000 active members, only 715 schemes continue to meet the Minimum Funding with little more than 100,000 active members. The Pensions' Authority suggests that in 2015 some 60% of the surviving schemes remain vulnerable.

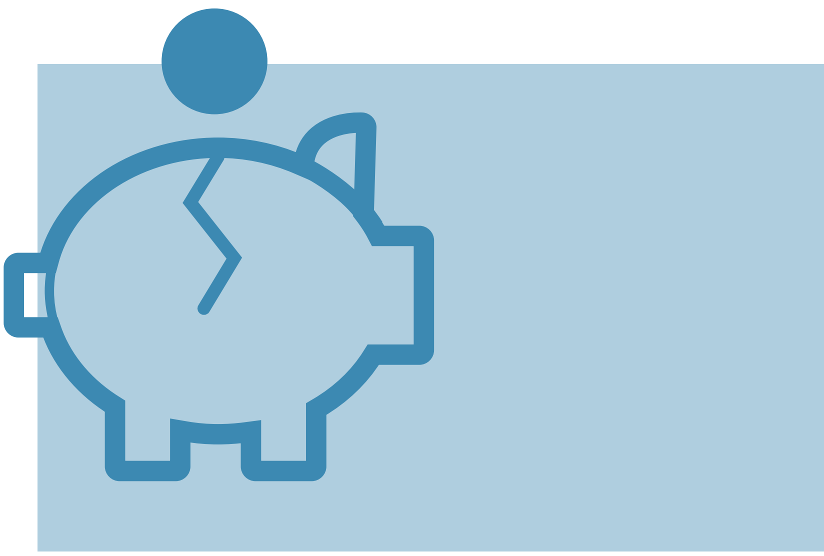
Congress believes and the LCP Ireland report suggests that the developing situation is much more serious. It is worth considering that the assets in schemes are not reducing. In fact the LCP Ireland survey shows that asset values in most schemes rose during 2016. These schemes are well managed.

However, as long as we cling to our bond and annuity based liability calculation most DB schemes will be subject to damaging volatility and continue to be driven towards unnecessary wind-up.

More than 90% of DB schemes are now closed to new members. Most of the surviving schemes will pay out benefits at a far lower level than what members earned and paid for, over many years. In addition, provision for increases in pension payments is almost non-existent, meaning that pensioners are likely to see the value of their pension fall by some 50% over 20 years.

In the event of a return of higher than expected levels of inflation the value of these supposedly secure pensions will evaporate even more rapidly.

Most of the surviving schemes have an agreed funding proposal in place (known as Section 50s), which involve a reduction in benefits and in many cases higher employer and employee contributions. Yet, as the real assets grow, these funding proposals are being derailed by assumptions based on low or negative bond yields.



DB Schemes Were Extolled as the Ideal Model of Pension Provision

The losses suffered to date did not happen because Irish workers or their employers failed to make adequate or prudent provision for their retirement. Nor does this crisis arise from the lack of financial literacy or good corporate governance skills amongst pension fund trustees.

The affected workers are, or were, contributing members of Defined Benefit (DB) Pension Schemes. Until recently funded DB schemes were generally believed to be the ideal model of pension provision. Government, the experts, and trade unions all extolled the virtues of DB. Trade unions tended to favor DB in the naive belief that the funds were safe and that there was a robust regulation system in place.

The risks associated with DB were to be borne by the scheme or the sponsoring employer. In the crisis that began in 2008, many companies increased their contributions to save their schemes. However, when wealthy opportunistic companies renege on their pension promise, the Regulator and the State does nothing to protect the scheme members.

Those adversely affected by the demise of DB are or were (usually) members of a trade union working in companies – big and small – in the private sector, the semi-states and former semi-state companies. Through collective agreements the employers agreed to sponsor schemes which required regular contributions from both employer and employees. These contributions were invested according to the best expert financial advice available. The schemes promised reasonably good benefits at the end of the employees' working life.

Regulation & Legitimate Expectation

Schemes are regulated by the Pension Regulator who levies fees from the members for providing this 'service'. Thus it was generally believed that workers' pensions were being protected. The legal doctrine of 'legitimate expectation' suggested that once one had a contract which included a pension promise and if one fulfilled one's side of the bargain in terms of the service requirement and making the contributions, then one could not be deprived of ones' entitlement. While the doctrine of 'legitimate expectation' has given significant protection to members of the judiciary and others in the political and social elite, it is now clear that as far as working people and their pensions are concerned, regulation and 'legitimate expectation' are mere chimera.

