PENSIONS ARCHIVE TRUST

Speech delivered by Michael Pomery, President of the Institute of Actuaries. 31 January 2006

Good evening, Ladies and Gentlemen. I feel very honoured to have been invited to speak to such a distinguished audience. I am particularly pleased to do so on this occasion, in support of the Pensions Archive Trust. I must congratulate Alan Herbert and his colleagues on their success in getting this very important venture off the ground.

The historical record of the development of occupational pensions in this country does need to be preserved. Partly because it was a success story, and in my view still is, despite recent events – about which more later. Also, because studying the past teaches us something relevant about today and tomorrow. Being aware of how something like occupational pensions has evolved is, I believe, vital to understanding how best to adapt it to meet present day circumstances and future challenges.

Thirdly, because contemporaneous records are important. Decisions which with hindsight seem ill advised may appear much more reasonable when viewed in the context of the circumstances of the time. Contemporary data helps us to present a more complete picture.

There is a fourth reason why it is important to preserve a historical record. The Chancellor of the Exchequer talked recently about “British-ness”. Many things go to form the cultural fabric of a nation. The way we as a country have provided for our citizens’ old age is part of that cultural fabric. And I believe the early growth of occupational pensions stands firmly in the liberal tradition of this country. (That is, after recent events, liberal with a small “l”, not a capital “L”!)

I am not sure why Alan asked me to give this talk but I was delighted to seize the opportunity. As some of you may know, my term of office as President of the Institute of Actuaries comes to an end in June and a couple of months later I will be retiring from Hewitt. By coincidence, and it is very much unplanned, that happens to be 40 years to the day since I joined Bacon & Woodrow as a callow youth straight out of University. It is an interesting challenge to look back over the past 40 years and see what lessons we can learn, particularly from the last ten years perhaps, and how we might apply those lessons.

The first observation I would like to make is that, when looking at the big changes which have happened, there is a fundamental difference between those which were cyclical changes and those which were irreversible trends. We need to be able to identify which is which, but often cyclical changes over a long cycle look, for much of the time, as though they are on an irreversible path and can therefore fool us. One trend which has continued unchanged for a very long time is the increase in life expectancy. I recently attended a lecture by an academic who has studied records going back some 400 years. These showed that

the human race in the civilised world has enjoyed a steady rise in life expectancy for four centuries. I will come back to the subject of longevity later.

Inflation seems very steady at around 2½% pa for the old definition of RPI. But life hasn't always been like that. For most of the first half of my career in pensions, inflation was both high and volatile, and it dominated the economic landscape. Those of us who lived and worked through the mid 1970s will never forget the days of 25% pa inflation – a monthly rate equal to today's annual rate. It is salutary to think that it is only those over 50 today who fall into that category. Salutary as well to remember that all those under 35 today will not have experienced inflation at 5% pa during their careers. My generation made lots of mistakes because we believed inflation would never fall below 5% pa. I would urge our younger colleagues not to fall into the trap of believing inflation could never go back to 5% pa again, although possibly they do not need to plan for the contingency of 25% pa plus inflation just yet.

I couldn't resist showing the corresponding graphs for interest rates, in the light of recent events.

A question which is exercising a lot of our minds at the present time is whether the move from DB to DC is an irreversible trend or a long term cycle. It has certainly felt like an irreversible trend over the last few years and Lord Turner, in the Pensions Commission's recent report, appears to have written off any chances of a reversal. Employers will simply not be willing to take on the risks and costs involved, is the report's verdict. But, for those of us who believe that DB schemes have served the country well and would like to see a revival, there are some reasons for believing this may be cyclical. Final salary schemes began in a small way, primarily for senior management and white collar workers in large companies, and then, particularly in response to the advent of contracting out in 1978, expanded to encompass blue collar workers and smaller firms, to the point where they completely dominated occupational pension provision. Now the pendulum has swung strongly towards DC. Could it swing back one day? Maybe we will not see 1/60th final salary schemes with full index linking, survivors' benefits and all the "bells and whistles" that were acquired – or forced – on schemes in the 1980s and 1990s. Maybe the defined benefit schemes of the future will involve a sharing of the risks between members and employers. What might cause the pendulum to swing back? It could be a failure by DC schemes to deliver. It is clear that many occupational DC schemes involve such a low level of contributions that there are going to be some very disappointed pensioners out there when these schemes start to mature. One other factor which may well turn out to be significant is the demographic change which will affect this country over the next 20 years. The baby boom generation will retire. They will be replaced by those currently aged between 0 and 20. We know how many there are in that age group – many fewer than the baby boom retirees. In the absence of major immigration, the workforce will shrink by roughly two million. The competition for labour, especially skilled labour, will force companies to differentiate themselves to attract recruits and retain staff. If every other company is offering a DC pension scheme, it may not be long before one major company decides to differentiate itself by offering a DB scheme, albeit a risk sharing version. Once one major company does it, others could

