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IS THIS THE END OF THE 'LONG TERM' FOR PENSIONS ACTUARIES?

A DISCUSSION MEETING

[Held by the Faculty of Actuaries, in Glasgow, 7 November 2005]

Introduction

The Profession claims to make financial sense of the future, and our particular angle is our purported ability to see past the whims of the short termists and keep an unwavering eye on the long term. The pensions arena has been no different ... until now?

In June 2003, the Government converted defined retirement benefits unambiguously from an arguably vague promise to a debt, behind which the sponsor has to stand. A series of subsequent legislative changes, including the introduction of Scheme Specific Funding and of the Pension Protection Fund (PPF), with its proposed risk-based levies, has forced trustees to take a more commercial view to make sure that accrued benefits are met.

This stands in contrast to the gentler 'funding' environment in which pension schemes and Scheme Actuaries had become used to working. In that environment, the actuarial 'long term' justified many of the decisions taken in funding schemes — the long-term focus drove investment strategy and the approach to setting or agreeing contribution rates.

Has the rationale for the 'long term' disappeared: now that some of the discussion about funding has included talk of deficit correction periods of less than five years; now that accounting standards put any investment and actuarial volatility in the pension scheme into the sponsor's accounts every year; and now that PPF levies will change from year to year as funding levels and sponsor covenants change?

Has the Actuarial Profession over-reacted in focusing on the short term, or has it under-reacted? Will investment strategies look very different in years to come? Will valuations and funding advice take on a different shape?

ABSTRACT OF THE DISCUSSION

Mr A. G. Sharp, F.F.A. (Panel Chairman, introducing the discussion and the panel members)**:** Is this the end of the long term? The way in which the pressures and the problems of defined benefit (DB) schemes have grown are, by now, well known. For those of you who need reminding, I would refer you to David Kingston's guest editorial in *British Actuarial Journal*, **10**, 909-913.

I now add two further points to this analysis, on opposite sides of the debate (as a balanced chairman should).

Looking back over 30 years, the nature of the final salary promise was very different then to what it is now — sponsors and trustees had huge discretionary powers over benefits, primarily for both pre and post-retirement increases, and vesting was after five years rather than after two. The big pension fund question in the 1980s was: "Whose surplus is it anyway?" Pension funds were more akin to discretionary trusts, and the long-term view was encouraged, whereas pension funds now are arguably more similar to insurance companies providing non-profit contracts.

Also looking back to history, the 1970s were, perhaps, the boom time for establishing new final salary schemes, which had previously been more the preserve (in the private sector) of salaried staff and employees of larger employers. However, in part because of the Finance Act 1970 which gave us the 'New Code' taxation regime, and in part also because of growing inflation, which seriously devalued previous money purchase arrangements, the fashion then was very much in favour of defined benefits. We should not always assume that the long-term trend will mirror the short-term trend, nor underestimate the power of taxation to influence corporate and personal behaviours over the short term and the long term.

The title of our discussion is "Is this the end of the 'long term' for pensions actuaries?" This is subtly different to: "Is this the end of the 'long term' for defined benefit pension schemes?" However, the two questions are intertwined, and I have no doubt that we will be addressing both questions together in this discussion.

I welcome our four panellists: Mr Ian McKinlay, Ms Shahbaz Hamid, Mr Martin Potter and Mr Alastair Walker, all deliberately selected from the younger half of the profession. However, to avoid any claims of age discrimination, I hope that we will hear contributions from across the full age range.

Our format is that the four panellists will address the question from four different angles with a short presentation, so as to provide a framework for discussion and to give some initial observations on the issues. Mr Walker will comment from the viewpoint of that hard-pressed person, the pension scheme trustee; Ms Hamid will speak from the viewpoint of the beneficiaries — the pension scheme members; Mr Potter will then take us to the other side, and discuss the role and viewpoint of employers sponsoring defined benefit schemes; and Mr McKinlay will examine the roles of, and impacts on, investors and markets.

Mr A. T. Walker, F.I.A. (Panel member, speaking from the viewpoint of pension scheme trustees)**:** So, is this the end of the long term for pensions actuaries? Rather than develop my arguments and lead to my answer, I shall put my cards on the table and then aim to justify my conclusion. I would stress that these are my own views, and that I have deliberately adopted a slightly extreme viewpoint to help to encourage discussion.

So, what is my answer to it being the end of the long term, coming from the trustees' perspective? I will venture: "Yes, it is the end", at least in terms of actuaries' long-term funding bases; or, if it is not the end, recent events have certainly put more nails in the coffin of actuaries being able to take long-term judgement calls on the assumptions for the funding of DB pension schemes.

Given that I am covering the trustee angle, I would also like to touch on what the short-term focus and other recent changes mean for trustees. Also, I will look at whether having trustees at all is still an appropriate structure in United Kingdom DB pension plans.

I now consider some of the recent changes. First, there has been the introduction of the Statutory Funding Objective (SFO). In addition, we have various Pensions Regulator comments. In particular, at long last we have a stronger steer as to what the new funding regime will look like. While this is still not finalised, it is clear that all valuations will be under the scrutiny of the Pensions Regulator, who will look for potential risks to members and to the Pension Protection Fund (PPF). This scrutiny will focus on the strength of the funding target, the period of deficit correction and the strength of the employer's covenant.

Never before have actuaries' long-term funding bases and deficit correction periods come under such scrutiny. For example, we know that there will be a focus on solvency and PPF funding levels; therefore, either directly or by inference from the solvency or PPF funding level, the Pensions Regulator will have a range of acceptable ongoing funding bases, and it is

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movement outwith these boundaries which triggers greater scrutiny and involvement of the Regulator. Therefore, it would seem very odd if such scrutiny did not lead to funding bases bunching close together, both in terms of demographic and of economic assumptions. Clearly, this constrains the ability for actuaries to make long-term judgement calls.

Turning to another aspect, we now have the prospect of risk-based PPF levies. As things stand, part of the formula for these levies will be based on the degree of underfunding on a solvency-related PPF basis. The solvency funding level requires little or no long-term actuarial judgement by the Scheme Actuary — it is simply a snapshot of estimated annuity market costs compared to actual assets held by the scheme. Therefore, regardless of what the SFO does or does not require, these levies will tend to encourage funding with reference to a solvency funding level. As a result, the long-term funding basis is diminished in importance, as, presumably, trustees and employers will wish to minimise their PPF levies and therefore be more focused on the solvency and PPF funding levels.