Why Should Workers Carry all the Risk?

It was once believed that a significant difference between Defined Benefit and Defined Contribution schemes is that with DB schemes the employer or scheme sponsor took the risk if things did not go as the actuaries, the investment managers and other advisors expected.

It is now abundantly clear with all forms of funded occupational pension schemes that the workers and the workers alone carry the entire burden of risk.

The volatility of the international investment markets in the last decade has shown that the advice of 'experts' is of little help and no hedge against risk. This may be of trivial consequence for the speculator who expects losses as well as gains.

However, when working peoples' life savings are in question it is shameful that those who make the rules do nothing to ensure that these hard earned assets are not squandered as a result of exaggerated liability assumptions.

Regulator rules forces DB pensioners to purchase over-priced annuities in the private sector on the spurious notion that this will ensure a stable life-long income. The annuity system is a boon for the pension industry but does not deliver either a stable life-long income or security to retired people. Annuities usually do not provide for annual increases so, over time, they become worthless (See Appendix 1).

Rigidity, Complacency & Cynical Opportunism

Official Ireland responded to the crisis with a mixture of rigidity, complacency and cynical opportunism. As the problems began to manifest, the Regulator favoured rigid adherence to the so called Minimum Funding Standard which significantly over values and exaggerates liabilities. The officials of the Department of Social Protection pretended that the problem had nothing to do with them. The Department of Finance dipped into the troubled funds and confiscated some of the workers' assets in the form of levies.

The pension promise in a DB scheme usually takes into account the level of state pension entitlement a beneficiary would purchase through PRSI contributions. As the value of occupational pensions tumbled, the government confiscated up to three years PRSI pension entitlement from many of these same workers by moving the pension age from 65 to 68. The cost of this decision alone to the workers concerned is €12,000, €24,000 or €36,000 depending on the age of the victim. The government also created more problems for working women by changing the rate bands for PRSI contributions in 2012. This had the effect of taking €1,500 p.a. in perpetuity from many women workers and carers. This clearly discriminatory measure may yet be challenged in the courts.

The government further increased the pressure on DB by insisting that schemes not only have to carry assets in line with overestimated liabilities but also that schemes be capable of building up significant reserves. This is cruel cynicism. In the past when funds generated reserves the trustees were obliged by the state to divest the schemes 'surpluses' (which were a very bad thing). Schemes were forced to take contribution holidays. The state instruction to schemes which did so much damage has never been withdrawn and has cost DB schemes and members dearly. Now the state changes tack and 'a surplus' is a good thing so long as you cease to call it a 'surplus' and instead it becomes a 'reserve'.

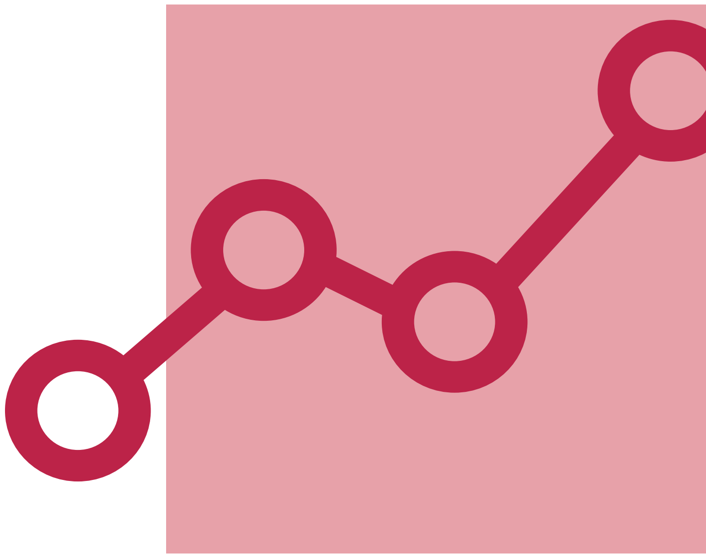
The State Evades Responsibility

Insofar as there has been any recognition that a problem exists, officialdom is determined to portray it as one, not of a systemic and policy failure underpinned by faulty assumptions and naive expert orthodoxies. Rather it is regarded as a problem for individual 'customers' who were unwise enough to entrust their contributions to imprudent and financially illiterate trustees and have suffered the inevitable consequences. It is hard to envisage a more blatant shirking of responsibility by those in authority.