follow. It seems to me that the DB → DC switch could well be a cyclical event, over a very long cycle, rather than an irreversible shift.

There are some other changes which seem to be permanent but may in time turn out to be just the swinging of a very slow pendulum. I refer here to changes in society, our collective behaviours and beliefs. There has over the last 25 years or so been a marked shift away from a world in which we give up some individual rights for the greater good of the community to a world which emphasises the rights of the individual as paramount. At the same time, people are much less willing to meekly accept the decisions of those in authority, so we live in a world where experts' views are subject to question and scepticism. Alongside this is a continuing pressure for more and more openness and transparency, with demands that those whose actions or decisions can affect our daily lives should be more and more accountable.

These changes, as I shall explain in a moment, have had a profound impact on the financial services industry, and pensions is no exception. We need to be aware of these changes in society. We cannot cocoon ourselves in our private patch and ignore what is going on in the world around us. Nor can we fight a lone battle against the changing tide.

Now, of course, final salary schemes are a collective way of providing retirement income, through a pooling of resources. And they are riddled with cross subsidies – from leaver to stayer, plodder to high flyer, those who die soon after retirement to those who live to a ripe old age and so on. From the members' point of view, the funding mechanisms are opaque, understood only by distant, faceless unaccountable experts, called actuaries. You can see how, in a world where people were demanding that their own money should be used for them alone and no one else and that their savings vehicles should be completely open and above board, a DC scheme is much more attractive. Each member has their own individual "pot", with no cross subsidy, and can easily see how much it is worth, openly and transparently, with no reliance on unaccountable experts.

Of course, the DC members also carried all the risks – investment risk, longevity risk and final salary risk. But in the heady days of the mid 1980s under the Thatcher government, this was seen as opportunity, not threat – by politicians, think tanks and the media alike. Final salary schemes were castigated – you were forced to join, forced to contribute and then ripped off. The law was changed to make membership optional, to give the right to opt out at any time, the right to transfer to a personal pension. Individuals were encouraged by Government adverts to throw off their final salary chains – Houdini like – and break free into the promised land of individual DC plans. Anyone who predicted that this would lead to chaos and an overall reduction in UK pension provision was dismissed as having a vested interest in the status quo.

What lessons can we learn from this? Well, I am sure you each have your own views on that question. But I would urge you not to lose sight of the social/cultural dimension. What happened in the late 1980s was not

just a pensions issue – remember the sale of council houses and the privatisation share issues at the same time.

Will these cultural changes reverse? Are they cyclical? I fear not. Although individuals will support pooled solutions, eg final salary schemes, my feeling is that they do so only if they provide a better solution for them individually, not out of any sense of community, and couple it with demands for accountability and a distrust of so called experts.

After the pensions misselling saga, the Government changed its tune and material emanating from the DWP (or its previous incarnation, the DSS) contained positive messages about employer sponsored final salary schemes. These were safer than DC schemes, it was explained, as the employer carried all the risks, whereas in DC schemes the member carried all the risks. How ironic that the Government is now coming under fire for not attaching a health warning. It was true that the employer bore all the risks in a final salary scheme, EXCEPT on the insolvency of the employer, when all the risks migrated to the member. On employer insolvency and scheme wind up, the members simply got to share out whatever assets were in the fund at that time, with no further protection.