In summary, these examples of the SFO and the Pensions Regulator's comments and risk-based PPF levies highlight the undermining of the importance of the long-term funding basis, with the focus now much more on short-term funding measures. This is not to say that actuaries cannot help to devise long-term strategies which aim to manage the new, more short-term focused regime; clearly, investment strategy will be a key factor in this. Mr McKinlay will pick up on this later.

I now consider what the short-term focus and other recent changes mean for trustees. A key change for trustees in recent years has been the change in the debt regulations. Effectively, employers are now on the hook for the full buyout level of liabilities from their pension schemes. This has brought with it a huge increase in trustees' powers; in extreme cases, the Trust Deed and Rules may even say that the trustees set the contribution rate, with no reference to employer consent. In this scenario, the trustees theoretically hold a sword of Damocles over the employer's head, with the potential of a demand for contributions up to the amount of the buyout deficit being served on the employer at almost any time. In the past, this debt was based on any underfunding on the Minimum Funding Requirement (MFR) basis, and, in many cases, was nil, as the scheme had a surplus on the MFR assessment. As almost all schemes are in significant deficit on a buyout basis, the potential to serve enormous debts on employers is a real one.

In the context of this discussion, this has had a number of effects. For example, trustees may well be more robust in their negotiations for funding the deficit. This arises partly from the more short-term focus on the solvency deficit, given the trustees' additional power arising from the new debt regulations. Deficit correction periods could also be under downwards pressure, as trustees look to get their schemes fully funded in a shorter period; again, the time horizons have been shortened. There are clear risks to the trustees if they do not use the additional powers which they have, whether from regulatory scrutiny or criticism from members. In the extreme, trustees could even find themselves being sued if they neglect to focus on short-term measures of funding and stick to what may become to be seen as the old way — of focusing on the long-term funding basis.

Another aspect is the significant reduction in discretion which trustees now have. To quote from the *British Actuarial Journal* guest editorial mentioned by the panel chairman, David Kingston puts it: "The benefits have, effectively, now become guaranteed.'' For example, for some time now legislation has required minimum pension increases on all pensions building up. The effect of this is that trustees have a much lower level of discretion over the benefits which the scheme provides than was the case, say, ten years ago. However, as David Kingston's article goes on to say: "it is not the trustees who are the guarantors.'' As a result of this and other factors, the goal posts for trustee knowledge and understanding, or TKU, as it has become known in the jargon, have increased. In part, greater emphasis on governance and TKU was a corporate reaction to factors such as FRS 17 coming onto the balance sheet, and a greater awareness of the significance of pension schemes to sponsoring employers, but lately it has been driven largely by the Pensions Regulator. Presumably, the Pensions Regulator's greater emphasis on TKU of late arises, in part, from wanting the trustees to do its dirty work in monitoring pension schemes, with an eye to the protection of the PPF. This even extends to trustees being required to monitor employers' covenants and to regard any deficit as being akin to an unsecured loan to the sponsoring employer. Once again, trustees are forced to consider the short term far more than in the past.

Pulling the above aspects of debt, discretion and TKU together, it strikes me that the role of the trustee is now far removed from that originally intended when DB schemes were set up. In fact, taking account of what will probably be a much more constrained ongoing funding basis under the new funding regime, you could pose the question: "Why do we need trustees at all?" For example, returning to the issues around employer debt; as the employer can no longer escape the liabilities, why not let the employer run the pension scheme just like any other part of its business?

In order to explore this point a bit further, it may be useful to consider the system in force in the United States of America. In that country there are no trustees, and the sponsoring employer has a direct fiduciary responsibility to the members of the pension scheme. As there are no trustees, and to help protect against unscrupulous employers, there are very tight regulations to protect the members, as well as the U.S. equivalent of the PPF, the PBGC. The powers of the PBGC allow it to interfere in corporate transactions of which they do not like the look. In addition, levies are payable relating to the degree of underfunding on a basis specified in regulations. This is very similar to the situation with the PPF in the U.K.

In the U.S.A., funding bases are almost entirely specified by regulations, with very little scope for actuarial judgement. The little scope which does exist relates mainly to demographic assumptions, but even these are at risk of becoming more prescribed. The U.S. equivalent of our HM Revenue and Customs, the IRS, polices the funding regime, and can dictate both the level and the pace of funding. While, at present, this appears to be more draconian than the SFO, is the U.K. system really all that far away from this, given the scrutiny which the Pensions Regulator will be applying to U.K. funding plans?

Overall, given the way in which the U.K. pensions environment appears to be heading, there could be a case for dismantling the trustee structure and replacing it with a more U.S. style approach of direct employer responsibility. So, it could be the end for trustees as well as the end of the long term for actuaries.

I leave you with the thought that Sir Derek Morris may even like this solution — actuaries would then be free from allegations of conflicts of interest, as we would only have one client; the employer!

Ms S. Hamid, F.I.A. (Panel member, speaking from the viewpoint of pension scheme members)**:** In my relatively short career advising trustees and/or companies, I have yet to give good news with regard to the funding or the security of benefits. Therefore, it is quite nice to present the members of final salary schemes' point of view.

In my view, they are the clear winners with regard to the recent wide ranging changes which we have seen in the legislation. Looking first at the changes in member expectation, in a fairly short space of time there has been a fundamental change. Seven or eight years ago does not seem that long, and at that time members had the expectation that there would not be a problem when they came to retire, the expectation being that, having worked with a company for many years, their pensions would be available for them without question or doubt. In the past five to seven years, we have seen fairly high profile cases of companies collapsing and leaving behind schemes in deficit. The impact that this has had is to increase the focus on the security of the members' benefits. Press coverage of what this actually means for members has not helped matters.