The government, guided by financial experts, made the rules as to how these schemes were to operate. The government introduced costly legislative changes such as revaluing deferred pensions the cost of which added to the burden on active members. The Regulator enforced the rules to the letter. The workers paid their contributions and paid for the regulation system but their pensions were not protected. The workers are given no say in what was happening to their own pension assets. Neither were they were given any choices as to what might be salvaged when things go wrong.

Limited Progress

When unions, employer organisations, the Society of Actuaries and the Irish Association of Pension Funds attempted to suggest contingencies they were, with one exception, dismissed with contempt by the officials and politicians who were determined that nothing should be done. However, mostly in response to trade union pressure in 2013, the then government enacted the Social Welfare & Pension (No.2) Act 2013 which attempted to address in a limited but positive way the inequities involved in the division of DB assets on wind-up.



The Pensions' Regulator & the Crisis

From the beginning the Regulator treated the crisis as a problem relating to individual schemes. If a particular scheme could not meet the funding standard there was only two solutions. Either increase contributions and/or reduce benefits. Although our economy was facing the worst financial crisis in history, employers in many cases increased their contributions and benefits were reduced. Nonetheless, many DB schemes were wound up in a domino effect. As schemes wound up the losses crystalised for individual members with an inequitable division of assets.

It appears that to the Regulator adhering to an outmoded Minimum Funding Standard was more important than achieving best financial outcome for scheme members. Surely the objective of regulation should be to protect the interests of members?

Rigid regulation which results in imposing unnecessary losses on workers instead of protecting them is not good regulation. This is not the 'nanny state' it is the wicked godmother state.

The unbending approach of the Regulator fuels and accelerates the flight from DB and makes things much worse than they need to be for the average DB member.

Since the introduction on FRS 17 in 2002, and now under the terms of IAS 19 (2011), these assumed liabilities must appear on company balance sheets. This provides an excellent incentive for rogue and opportunist employers to welch on the pension promise. They can repair their balance sheet, pay a dividend to shareholders and merrily walk away from their pension promise in the knowledge that they will suffer no penalty for doing so.

One of the most frustrating aspects of the response of the Regulator to the crisis is the upbeat tone of the annual report and faulty focus of other publications issued by the Pension Authority. On a cursory reading of the annual report, one could be forgiven for thinking that everything is fine with occupational pensions in Ireland.

Rather than focus on the gargantuan bloated elephant in the room that is the DB crisis, the Authority held a consultation on the future of Defined Contribution where there is no obvious crisis whatsoever. In its consultation document the Authority sees the main problem in Ireland as that there are too many individual schemes (160,000 +) overseen by too many trustees. These are grossly misleading statistics.

The figure of 160,000 includes 80,674 frozen schemes that have no active members, 4,458 AVC schemes and 15,954 Death Benefit schemes. It is also worth noting that the UK Regulator does not require one person schemes to be registered, which would remove the 56,714 non-group schemes from the Pension Authority's register if Ireland did the same.

Of course it is a nice little earner for the Authority, which can levy €567,140 in fees from one person schemes to which the Regulator brings no added value. A very easy way for the Authority to reduce the number of schemes is to let the Insurance Regulator regulate one person schemes but as is clear it has more than half a million good reasons for not doing so.

The Authority's consultation document goes on to suggest that "better trained and informed" trustees and improved corporate governance will greatly enhance the prospects for occupational pension schemes. This is a dangerous illusion. It is also a neat sidestep from asking the searching questions of what is going wrong with DB schemes. What is being suggested here is that the failure of our occupational schemes to deliver a sustainable pension is down to lack of knowledge on the part of trustees. Nothing could be further from the truth. While the Pension Authority was happy to apply its rules regardless of the consequences for members, the trustee often played an innovative, imaginative and heroic role in very complex and difficult situations defending member interests as best they could.

It is to propagate a dangerous illusion to suggest that to professionalise trusteeship and thereby place the trustee role in the grasp of the pension industry will somehow prevent that industry from repeating past mistakes, or from clinging to outmoded orthodoxies. It will do nothing to protect workers' interests.

