Issue 92: A year to remember or a year to forget?

The year 2008 may be remembered as the year it all went wrong. In the context of pension schemes, the impact of recent financial changes has been highly scheme specific. Plummeting stock markets had a significant effect on many schemes but a reduced effect on those with Liability Driven Investment (LDI) strategies already in place. Offsetting the asset falls, higher corporate bond yields have reduced the value of liabilities, at least for accounting purposes.

In this edition of Spotlight, we look back over some of the key issues of 2008.

Managing risks

Financial uncertainties have been front page news. In addition to the sharp falls in equity markets, annual (RPI) inflation rose as high as 5% in July for the first time in a generation and we now have the prospect of a short period of deflation - something not experienced since the Second World War.

The management of risk has been placed firmly on the agenda for pension scheme trustees and corporate sponsors. Pension risk is not just an inconvenience but life threatening to some employers. Despite this, many schemes still have no policy for dealing with interest rate and inflation exposure. Schemes that implemented hedging and associated LDI policies before the recent market decline saw their funding levels holding up better during asset falls.

Whilst most pension funds' returns have gone down, there is a noticeable variation between schemes. Apart from reducing risk through LDI strategies, the key feature protecting pension funds has been diversification: reducing equity exposure and adopting hedge fund strategies, as well as diversification into other asset classes such as infrastructure. Other asset classes such as commodities offer diversification but, as we have seen in 2008, the timing of changes in exposure to asset classes such as commodities is critical.

Hewitt's recently released Global Pension Risk Survey 2008, showed that corporate thinking on pension risk remains focused on controlling accounting measures. The key risks from a corporate perspective are considered to be in relation to interest rate movements, longevity and equity investments. Accounting liabilities are driven by corporate bond yields which rose in 2008. However, trustees are generally becoming less willing to accept that an accounting style approach, based on these bond yields, is sufficiently prudent for scheme funding purposes in the future.

Monitoring employer strength becomes crucial

From a trustee perspective, the credit crunch and the bailout of the banks has brought the strength of the employer into particular focus.

The vast majority of trustees are now regularly monitoring the strength of the employer's covenant. The Pensions Regulator is also strongly encouraging trustees to seek mitigation where an employer takes action which will reduce its covenant, and was given additional powers under the Pensions Act 2008 to act where an action (or failure to act) has detrimentally affected in a material way the likelihood of accrued scheme benefits being received.

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Buy-out and Buy-in options

The means of the ultimate risk reduction strategy, the buy-out market, continued to develop in 2008, with the number of quotations supplied by potential buy-out providers peaking in the year's second quarter. More competitive quotations led trustees and sponsors of many ongoing schemes to consider a 'buy-in' of pensioner liabilities. This also reflects the continued concern over longevity risk.

Although the downturn in equity markets may make these options less affordable for many schemes in the immediate future, well prepared schemes will be ideally positioned to move quickly, at the right time, and secure favourable terms.

Benefit changes

Financial conditions have led to more Defined Benefit schemes being closed to new entrants and, in a minority of cases, closed to all future accrual. The move to Defined Contribution (DC) is gaining pace at a time when the risks being transferred to members are increasingly apparent.

Cash is likely to remain a scarce resource in the year ahead, leading to further scheme closures and pay freezes. Even for benefits which have already been earned, companies may prefer to provide contingent assets rather than making cash contributions to fund deficits.

Against this background, the Government's response to the consultation on risk sharing was disappointing, although it has undertaken to investigate the possibility of collective DC schemes (see **Spotlight 82**) and the sharing of longevity risks between members and employers in more detail.

Looking ahead

For some trustees and employers, 2008 will be remembered as the year in which their risk reduction strategies paid-off. For others, the experiences of 2008 will increase the deficit to be financed at the next valuation and possibly reduce the sponsor's ability to make higher contributions. The Pensions Regulator has indicated that longer recovery periods might be an inevitable consequence for some schemes.

If you have any questions on this Spotlight please contact your usual Hewitt contact or Peter Williams (+44 (0) 1372 733763).

If you would like to receive these bulletins by e-mail, please contact spotlight.enquiries@hewitt.com.

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