As mentioned earlier, there has been a fundamental shift away from what members initially perceived as a promise to what is now effectively a guarantee for members. Clearly, the downside is that any guarantee will have to be paid for. The PPF may not secure full benefits, but would certainly secure more than members would have received under the MFR. Of course, the changes effective from 11 June 2003 put a stop on companies being able to walk away from their pension obligations. Members are now more likely to consider: "Is my pension going to be there

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for me?'', rather than accepting it as a given. Couple that with annual funding statements being issued to members from 2006, I would suspect that more focus will be on the short term with regard to monitoring the scheme's funding on a year-by-year basis. I would, however, question the extent to which members would understand any communication which is issued. I think that actuaries will play a big role in assisting trustees and companies to ensure that fairly difficult concepts are explained clearly and concisely, so that members can understand the funding and the security issues.

From the members' point of view there is little about which to be concerned, but, as I said earlier, a guarantee requires someone to pay for it. Whereas I consider that the PPF and the moral hazard provisions surrounding it are a giant leap forward for members, they are clearly going to be detrimental to the employers, who will be picking up the tab.

I now talk a little about these issues from an employer's point of view. We know that the Pensions Regulator has a key role in preventing the PPF being called upon, and there are various frameworks available already, such as the notifiable events and the moral hazard regimes. The sole purpose of these is to ensure that the PPF is not diminished in any way by big claims.

When you consider pension schemes — as Mr Walker mentioned earlier — the Regulator is encouraging trustees to act and to think like creditors of the company, and to behave as banks would. It is interesting that banks would not necessarily grant a long period of time for the company to make good any shortfall. There would be a very hard line: "You owe us money. We want it, and we want it now. If you cannot pay us now, when can you pay?'' It very much becomes the bank or the unsecured creditor's right to be satisfied that the company will pay any deficit over an agreed period of time, which is not as long as what we have been used to seeing with pension scheme deficits.

This leads to repercussions on any corporate deals which the company is wishing to go through. They cannot do such deals now without considering the pension scheme and the position of the trustees. Companies are having to satisfy trustees before they conduct any transactional deals which may be beneficial for the company in the longer term. To me, this is a fundamental shift away from the long term to the short term, which I think is a burden on to the corporate sector and on the economy as a whole. If the trustees are considering themselves as creditors, then they do have to rely on the company for information about how much they would get if there were a break up of the company today. If you are considering a transaction, what would be available after that transaction has gone through, and how does this compare with the position before the transaction? The covenant issues with regard to the strength of the employer and the ability of the employer, not only to pay contributions now, but also several years from now, is something with which the trustees are going to have to get to grips. I would question to what extent trustees have the necessary skills to be able to understand the financial implications and to negotiate with the company in the best interests of the members.

My view is that the long-term view for pensions is dying, if not already dead. I hope that we do revert to a point when the long-term position comes back into focus, where we can take account of all the different parties, and how each impacts on the others.

Mr M. A. Potter, F.I.A. (Panel member, speaking from the viewpoint of employers)**:** I have never acted as a director for a large company running a DB pension scheme or, indeed, a small one. However, I do find myself talking to clients, directors and company secretaries who know more and more about pensions and who are more and more versed in actuarial matters. An example of this is the chief executive of a listed company who told me recently that, when he joined the board of his company over 15 years ago, he never recalls pensions ever being discussed at board level, and now it is discussed at every meeting, high up the agenda, in depth, and sometimes in between meetings as well.

So, what is being discussed? What makes pensions so interesting that it is distracting the board room from the important business of actually making profits? I think that it is what appears on Figure D.1, which shows the aggregate assets and liabilities of the FTSE 100 companies. The darker bars are assets and the lighter bars are liabilities. It does not take a room full of actuaries to work out that the difference between the two represents surplus or deficit,

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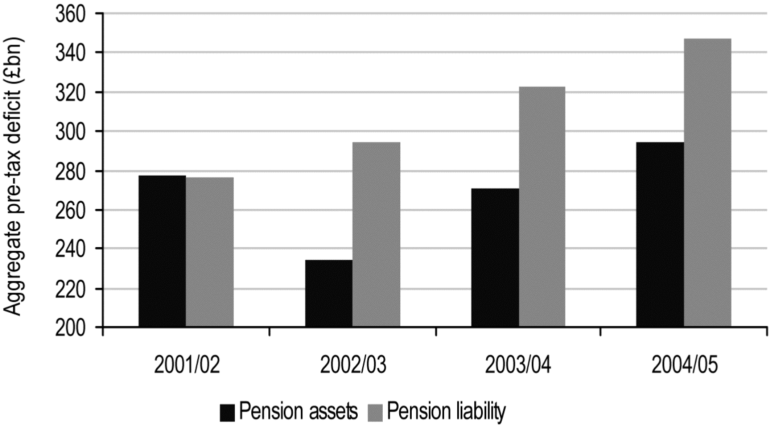

Source: UBS Global Equity Research

Figure D.1. FTSE 100 aggregate pension assets and liabilities

and we see that in 2001/2002 these were nicely balanced, and there was a small surplus. The year after that everything went horribly wrong, and suddenly there was a big black pensions hole, of the order of £50 billion, which opened up. I shall not talk about the reasons for that, which could be a whole session by itself. Equally, I am not here to discuss whether that hole was lurking for many years before; whether it should be bigger or smaller; or if there is worse to come. However, the point which I want to make is that, three years on, after all the steps which we have been taking our employers through to close schemes, cut back benefits, increase member contributions and certainly to increase their own contributions, the gap is still around £50 billion.

This does not just apply to FTSE 100 companies, but across the board, in the private sector and in the public sector. It is this picture which our clients are seeing in the Sunday papers, it is this picture which they are seeing in the *Financial Times*, and it is this picture, for their own scheme at least, which is taking up all that boardroom time for discussion.

In my view, it is accounting standards which have brought pensions sharply into view for employers and which are making those liabilities very real. Gone are the days of hiding behind theoretical actuarial valuations or even hiding behind the fact that some of these liabilities are even way off the balance sheet. These liabilities are firmly on the balance sheet now with the accounting standards which we have in place, and, at the same time, the legislative environment has changed radically. Reference has already been made to 11 June 2003, when the change to the debt on employer legislation changed the balance of risk between employers and members. Also, in 2005 we have all been very busy with the Pensions Act 2004 changing the regulatory environment. It has certainly changed the goalposts for employers, and, as has been mentioned earlier, it is impacting on their corporate activities as well. So, it is very much a short-term focus for employers, looking at their liabilities and how best they can manage them from one accounting year end to the next. Further evidence of this is the complete lack of time and, let us face it, lack of money, spent on the new generations of workers who are going to present a huge problem in the future; the under-pensioned defined contribution (DC) generations.