I suspect most, if not all of us, at sometime have been guilty of forgetting to add that caveat when comparing DB and DC pension provision. And, of course, not only did the members bear the risks if the employer became insolvent, but those who had not retired have a disproportionate risk, because on a wind up, pensioners had priority and the remaining members shared out what was left of the assets.

The recent cases of pension scheme members who have suffered severe losses when their employer has fallen into insolvency have come as a great shock. There is enormous sympathy for their plight and the distress it is causing them and their families. How did this come about? What is the historical context for those events?

If we go back to the formation of many final salary schemes in the 1960s and 1970s, they were invariably established with an "escape clause". The employer retained the right to cease contributing, in which case the scheme would be wound up with no further call on the employer. Without such an escape clause, no responsible Board of Directors could have agreed to set up a scheme, as they would have been saddling future Boards and shareholders with a potentially open ended commitment.

Moreover, it was common for companies to grant past service pension rights to the initial members, to cover their periods of employment before the scheme was established. The costs of these initial extra pension rights were typically met by additional contributions over 10, 20 or even 30 years. In other words, many schemes started life with a large deficit and with no likelihood of being able to provide the promised benefits in the event of the employer's insolvency in the short or medium term.

Not surprisingly, in such an environment, there were no laws about minimum funding levels. To have introduced any such law would have killed off employers' generosity. So we had a situation for many years where deficits were common, often quite large ones; there were no laws about minimum funding and members had little protection in the event of employer insolvency. This may seem outrageous today, but I put it to you, that without such an environment, final salary schemes would not have existed and it is true to say that many millions of our citizens would have been much worse off than they are today.

The first call for a minimum funding regime (other than for contracted out rights) came from the Goode Committee, set up in the wake of the Maxwell affair. The Goode Committee's original proposal was a solvency test, but this was watered down in the eventual design by the Government of the Minimum Funding Requirement. There is no doubt in my mind that, at the time the Pensions Bill was going through Parliament, in 1994/95, Government Ministers and civil servants understood what they had specified – a strong test for pensioners, at or around the buy out level, but a much weaker test for non pensioners, based on a transfer value of accrued rights to a personal pension. The aim was to raise the level of funding in the schemes which were least well funded. With hindsight, this seems to be an unduly modest aim, but in the historical context, it was a big step forward from the previous position.

Regrettably, the average pension scheme member, if they thought about these things at all, quite naturally assumed that if their scheme had a Government "good housekeeping" seal of approval for meeting the Government's minimum funding test, their benefits were safe. And this view became quite widely held. Interestingly, if you look at the two statutory actuarial certificates, contained in legislation, that the Scheme Actuary had to sign, one on the MFR funding level and the other on the adequacy of the Schedule of Contributions, you will find that they each contain a warning note on the face of the certificate.

The second of these certificates, the contributions one, had to be reproduced each year in the Trustees Annual Report and Accounts, which was sent to, or made available to, members. It stated:

"The certification of the adequacy of rates of contributions for the purposes of meeting the MFR is not a certification of their adequacy for the purpose of securing the scheme's liabilities by the purchase of annuities, if the scheme were wound up."

You will not be surprised to learn, I am sure, that the warning note was included in the legislation at the insistence of the Institute and Faculty of Actuaries back in 1995.

The MFR started life in April 1997 and almost immediately got into difficulties, when the incoming Chancellor in a new Labour Government abolished ACT in July 1997. With the benefit of hindsight, we can see the flaws in the design of the MFR but at the time it was drawn up, in the mid 1990s, it reflected the way long term funding calculations were carried out. Oversimplifying slightly, it was designed to produce reasonably stable results if a scheme invested a proportion of its assets, based on its liabilities which related to members not yet retired, in the All Share Index of UK equities. It relied on two relationships that firstly,

in the short term, that movements in the market value of the index were inversely proportional to movements in the dividend yield and secondly, in the longer term, if the dividend yield stayed the same, market values went up in proportion to increases in dividends.