German Bonds & Annuities

The fixation with German bonds ensures that we have not yet reached the nadir of this crisis. We are fast approaching what may be the terminal crisis for DB provision. The Regulator's insistence on valuing liabilities on German bond rates and annuity buy-out rates means things can only get worse for surviving schemes. The heroic work of trustees, employers and unions to salvage something from the mess (in the form of Section 50s) may well yet be set at nought. If the authorities maintain the approach of unbending rigidity on one hand and a devil may care complacency on the other, then scheme members in this country will be visited with injustice on top of injustice.

This fixation with German bonds rates and annuities was probably rational once upon a time. When a pension matured the accrued value was used to buy an annuity on the open market. The idea was that the pensioner would then be certain of his/her income until death. It was even possible, back then, to purchase an index-linked annuity as a hedge against inflation at an affordable cost.

Back in those days the experts assumed that while bond rates might vary the very idea of investing in a bond was that there would be some positive interest yield year on year. The experts also assumed that the market would ensure a fair price for an annuity. However, other 'experts' felt that annuities were a boon for the industry and not good value for money.

In 2001 the then Minister McCreevy decided that annuities were only suitable for the 'little people' so rich people were allowed to convert most of their pension to a personal investment fund and avoid the annuity trap.

The rules were eventually changed for DC members and now no rational DC member would have anything to do with an annuity. The trustees of most DB schemes have circumvented the obligation of buying annuities by paying pensions directly out of the fund. This is all very well if the fund is allowed to continue in existence. However, in a climate where the regulator and the government have made it clear that they have no interest in DB survival and when rogue employers can welch without penalty this could be a self- defeating strategy.

The UK Government changed the rules recently and no longer forces DB pensioners or indeed any of its citizens into annuities.

All informed observers are aware that there is no functioning annuity market in Ireland today. Annuity prices in Ireland are a mathematical exercise in a non-existing dysfunctional market. Annuities are not affordable or good value for money. Index linked annuities are not available at any price that a rational person would be prepared to pay. No DB pensioner can be certain of the value of their income until death as inflation is likely to consume much of the value over time.

That those who have presided over the collapse of DB will now insist that what remains of a DB pensioner's pot must be eaten up by the cost of a product no rational person would purchase. As no rich Irish citizen, no UK citizen regardless of their income or social class, no Irish politician, no public official or no DC scheme member is obliged to buy an overpriced annuity why is it that only Defined Benefit scheme members are forced to do so?

Any bond, even a German bond, which offers a negative return on investment is perverse. The yield on these bonds is not determined by market confidence in the German economy. It is determined on one hand by speculator jitters in relation to the rest of the world. On the other hand it results from market distortion arising from monetary policy which uses a combination of low interest rates and Quantitative Easing (QE) to reflate the European economy. This involves the ECB and the Bank of England buying government and corporate bonds to the amount of €80 billion a month in the case of the former. Valuing the liabilities of a DB scheme on perverse negative yielding German bonds driven by speculator jitters and temporary monetary policy does nothing to help pensioners. It pauperises the active and deferred members of a DB scheme in wind-up.

German government bonds rate yields are currently very low. It is highly likely that yields will increase over the medium-term from their currently low levels (0.4% in mid-December 2016). This in itself is a major improvement in the situation outlined in the LCP Ireland survey (see page one). German government 10 year bonds have averaged around 5% over the last 35 years and a forecast long-term average in excess of 3% seems reasonable. As the European economy recovers there will be a move from safe assets such as bonds and this will translate into higher yields on the secondary market. In addition, the expected gradual unwinding of the European Central Bank's programme of QE will put upward pressure on bond yields as the period of artificial demand comes to an end.

In the short term, ways must be found to salvage the maximum that can be salvaged for DB members. This means the immediate enactment of emergency legislation to prevent rogue employers welching on a pension promise without penalty. This will give space for trustees to examine all options including an orderly change over to DC with a fair allocation and appropriate use of assets. We should follow the lead of the UK Government which has had debt on the employer legislation since 1995 and no longer requires pensioners to leave their pension pot in the control of the industry in the form of overpriced annuities.

Conclusion

Unless some consideration is given to the figures, the Pension Authority report might suggest 'nothing to see here, move along.' However, a cursory analysis suggests that unless something is done we are facing a DB train wreck. Instead of an emergency response plan the official reaction is to pretend nothing of consequence has happened or is happening. Those who have and will suffer losses just need to grin and bear it.