The long and the short of it is that, as pensions actuaries, we have had some pretty interesting and challenging meetings over recent years. So, how have we dealt with them? As a profession, we have to admit that we have had some change management issues on replacing some of our traditional long-term methods, where we sought to smooth valuation results and gazed into crystal balls. We have largely recognised that these are out of tune with the modern pensions environment, and that the accounting world is not letting us use these methods any more for accounting purposes.

While we have been going through that, we have also been learning on the hoof, adjusting to new legislation. However, while we have been doing this, the problems which appear in Figure D.1 have not gone away. We have not solved them, despite all the efforts taken. So, the magic solutions remain elusive. The deficits are so stubborn that we are actually moving away from some of the earlier steps which we took (as employers are coming back to us for a second and third bite of the cherry to review their benefits) to review their strategy, and we are now referring to legacy deficits.

So, I would agree that we are using much shorter horizons in our work, and that employers are focused on the much shorter term, but I would argue, at the same time, that the problems are not going to go away overnight. They are going to be with us for some time, and therefore we need solutions which can work over time, as these liabilities will remain long term in nature. So, rather than throw in the towel, I think that we need to start thinking of the long term as a series of short terms, and that these short terms need to fit in with the employer's viewpoint. We need strategies which address the problems over time to help employers to find robust solutions which allow them to see the risks as transparently as possible, but that these also respond to their own business circumstances as best as possible. I think, perhaps, that it is time for actuaries to take a few lessons from the finance director on corporate finance, so that we can face up to that challenge in the future.

Mr I. W. McKinlay, F.F.A. (Panel member, considering investors and markets)**:** The views which I shall express are my own, although they are coloured and formed by many years in a consulting environment. When I started considering this, I thought that this is a bit easy. The long term is all over. We are driven by the short term all of the time. However, I shall come to a conclusion which is slightly different.

What about the long term? The following quotation comes from the Pensions Regulator's consultation on Scheme Specific Funding, and is dated 31 October 2005:

> "We will be more likely to consider intervention if the recovery period is longer than 10 years. We may also look at schemes where the recovery period is 10 years or less but where the employer's strength suggests it could reasonably clear the shortfall more quickly."

No-one in this discussion has tried to define what the long term is. Is the long term ten years? It is probably a lot longer than that. When the Pensions Regulator states something like this, it does influence our thinking, and it gives a strong signal to trustees, employers, advisers and others that the long term really is over.

One of the interesting things from the consultation document is that it suggests that the MFR test, which we know is now on its way out, led to the focus on the short term. To some extent this is a bit laughable, because, to me, this is about the short term all over again; it is not going to get us away from funding or investment frameworks which concentrate on the short term. I say this because the funding standards which the regulator suggested that we look at are bond based (whether it be the PPF, FRS 17, or a proportion of buyout). Meanwhile, schemes remain heavily invested in equities, and the equity volatility against a bond-based measure of liabilities is risky, so the focus is going to tend to be on what is happening over the short term.

So, aside from the regulator, consider some additional facts. If you look at the liabilities of a pension fund, most of the schemes at which we look are about 50% pensioners, 50% actives and deferreds. In such a scheme, let us assume that you project the liability cash flows and produce a graph. Such graphs will be somewhat like an armadillo in shape, because they tend to peak and then smooth out over many years — going out beyond 80 years, some even over 120 years. The people who are involved in the decision making or in the governance framework around this are human beings, and they struggle to think about such long-term horizons for decision making.

I was interested to hear what Mr Walker said about the governance framework which we have, and he made an allusion that the governance framework within which we work is flawed. I think that it is. I think that the solution proposed by Mr Walker may work, but the Government may have to get involved to drive that.

Fund managers tend to work to three-year cycles. Clients require them to report against three-year performance. There are investment management agreements where the performance is orientated to performance over that sort of period. Again, it is focusing on the short term, much shorter than ten years even, never mind the 80 years which I mentioned.

What is the tenure of a finance director? Typically, they are in post for two or three years, and their performance bonuses tend to be orientated around that. When asset managers or investment bankers analyse stock prices, bond prices and such like, they are, typically, looking to value stocks or bonds based on cash flows over shortish terms — around three years. So, again stock prices tend to be short-term focussed in terms of valuation. Everyone is thinking within a framework of three years or less.

The theoretical time horizon for investing could be beyond 50 years, but the regulator is suggesting a period of less than ten years, and everyone else is thinking about three years and less. Even though actuaries are trained to look much longer term, we must ultimately reflect the views and the prejudices of our clients. This leads to short-term focussed advice.

So, what are the solutions which asset managers and investment banks have developed to try to deal with that? If your time frame is one year, what are the main threats to your funding over that period? This is really about volatility in the liabilities. We have seen significant developments in this way of thinking over the last three to five years. Fund managers and investment banks have become fantastically inventive. What we have seen is the development of liability driven investing type solutions. Traditional asset solutions — I have called them 'traditional' because they would look something like 60% equity, 40% bonds, or with variations around that — will have been set through asset/liability modelling following an actuarial valuation. Volatility of that sort of asset mix is about 10% p.a., with a return expectation of about 6% p.a. So, there is an 'information ratio' of 60%.

Liability driven investing can, theoretically, deliver a much more attractive solution with much less volatility, but with a similar return potential. So, you might see volatility coming down from 10% to 6%, sometimes even lower than that. It depends on the maturity and inflation or fixed exposure on the liability profile.

If we maintain the return potential, we have an information ratio of 100% and less volatility over the short term, which is more attractive for everybody. Liability driven investment does support short-term thinking — that is why it is on many of our clients' agendas. I know that it is in our interest to talk about these things, but it is of huge interest to clients and particularly to finance directors, because of what they have the potential to deliver. So, I think that the long term, because of people's thinking and because of governance, is now really 80 one-year planning cycles.

At this stage I now return to our original question: "Is this the end of the long term for pensions actuaries?" Having said all that I have said, I now present a contradiction, because an ideal situation would be if every scheme was well funded against a bond type standard. Then some people might say: "We will just go to the market and buy out the liabilities", but I think that that is not correct, because the capacity of the bond markets (either via direct investment in bonds or through an insurance company) to take on about £1 trillion worth of liabilities is not there.