Following the ACT change, this latter relationship broke down, as companies started to remunerate shareholders in more tax efficient ways, such as share buy backs. This meant that a pension scheme which invested the correct proportion of its assets in the All Share Index would have seen its MFR funding level falling gradually. At a time when share prices were rising, the MFR test was therefore forcing companies to increase their contributions. No wonder it became discredited. Indeed, at one stage, a member who took a minimum transfer value, calculated on the MFR basis, could reinvest the proceeds in a gilt based personal pension and virtually guarantee a significantly higher benefit than they had given up in their scheme.

Later on, events such as the Vodafone takeover of Mannesmann, which at a stroke doubled Vodafone's market capitalisation, but without changing its dividend, and the similar but smaller impact from the RBS takeover of Nat West, caused further distortions. Twice, there were small steps taken to adjust the formula to partially correct for these effects.

Meanwhile, a more serious problem had emerged. The gap between a "funding" test, based on long term assumptions, and a solvency measure, based on the cost of buying out benefits, had grown considerably. The widespread misconception that, if you belonged to a scheme which satisfied the MFR test your benefits were secure, was becoming further and further from the truth.

The actuarial profession was asked by the Government in Spring 1999 to review the MFR and we delivered our report in May 2000. It included among many proposals for a redesign of the MFR a "strong recommendation" that members should be informed each year about the level of benefits they would get if their scheme were to wind up. We pointed out how the buy out position was very much worse than the picture painted by the MFR test and that the relationship between the two was volatile. We highlighted the widespread misconception that the MFR was some sort of guarantee. In May 2000, I was invited to speak at the NAPF Annual Conference and I devoted my entire speech to this topic. In order to shock the audience into thinking about the problem I painted the worst picture I could think of. Revisiting the speech recently, I was horrified to realise how many of my worst fears in 2000 had actually transpired : the insolvency of employers whose schemes passed the MFR test; members with significant pension losses; lurid front page headlines in tabloid newspapers about pension scheme failures; widespread disenchantment with pension provision; knee jerk Government legislation, with unintended consequences.

One lesson which I learned from this experience was that we failed to recognise clearly, and to explain clearly, the difference between funding and solvency. Funding is a long term concept, designed to ensure that there is enough money in the fund to pay each members' benefits when they fall due, assuming the scheme is ongoing. Generally, it is also implemented in a way which produces reasonably stable employer

contributions. Solvency is about member security and protection in the event of employer insolvency. Careless use of the phrase "your scheme is fully funded", when it is meant in a funding, rather than a solvency context, is seriously misleading to trustees and members – it undoubtedly suggests safety and fully secure benefits. I for one plead guilty to having fallen into this trap.

What we did in the UK pensions industry for many years was to invest heavily in equities, focus on long term funding with stable contributions and largely ignore the buy out position.

One of the insights which I have learned is that, if you have three objectives in managing your pension scheme:

Investment in equities

Stable employer contributions

Stable member security

then you cannot achieve all three simultaneously. You can achieve any two out of three. If we now switch our focus to preserving (or indeed enhancing) member security, then we could invest in bonds instead of equities – and de-risk the employer contribution outcome, at the expense of course of higher contributions in the short term. Alternatively, if we continue to invest in equities while trying to maintain member security, the natural consequence will be fluctuating employer contributions, ie every time equities do badly relative to gilts, the employer tops up the fund with an extra payment and vice versa – except that vice versa, ie taking money out of the fund in good times, is not allowed.

So far, I have talked about MFR and the misconceptions it attracted, while skating around the problem of pension fund deficits. How on earth did we manage to go from a position of substantial surpluses (on an ongoing funding basis) in the mid 1990s to substantial deficits from 2002/03 onwards?