- So what if they paid the Regulator to protect their pensions?
- So what if they were assured all along that they were not carrying the risk?
- So what if they believed that the doctrine of legitimate expectation applied to them and not just the well pensioned elites?
- So what if the state damaged their schemes by treating potential reserves to as illusory 'surpluses'?
- So what if the state has taken up to €36,000 of their contributory old age pension entitlement? And €1,500 p.a. from many women workers.
- So what if the state confiscated the hard earned pension assets in the form on levies?
- So what if their funded hard earned mediocre pensions are being destroyed?

Now, as we approach the abyss, real and substantial assets will fall victim to perverse assumptions. They will be allocated in such a way that active and deferred members will lose their entire pension and pensioner assets will be squandered on junk annuities which will eventually be worthless.

Of course, a significant amount of the remaining asset will be paid to the pension industry simply for using their calculators as part of the wind-up.

We must not sleepwalk into this avoidable catastrophe. There are alternative strategies which will result in better outcomes for all the members. Any experienced pension trustee knows this quite well.

Congress is now calling for:

- ***the immediate introduction of emergency Debt on the Employer legislation, such as has existed in the UK since 1995***
- ***a halt to DB regulation and***
- ***the establishment of an expert Commission (which includes stakeholders) tasked with devising a plan to protect the remaining assets of the DB schemes, to maximize the commitment of employers and to ensure that as much as possible can be salvaged in the interests of all scheme members.***

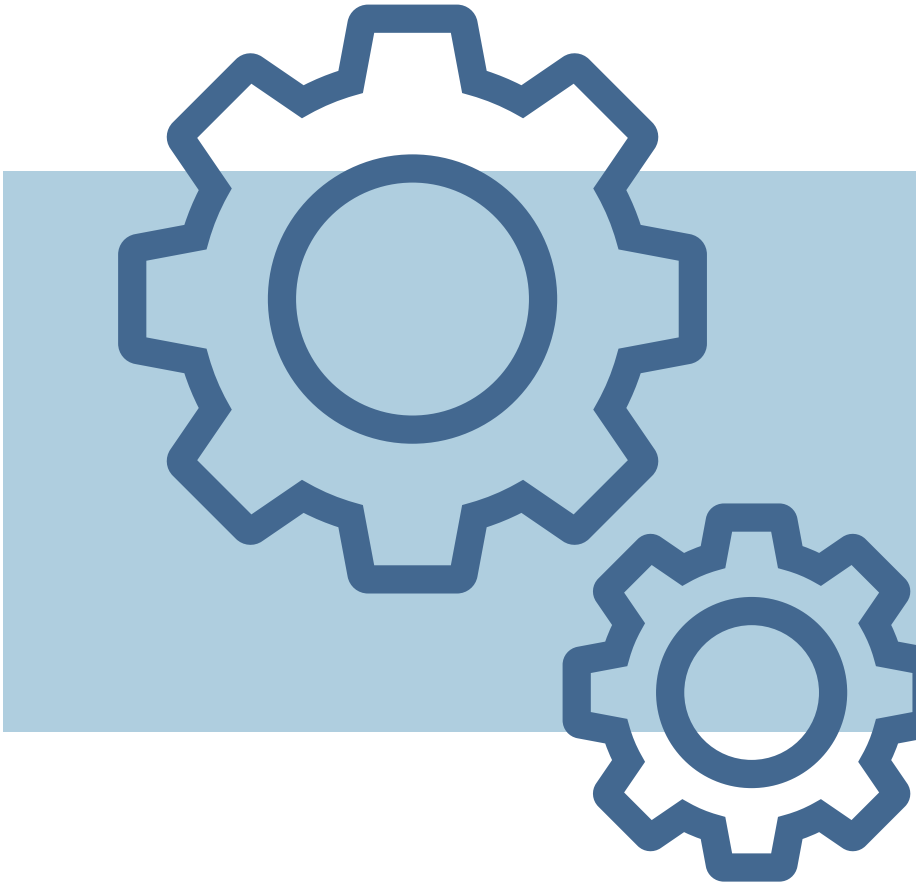
Appendix 1

The Cost of an Annuity

A pension entitlement of €25,000 p.a. from age 65 with a 2.0% escalation rate and a 50% spouse's death in retirement pension would cost approximately €980k based on annuity rates at today's date.

If this sixty five year old pensioner reaches the average life expectancy in Ireland of 80.9 years and a surviving spouse out lives the pensioner by two years, between them they will receive a total of approximately €547,700 in payments over 18 years.

There has to be a fairer and more prudent use of a citizen's pension assets.



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