So, even if they were all perfectly well funded, they could not go to the markets tomorrow and buy out the liabilities. In fact, the capacity of the markets to take on those liabilities is actually quite restricted. At the same time, there are the funding consequences of trying to get to a buyout standard in a programmed way. If companies can only reasonably afford to put a certain amount into the pension scheme, they will try to fund over a longer period. My own view is that it could be something of the order of 30 years — perhaps 40 years — before we manage to:

(1) put enough into our schemes such that they are fully funded on a solvency basis; and
(2) have bond or insurance markets capable of satisfying the demand.

So, I think, to answer the question: "Is this the end of the long term for pensions actuaries?", we are going to be around for a while yet, something like 30 or 40 years.

Mr J. A. Porteous, F.F.A.: One of the panel members said that she thought that the members were the real winners, but I think that they are losing. Are employees well served by all these DB schemes closing to new entrants and closing to future accrual? It does not strike me that that is a great win.

Why do we think that windup and debt are so important? I suppose that 'Man Gets Right Pension on Time' is not much of a newspaper headline. However, there are many people who are still getting the pension to which they are entitled, and not every company is a budding 'Maxwell'.

It strikes me that we are letting the Pensions Regulator and the PPF tell us what to do. One reason why we are going short term is because of the issue of liability minimisation for the PPF. Why are we letting that happen? What is so important about keeping the PPF under control? The Government may have made a mistake by creating the PPF in this form, and it now wants to minimise it. We should not let our clients be driven by the Government's short termism; as soon as we get tied to the Government we are inevitably driven by five-year terms, because it wants to get re-elected. This fits very badly with the long-term nature of retirement planning.

I do not think that pension deficits are anything like a bank debt, and I think that we are getting crazy when we start to talk about pensions being creditors and trustees having to engage robustly with their employer. I would much rather be in a DB scheme where I am taking some of the risk that my employer does not deliver the promise, than in a DC scheme where I am taking all the risk myself.

Also, pension schemes can afford to be pay-as-you-go, to some extent. Companies are still generating cash. There are still companies out there making a profit. Some of them are getting really irritated by what the Government is doing to them. I was speaking to a company where they said: "Our Pension Protection Fund levy says that we are an insolvent company, but we keep making profits and we keep generating cash flows.'' Where is the sense in that?

I worry very much that U.K. PLCs are going to be completely hamstrung by some of the things which we are doing at the moment — we are so obsessed by solvency and getting cash into schemes. One of the ways in which companies can fund pension schemes in the long term is by doing business.

I think that we should take it on the chin that we have been long term for quite a while now. Our short termism in the late 1990s created a mess, because we let our clients spend the 'surplus' created by the TMT bubble, when it was not real money. I remember a client who always referred to the surplus as a timing difference, so he did not spend it. In the case of others, we perhaps did not argue against proposals to reduce contribution rates. We do have a nasty habit of giving employers money back when they do not need it and asking them for money when they do not have it.

Professor R. S. Clarkson, F.F.A.: I agree with Mr Porteous that we did have 'funny money' in the Dotcom bubble, and I think that much of what has happened is the understandable reaction of human beings — regulators, trustees and finance directors — to the fall in equity prices.

Many people talk of risk. Risk, to me, is only on the downside. At the bottom of the market, in March 2003, the dividend yield on the FTSE All-Share Index was the same as the yield on long gilts. If you take any likelihood of our capitalist system surviving, it was obvious that gilts were a very poor investment. More recently, Alan Greenspan of the U.S. Federal Reserve Bank, warning that interest rates were too low, said: "Those who invest in long bonds are perhaps desirous of losing money.'' I think that we are in great danger of falling into the trap of short termism.

If you look at long-term investment returns, bonds give a real return of, perhaps, 1% p.a., and equities 5% p.a. real. I can understand completely the pressures which regulators, trustees, finance directors and scheme members are under as a result of the recent fall in equity prices. However, I hope that we, as actuaries, can get our act together and resist all these short-term pressures to switch from equities into long bonds.

Mr M. T. Chigariro, F.I.A.: I am a pensions actuary who has just jumped ship to fund management, because, at times, I cannot see the future of pensions actuaries.

I feel that pensions actuaries are just sitting down and being told what to do by other people. We were forced to move into equities through traditional asset/liability methods to enhance returns without focusing on risk. We do not introduce solutions like LDI — the fund managers are running the show. We are supposed to be the ones leading these ideas and advising them to our clients.

If you look at the equity market since 1994, you would think that what has happened since the new millennium was just a correction from previously super-normal returns, and that where they are today is just, basically, a correction. However, look at what happened to gilt yields. They fell by 4% over the decade. This, on pension schemes, will cause a 120% increase in the liabilities for an average scheme, but this did not happen overnight. We never did much about it.

Now liabilities have more than doubled compared to a decade ago, and pension schemes are in deficit. If, as pensions actuaries, we had seen this coming and had advised our clients to take action, I do not think that we would be having these problems now. We should act like clever people, by starting to see these problems and by addressing them. We should start by looking at the short term before we get into the long term. The short term is the one which is causing most of the problems. Equities are fine over ten years, but they are not fine over two years.

Mr Sharp: I was intrigued by one of the references at the start to more and more similarities coming from the U.S.A. in terms of more pressure on the short term. I read an article recently which stated that, if anything, the average equity content of U.S. pension schemes has now gone ahead of that of U.K. schemes for the first time. So, there does seem to be something of a contradiction there.

Mr Chigariro: Nobody is saying that we should move out of equities. If you take all the assets and put them into bonds, you are not actually measuring the risk, because less than 15% of the bonds have a duration of more than 16 years. It is not the solution just to move out of equities and to go into bonds. Just make sure that you have enough duration in the assets to remove all the risk. Then, whatever is left, you can leave 30% in equities, if you want to do so. The solution is not just moving into bonds.

Mr C. W. F. Low, F.F.A.: I am not in the camp which thinks that pensions actuaries are doomed. I think that we have a long, profitable and interesting future.