Part of the answer lies in seeds of destruction which were sown during the years of plenty. Successive changes in legislation improved the position of early leavers and converted discretionary benefits, especially pension increases, into automatic benefits. This removed the flexibility to turn the discretionary benefits tap off during hard times and turn it on again when things improved. Also, companies gave away improvements in benefits, which ratcheted up their pension costs. This was a wonderful game for management to play – awarding extra benefits to their employees at apparently no cost to the company, because they were all paid for out of the surplus. No amount of lecturing from that miserable, "doom and gloom merchant", their over cautious actuary, that there was no such thing as a "free lunch" and all these extra benefits would have to be paid for one day, made any impression.

Also, the infamous withdrawal of ACT relief by Gordon Brown was partly justified by the strong funding potions pension schemes were in at the time of the 1997 election.

However, the principal cause of the deficits was a "triple whammy" of extraordinary proportions: namely, falling interest rates, increasing longevity and tumbling equity markets. Of these, falling long term interest rates was by far the most important. Until mid 1997, long dated index linked gilts had yielded around 3½% to 4% pa for quite some time. Between mid 1997, when the new Labour Chancellor handed over control of interest rates to the Monetary Policy Committee, and the end of 1998, some 18 months later, the yield had dropped to around 2% pa and there it stayed, until 2005. If your inflation linked liabilities are, on average, 20 years in the future and the real return you can get on your investments falls by 2% pa then you need to hold almost 50% more assets today to meet those liabilities. For every £100 in 1997, you needed £150 in 1999. That is a massive change in just 18 months.

I have already mentioned increasing life expectancy at the beginning of my talk. In early 1999, just after the end of the 18 month period of tumbling interest rates, the CMI published new tables of mortality. These are based on data collected each year from life insurance companies (hence the word "Continuous" in their name). Every four years, they publish updates on the mortality experience and every eight years, they produce new projections as to what future life expectancy might look like. Remember, there are two stages to projecting future life expectancy. First, base tables of actual mortality according to the latest data on the ages at which people are dying now. Secondly, projections of future mortality improvements, which have a large element of uncertainty in them. The updates of experience published in late 1998 showed very much greater improvements in mortality than previously experienced in the crucial 60s and 70s age ranges. The new tables of future projections, which followed in early 1999 reflected this and projected the improvements forward. Now all actuarial calculations allow for improving longevity – each generation living longer than the previous one. The crucial question is how much longer – is it a steady improvement, or is it speeding up or slowing down. The generation born between 1925 and 1945 (called in the jargon of demography, a "cohort") is exhibiting far faster improvement than ever seen before. We do not know why, although we can speculate – the generation that, largely, gave up smoking, better diet, improvements in medical science, particularly in relation to heart disease in early middle age. This generation, or cohort, entered the retired population in significant numbers in the 1990s and began to affect the data for pensioners' mortality at that time. Subsequent CMI updates since 1999 have indicated yet further increases in the rates of improvement for this cohort. This phenomenon led to, broadly speaking, a 10% increase in liabilities in 1999 and a further 10% increase by 2003.

So, if you take the falling interest rates and rising longevity together, the £100 in 1997 has grown to £150, as I mentioned earlier, then by 10% to £165 and by another 10% to £180. Amazingly, other than actuaries, nobody fully appreciated the significance of this for a long while because, of course, equity markets were booming in 1999. UK equities reached their peak at the end of 1999, as we know, and then fell for three consecutive years, reaching a low point in March 2003, having fallen over 50% from the peak. I have likened this process to the tide going out and exposing the rocks that had lain hidden beneath the surface.

What lessons can we learn from the events of 1997 to 2003? Our stochastic models suggest that the "double whammy" of falling interest rates and falling equity markets was a 1 in 30 year or 1 in 40 year event. Insurance company regulations require them to hold sufficient capital to meet every eventuality up to a 1 in 200 year event. That suggests to me that we should have been more robustly spelling out the downside risks to trustees and employers. Whether they would have listened is another matter. I also think we were all slow to react to the paradigm shift from a world of surpluses to a world of deficits. For some time, we were in denial, waiting to see if equity markets would bounce back or even if long term interest rates would rise a bit.