From now on, contrary to what is usually said at this time, I hope that my remarks will be fully consistent with the policy of my employer, the Pensions Regulator, because I do not have freedom to say anything else. They have not been peer reviewed!

Much of what we are talking about here is the sharing of resources and who controls the share of resources. Pensions regulators, or Parliament, or anyone writing something down and saying that x will be paid off in five years or two years or three years, it just cannot be done unless the economy sustains it. We have had political decisions affecting the intergenerational sharing. We have seen it in state pensions over the years, and there was a watershed on 11 June 2003, which made the employer debt on a buyout basis come into force. There was another political watershed on 6 April 2005, when pensioners' priorities under trust deeds were rearranged in respect of their future escalation. So, these sort of things happen. The PPF came into being, but, once again, the levy basis, which I think somebody has criticised as bearing very heavily on companies, is about the equitable distribution of the levy between those companies and funds which are well-funded and not at risk and those which appear to be at risk. You have

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to balance that with affordability and practicality, because those who are at the greatest risk cannot always get cover and borrow, etc., so that there has to be some element of cross-subsidy.

There was a view expressed that you could not get to full funding, whatever that is, after ten years; and, in any event, once that had been done, what was there for actuaries to do? Had the law been so stupid as to say that everybody has to have their pensions bought out in full after ten years? If it could be done, maybe that would be the end of the pensions actuaries.

However, what the law has said is that the target for funds should be based on prudent assumptions. In other words, those who were certainly pension Scheme Actuaries before 1997 and the ill-fated MFR, have to say to themselves: "Did we feel that we were using imprudent assumptions then? If we were not, what has changed?" Of course, economies change, interest rates are lower, and we know that longevity is increasing, so that the assumptions would not be the same, but what is the difficulty about coming back to prudent assumptions? That is all that the Act is asking for, that is all that the Directive is asking for.

Different governments throughout Europe have taken difference stances. Ireland's interpretation of prudence is buy out. The Dutch interpretation of prudence, if you invest in bonds, is 104.1%, approximately, of buy out. If you invest in equities, it is way up over 125% of buy out.

The regulator has certainly not defined prudence, but there was a recent statement, and from the Government repeatedly, that prudence is not buy out. If you look at the recent terms for Marconi and Ericsson, and the cash injection there, that was not buy out. It took into account the employer covenant. So, we are not talking about going for buy out. There is much scope for talking about prudence. Yes, it is coming in at a time when, unfortunately, there are many deficits against where funds would like to be at this time, and therefore it seems that there is a mountain to climb.

However, what the regulator is talking about is not where we are now, but where we are aiming to be. "Where are you aiming to be?" is the first question. Are you aiming to be at something prudent which is definitely not buy out? The second question is: "How quickly can you afford to get there?" There can be a debate between shareholders and members, and it would be very nice to be fully funded now, but have they still got money left for research and development to keep an ongoing business? It is very clear, as both the PPF and the Pensions Regulator have said: "The best security for members' pensions is an ongoing, viable employer."

The paper from the Pensions Regulator, published on 31 October 2005, and quoted from by Mr McKinlay, contained research which showed that about 65% of British industrial firms have free cash flow which would allow them to pay off their deficits on a prudent basis, not a buyout basis, in ten years. Some 25% would have some constraints on their free cash flow, and that is where there will need to be a debate if you are to balance member security and investment in the ongoing business. However, we acknowledge that the other 10% will struggle. Those who are struggling can only pay what they can pay. Whatever one decides that prudence is, and what the term is, it is not going to make more cash available to go on the table.

So, within all that there is much for actuaries to do to advise on the balance of risk, and certainly there is nothing in the paper quoted to suggest that there should not be equity investment or that there should not even be some limited anticipation of equity outperformance over bonds through an equity risk premium, on the condition that, if it goes the other way, there is some protection. Here we are talking about contingent assets, whether credit insurance, credit default swaps, escrow accounts, or whatever.

It seems to me that there is much interesting actuarial work in this. After another valuation three years down the line, after another recovery period which will go past ten years from now, and even when the pendulum swings, as it will swing, and funds get better funded, there is still the gap between prudential provisions and the long term. There are new benefits to be considered, with new, exciting designs.

I think that DC, where all the risk is on the member, is too simplistic a view. There are many hybrid designs where there is partial risk by the employer, which will need regulation and actuarial involvement.

So, I submit that the pensions actuary is alive, well, and has a good long-term future.

Mr A. M. Rubenstein, F.F.A.: I have one small codicil to add to Mr Low's remarks. I think that it would be a dangerous assumption to make that the Pensions Regulator would not have preferred a buyout in the Marconi/Ericsson case. Until the full details of that come out, we should assume that that would be the starting point, and where it ended up might have just been a compromise.

Mr R. S. Bowie, F.F.A.: I am, in general, an optimist by nature. This topic is no exception. My optimism has only one caveat to it, to which I shall refer later. My optimism is at several levels. First, if we take the current challenges, the ability of actuaries to understand the risks, to model the risks, and then to explain them, ought to give us a significant role for several years within the plans as they stand currently.

Next, Mr Low mentioned earlier the use of escrow accounts and similar ideas. Historically, pension schemes have been able to take risks, in part because, in a sense, the employer is providing the risk capital. The existence of the employer provides the risk capital, but it is an odd situation where the trustees rely upon the risk capital provided by the employer, but cannot get their hands on it. So, it has always been on the basis of trusting that the employer will come up with the goods. Equally, the employer does not want to part with the risk capital to the trustees because, if the risk capital proves successful and the risks which are taken on the back of it turn out to be fruitful, then the employer cannot get it back. So, you have risk capital, you have a need for risk capital, but the way in which trusts are structured means that the risk capital cannot be used in the most efficient way.

One of the challenges for actuaries must be to find ways of bridging that. Whether that is actuaries and actuarial firms or whether that is actuaries and others in investment banking firms, one way or another clever people will eventually manage to bridge that gap. Whether we are still called pensions actuaries when we play that role is not, to my mind, important. My first reason for optimism is, therefore, that there is a need, and I think that we have the skills to be able to meet that need.

The second reason for optimism is that there should always be people who need to save for retirement, and that we should assume this. I do not see why we should not adapt and be people to whom individuals can turn for help in their retirement planning.

Whether we fulfil that role as advisers to employers, because the convention remains that people will look to their employers to solve the problem, or whether people will look to other means to save for their retirement, I do not know, but we must adapt.

So, I am optimistic at two levels: firstly, in the DB situation which has been our bread and butter to date, provided that we adapt; and, secondly, in the new environment, provided that we adapt. That is my cautionary word. I am worried that, for too long, there has been too good a living from what has increasingly become compliance. For people of my age there is absolutely no incentive to change, because it will see us through to retirement.

It is encouraging that the average age of the audience is, I think, the youngest which I have seen at a Faculty sessional meeting for some time. Therefore, I hope that those who are much younger than I am will take the courage to do different things and break out of the mould. That would be my one caveat. Unless the next generation breaks out of the mould, the time horizon may not be as long as I think it should be.

Mr I. A. Farr, F.F.A.: I, too, am an optimist about the long term and the role of the actuary therein. I am encouraged by the long-term concept of the PPF. However, I am a little concerned about a short-term element of it: the calculation of the risk-based levy; the material consequences of the failure score; and the lack of transparency of that calculation by an agency which, so far as I understand it, is not regulated.

However, it must be good that the tragic cases which we have come to read about in the press, of companies becoming insolvent and people being left bereft of pension, will be things of the past.

I have been encouraged by the long-term nature of the actions taken by the Pensions Regulator, and, in particular, by the draft statement which was published recently. The one short-term issue on which I would comment is that one of the triggers concerning the prudence of the funding target is related to the cost of insured annuities, because, as of a couple of weeks ago, there are now no published 'rules of thumb' available to anybody in this room or anywhere else in the U.K. market. No-one really knows what, in practice, insurance companies will quote for bulk buyouts of different sizes, and, until that situation is changed, I think that basing a trigger on estimated annuity rates is something to be avoided. Obviously there is an issue there for Section 75 debts, which might even be more important.

I was encouraged by what Mr Low said. Indeed, what he said agreed with my reading of the draft statement; that there is much scope for actuaries to practise their professionalism, not to be actuarial mechanics interested in ticking boxes, but to engage with the Pensions Regulator and to demonstrate why the actuarial basis chosen by the trustees and the employer is as it is.

When we think of the PPF and the Pensions Regulator, we tend to be focussing on current DB schemes, many of which, of course, are closed to new entrants, and a growing number of which are closing to future service accrual. However, in my view we should lift our eyes and look over the horizon and think about what the future may look like, because, as has already been mentioned, the DC approach, by itself, is almost certainly not the answer for the vast bulk of the population when it comes to securing a reasonable level of long-term retirement income.

My vision of the future is one in which we have an enhanced Basic State Pension — I do not mind whether it is a citizen's pension or whether the current national insurance contribution rules change — but a basic pension of about the level of the minimum guaranteed pension linked, in future, to national average earnings, with contracting out and the S2P abolished. That is the first pillar.

The second pillar is the well tried and tested occupational pensions route. There have been two main problems with DB provision in the past. One has been the size of the benefit, which has generally been too large, and the other is mortality longevity risk. So, in the future, perhaps the way forward is for employers to be encouraged to provide much lower levels of DB, perhaps a low level of career average revalued; and with regard to mortality, why not, in this second wave of DB arrangements, have legislation which allows employers, in certain circumstances, when longevity is improving faster than anticipated, to cut back past service benefits, perhaps by increasing normal retirement age or by adjusting slightly increases to pensions in payment. What is wrong with that, provided that it is in legislation and that people know that this is the deal from the start? That is the second pillar.

The third pillar comprises DC arrangements, whereby individuals can decide to trade off consumption now against saving for the future, and I suggest something like that. Obviously there are many hybrid possibilities, but DB is really the only hope for the average non-financially aware person, which is 95% of the population, using the occupational pensions route if possible. Therefore, as a profession, we really have to work to try to make sure that the framework being established now is successful, not just for the current legacy of DB schemes, but also for that second wave which will come in the future.

Mr T. M. Ross, O.B.E., F.F.A.: We have all grown up believing that it is right that members should get their occupational pensions without fail — or, perhaps, other than in the most extreme circumstances. Many of us also believe that the returns from equity investment have been a very important ingredient in delivering the good levels of benefits which employers have provided at a cost which can be afforded. Also, we want it all without too much volatility in contributions.

My generation grew up in the belief that equities were a natural match for the liabilities of DB pension schemes. We now know, thanks to the work which was done in developing the recent accounting standard FRS 17, that equity returns and the benefit cash flows from pension schemes are anything but 100% correlated.

So, where are we? I think that the nub of it comes back to what Mr Bowie said, that we do need to take a long-term view on pensions. We do need equity investment; but can we cope with the associated uncertainties without the capital which employers may, in the past, have been unwilling or unable to provide?

It has often been said, recently, that pension funds are looking more and more like insurance companies, and indeed they are. Of course, life offices are required to have adequate reserves in with-profits funds, to the extent that they still exist, before they can invest materially in equities. Those which are weak are prevented from doing so. The equivalent of capital in the pension fund is the employer. Clearly, the identification and earmarking of the capital available from the employer should be undertaken at the time when the promise is made, not when it is due to be delivered, by which time the employer may not exist. Imaginative ways need to be found for earmarking resources for this purpose, without stifling capital investment in the employer's business.

Mr Farr suggested that it may be necessary to cut back benefits in some way in order to square the circle with some funds. That, indeed, may be true. It would be necessary, clearly, to effect legislation to permit this, but I suggest that members of private sector schemes would feel justly aggrieved if that legislation was enacted by a Government which seems distinctly incapable of effecting sensible measures to adjust the benefits of its own employees in the public sector. So, I would be very cautious about advocating that line. Perhaps, if it was conditional on appropriate action in the public sector, I might be more sympathetic.

I now turn to the higher levels of equity investment now backing U.S. pension funds. It should be remembered that accounting standards in the U.S.A. are rather different from those in the U.K. You may be aware of the case of a well known automobile manufacturer which was able to borrow a very substantial amount through the debt markets and place the money in its pension fund. The board made its own assumptions about the future returns on that money, and the difference flowed straight through to the bottom line. Thus, magically, a company which has difficulty making cars profitably produces very substantial profits, which, no doubt, richly enhance the performance bonuses of the executive management and the investment bankers who raised the debt. It was not necessarily a bad thing, because I suppose that it represented a risk transfer from the members of that pension fund to those who subscribed for the debt, which I believe has since been downgraded, but I doubt whether it enhanced long-term confidence in equity investment generally.