I should end by saying something about the future, which immediately leads me on to uncertainty. The future is inherently uncertain. Pensions, the provision of retirement income, is about the future – so is full of uncertainties. Whether it is a national pension policy, there are huge uncertainties in planning for the future, as the Pension Commission report repeatedly stresses, and rightly so. Or whether it is designing, funding or investing a pension scheme, there are future uncertainties to cope with. This presents a challenge to us, to explain that uncertainty in a world where people expect to be given answers – and often expect or demand a single answer. We can communicate uncertainty by giving ranges of possible answers; by creating different future scenarios and showing the outcomes; or by more sophisticated stochastic modelling to show a probability distribution of outcomes. But in many situations, a single answer is needed – the figure to go in the company balance sheet for the pension scheme deficit, or the annual contribution to be paid by the employer this year. We have not been very good at communicating uncertainty but we are improving gradually. One lesson for the future, all those who work in pensions need to get much better at explaining future uncertainty.

To cope with that uncertainty, we need to build in, whenever we can, flexibility to our pension arrangements, whether in design, financing or investment, so they can be adapted as the future unfolds. For instances, when it comes to future rises in the State Pension Age, it would be ideal if we could design a system which flexed as we gained more evidence of future life expectancy.

For those who are toiling over the implementation of A Day, the PPF levy and the new funding regime, it may seem unfair of me to say that I think the most significant issues on the table today, with the biggest impact on our futures, are those dealt with in the Pensions Commission report. I would hope that the pensions industry could speak with a reasonably united voice, to encourage the Government to be bold in its reforms.

It is not an exaggeration to say that over the next few months, the shape of the UK pensions scene could be set for a generation to come. That puts a great responsibility on us, not to saddle future generations with financial burdens that we ourselves should be bearing.

Nearly 60 years ago, when another Government review of pensions was taking place, the Councils of the Institute & Faculty of Actuaries published a paper, which analysed the issues at that time and proposed some principles on which Government policy should be based. The paper was entitled "An Appeal to Statesmanship".

I will offer you two brief quotations from that pamphlet – the language is that of the 1950s but the sentiments are as relevant today as they were then:

"Pensions are different from any other problem with which Parliament has to deal. Promises of pensions are given now but the cost of their fulfilment grows through the years into the distant future and an unexpectedly large proportion of the future national income can become committed. The voice of the future is noticeably absent from present discussions: our responsibility as actuaries is to make that voice heard."

"We recommend the setting up of a National Pensions Council – 'an authoritative and independent body' to guide the country through the financial, economic and technical aspects of this peculiarly difficult problem. Ultimate decisions must rest with Parliament but only after thorough and quiet examination by an independent body."

There is, it seems to me, a perfect opportunity, early in a new Parliament, and the Pensions Commission report having been published, for the Government to take a long term view, to plan ahead in a rational and statesmanlike way and to take some difficult and possibly unpopular decisions.

In conclusion, what lessons are there for the future? I have indulged myself tonight by looking backwards over the past, but it is the future which matters most. What advice would I give someone starting a career in pensions?

Firstly, the future is uncertain, so plan for a wide range of eventualities. Don't fall into the trap of thinking that things will always be like they are today. They won't – and some of the differences will be quite surprising. Build in flexibility where you can.

Secondly, try to distinguish between those trends that are part of a cycle and those that are set on a singular course. This is sometimes difficult to do, because it is hard to envisage that the pendulum will ever swing back. The DB to DC switch comes into this category, in my view.

Thirdly, social and cultural changes are just as important as economic changes. They invariably have a big impact and often lead to changes in legislation. Often the changes are incremental and barely noticed, until you compare today with several years ago and suddenly realise how much has altered.

Fourthly, and lastly, I would stress the importance of good communication. Looking back, many decisions may appear with hindsight to have been less than ideal, but I believe most were reasonable in the circumstances which prevailed at the time (another good reason as I mentioned for preserving historical

records). Where there have been failures, these have in my opinion been made much worse by poor or non existent communication. Misconceptions over the MFR and it not being a solvency test are a case in point.

So, Ladies and Gentlemen, as I metaphorically ride off into the sunset of my career in pensions, I hope I have given you some food for thought. Thank you very much for listening.