Anyway, these things are going to change. For a start, we may not like volatility, but I think that it has been amply demonstrated in the work done in the research behind FRS 17 that the nature of the DB funding is inherently volatile, and we should not pretend that it is not. We may like smoothing, but smoothing is just not realistic.

Sir David Tweedie, an Honorary Fellow of the Institute and Chairman of the IASB, has said that the logic of smoothing, and the formulae under the U.S. rules for doing it, are no more credible than taking the cube root of the distance to the moon and multiplying that by his shoe size. That is right. It is inherently a volatile arrangement, and that is why it does need capital behind it, and ways need to be found for identifying and earmarking that capital without necessarily receiving it in cash.

In my view, the new accounting standards and funding requirements are necessary. I think that many companies will take the long view, and continue with equity investment. However, they will now have to recognise the risks, and develop ways of providing capital in kind as well as in cash to make such a strategy possible. A whole new world may open up for pensions actuaries.

Mr M. A. Pomery, F.I.A. (Institute President)**:** I agree with the speaker who referred specifically to the fall in interest rates in the late 1990s, and I believe that that was the principal cause of the problems which we have today, allied to the increases in longevity, about which the CMI told us at around the same time.

Other things which have caused the problems which we have with final salary schemes now are the progressive switch, over a long period of time, from discretionary benefits to making them guaranteed, and also the increasing maturity of schemes.

Some time ago, when I was advising pension schemes, the cash flow was hugely positive, and, as far as the eye could see into the future, it was going to remain positive. There would always be more money coming in from contributions than was going out in benefits. We have seen that change dramatically.

What that has meant is that the long-term funding position which we advised schemes to adopt now falls well below the level of buyout. When a company fails the members lose their pension rights, with catastrophic consequences for the individual members involved. The Government has reacted to that by introducing a compensation scheme. Once you do that you have to have rules around short-term funding levels, otherwise you get a moral hazard, where the good employers, which fund their schemes properly, end up paying for the poor employers who do not.

I would say to those earlier speakers who argued that we, as actuaries, should take the long-term view and should resist this desire to take a short-term view which we see other people taking, that we have somehow to explain how we can do that in such a way that we still protect the members against short-term vagaries.

It would be nice if interest rates rose again and everything returned to a happy state, where we no longer have deficits on a buyout basis, but I do not think that we can just sit around and wait for that to happen. It would be nice if we could turn many of those guaranteed benefits back into discretionary benefits. It is interesting that the way in which the PPF has gone about things is to cut back on the post-retirement increase amount which they are going to cover. However, I do not think that that is going to happen.

So, am I pessimistic about the long-term view? No, I do not think that I am. Those of us who have been around a long time can remember when DC schemes outnumbered final salary schemes before they went out of fashion. I think that the switch back now from final salary schemes to DC schemes has built into it the seeds of its own demise. I think that what goes around comes around, and I can foresee a time when people will get disillusioned with DC schemes. I think that the way forward then will not be to go back to final salary schemes, but to look much more closely at designs of pension schemes which share the risk, as hinted at by Mr Farr. So, I see the future, not as final salary schemes, but as risk sharing DB schemes.

On equity investment, I think that the fundamental point about which we lost sight is that equity investment involves a risk/reward trade-off, and that it will only work if those people who get the reward are also the ones who take the risk. It does not work if equity investment means that: when it does well the employer cuts his contribution; and when it does badly the members suffer. There has to be a proper alignment between the risk and the reward.

Mr Potter: The end of the long term for pensions actuaries is a subject dear to my own heart, because I hope to see my own future as a pensions actuary stretching a couple of decades at least into the future. I agree with Mr Bowie on the proviso which he made to prevent us slipping into obscurity. However, I do think that times have really changed. One of the things with which I back that is that employers are saying to us that they will never make this mistake again. That is all very well. Perhaps they will; but I think that the chief executive, about whom I referred earlier, who said: "We talk about pensions more than ever and we certainly never talked about them 15 years ago", was probably talking about a number of other things on that agenda, such as corporate governance and risk management, about which they also did not talk 15 years ago.

So, times have moved on. It is for that reason that we need to remember the old saying: "The past is not necessarily a guide to the future." I agree with some of the previous speakers that we need to adapt our skill set closer to that of the corporate finance community, and be very active, as pensions actuaries, in finding the pensions solutions, both for the current generation and for the future generation of employees.

Mr McKinlay: I am surprised that no one has said anything about governance. Regarding the framework, the key change which I have seen influencing people's behaviour has been largely driven by regulation. Markets have had an impact, and also the independence of the Bank of

England, but the way to change how trustee boards think about the long or the short term has to be, in part, through regulation. Presently, I see a wave of regulation which is forcing short-term thinking, whether it comes from accounting or whether it comes from other regulations and what the PPF says.

If the trustee governance framework was freed, then you might see DB schemes taking precedence again. However, considering the way in which it now stands, I do not think that it is going to happen.

Mr Sharp: I found the comments made earlier about where the risk capital is coming from to support the long term interesting. In the past, that risk capital was in the pension fund, because pension fund funding levels were so much above what were then solvency levels, merely because the benefits were so much lower.

If we do get into a situation where the employer assets supporting the business are important, I think that that will call for something of an extension of our skill sets. I think that our skill sets are going to have to change. To try to look in a more positive way, and perhaps other actuaries can develop this, but a growing part of the profession has been in general insurance, which surely is about, in a sense, the shorter term, and is much more to do with guarantees than we are used to on the pensions side. We might see some cross-overs there.

The President (Mr H. W. Brown, F.F.A.): This has been a very interesting discussion. The panel set the scene very well, with a very wide ranging series of topics, although some — like governance — have not really been discussed to any great extent. Nevertheless, we have had a wide ranging and good discussion. Thank you very much to all of those who contributed. Thank you also to the panel for putting together their presentations, and, indeed, for the comments which they have made. Please join me in thanking the panel for their contributions.