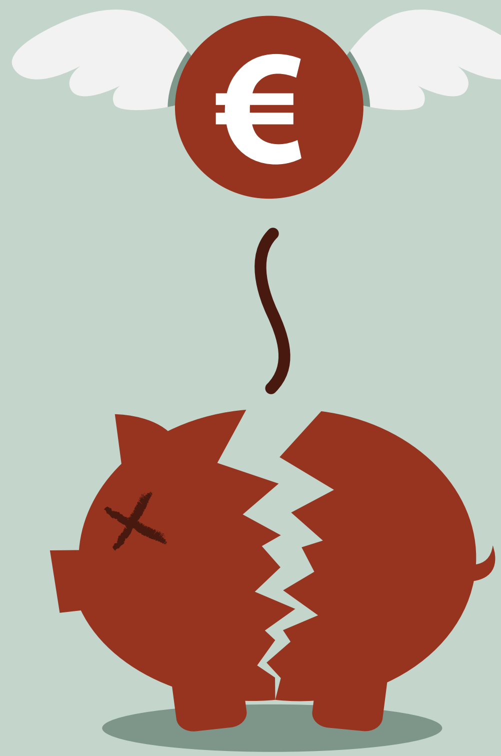

SCHEME MANAGEMENT

Tackling deficits

European countries each have their own way of handling DB scheme deficits, but two common approaches appear throughout – collaboration and consolidation. Louise Farrand **finds out more**

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European countries with a history of providing defined benefit (DB) pensions face many similar challenges. Life expectancies have increased and a golden age of investment growth withered and died. Companies' abilities to afford their commitments have looked less and less certain, irrespective of where their border lies.

Yet contrasting philosophies have evolved when it comes to evaluating the severity of scheme deficits. For instance, the Netherlands takes a tough approach to investment risk, forbidding pension schemes to increase their risk when their funding level drops below 105 per cent.

The UK might look less cautious by contrast. Yet it is more risk averse in other ways. For instance, UK pension schemes are required to make more cautious longevity assumptions in their deficit forecasting.

"The professionals in this country *[the UK]* have got ahead of things and been very prudent in figuring out how long people will live," explains Willis Towers Watson senior consultant, David Finn. "The applied lifetime of a member might look like 91 for a UK member, with the equivalent company or pension plan in the Netherlands showing a life expectancy of 85 or 86. Across borders, there is not that much difference in people working for a similar company. Rather in the UK, prudent assumptions were applied."

The UK is also strict when it comes to making companies honour their pension obligations, however long it takes. As JLT Employee Benefits director Charles Cowling points out: "The UK has a pretty hard guarantee applying to all pensions. You can't default, you can't reduce benefits, you can't get away from the fact that what you have committed to in the rules, you have to pay for. We have a Pension Protection Fund that provides a safety net and regulation to make sure that pensions are properly funded. All of those things force a more robust approach to funding."

He caveats: "However, in the UK we still have our significant problems. Funding levels are not as good as people would like and there's a serious possibility of defaults and people falling into the PPF."

The UK's PPF is the envy of some of its neighbours. "There is no PPF equivalent in Ireland. There are funding rules but in fact there was a default quite recently in Ireland that caused quite a bit of angst and demands for toughening up, not dissimilar to the political fallout we had in the UK over BHS. So the Irish are looking at whether they can do some significant strengthening to avoid another example of a default causing members to lose out," explains Cowling.

In the UK and Ireland, pension schemes are required to fund their commitments and if they cannot afford to, they must come up with a plan to bridge their funding gap. In Germany, this is not the case.

"Germany also has a strong level of DB pension provision but in Germany there is not a statutory requirement to advance fund pensions," explains Finn. "In the UK or Ireland there is a tax efficiency to advance funding pensions because of the tax efficiency on contributions and investments. Therefore, to have an approved plan status you need to have advanced funding. In Germany, there is no such advantage or compulsion to advance fund."

Whilst Germany has a raft of final salary-like pensions provision, historically no assets sat behind these promises, although this is changing, says Finn. "Cut to today in Germany, there is a much stronger practice of advance funding, but that is motivated by companies' own decisions rather than something that is required by regulation. There is much more autonomy on how much to put into plans and how to invest, unlike the trustee system we have here *[in the UK]*."

The Netherlands is also less adamant that companies meet their DB promises, whatever the cost, than their UK counterparts. "The way most DB pensions in the Netherlands are effectively constituted, they are not absolutely guaranteed. In the past two or three years in the Netherlands, pension schemes were looking to stop giving pension increases and even talking about reducing benefits. That is done in a much more collaborative way than would be possible in the UK or Ireland. They find it quite extraordinary that a pension scheme could bring a company down. Over there, that is inconceivable – people will find a solution and if benefits need to be cut back then they will be cut back," explains Cowling.

The Dutch even have a special model for this type of conversation: "Polder. It means collaboration," says Netherlands-based State Street Global Advisers senior defined contribution strategist, Jacqueline Lommen. "They talk and talk until they have a compromise. It takes a long time but it means we have broad agreement once it is agreed on. We have stability because of polder and it means we can make these large reforms."

Bridging the gap

Whilst countries differ in their DB funding requirements, elsewhere, ideas are converging. Parallels between investment and governance strategies can be drawn, as schemes increasingly compare notes.

Investment strategies are becoming more sophisticated, as professionals take over from laypeople. This has been happening for a while in the Netherlands, says SEI head of institutional sales in the Netherlands, Jasper Streefland.

"Our market is sophisticated; the people on investment committees all have CFAs and a lot of experience and they are complemented with an investment consultant," says Streefland.

"There is more sophistication and professionalism in how pensions are run," agrees Finn. "In the UK, that means that particularly the small- to medium-sized funds are looking to fiduciary management. A group of trustees meeting every three months can't manage money as effectively as professionals, particularly in a closed fund, end-game situation."

In Germany, this professionalisation trend manifests in multinationals hiring their own investment teams. Finn cites Siemens, Nestle and Novartis as three examples of large companies that are managing their own pension obligations internally, having recruited professionals. "I characterise it as professionalism, not lay people round the table. It is a much more rigorous way of deciding what to invest in and then having made those strategic decisions, making a decision," he adds.

Consolidation of assets, in the name of achieving better governance and fee reductions via economies of scale, is another cross-European trend. "There is lots of pressure on fees – pension funds consolidate or liquidate so that there are fewer RFPs in the market but they are greater in size," says Streefland.

Parallels can be drawn with the UK local government pension scheme reforms, which have required funds to pool their assets in the interest of greater efficiency and economies of scale.

In future, as defined contribution (DC) develops, consolidation may get even more pronounced and investment strategies still more unified, thanks to the burgeoning trend of cross-border pension schemes, says Lommen. "This is on the way," she predicts. "There are already around 80 of these cross-border pension funds, of which 20 or 25 are larger ones. Their creation is often triggered by DB plans having to change into DC, for instance."

A major advantage is quality enhancement, she says. "If the corporate can combine their pension arrangements then they can select the best consultant, the best asset manager – in the end you get a much better pension solution. For example, they can introduce lifecycle in all countries. In southern Europe at present, this is less common but because you combine it you bring best practice to other countries."

Challenges remain

Collaboration and consolidation may be improving in Europe, but even the Dutch concept of polder is not a panacea. "There's a lot of public distrust in the DB pensions system in the Netherlands", concedes Lommen.

Low interest rates remain a perpetual problem across Europe. Cowling is critical of forward rating, a way of discounting pension liabilities, which he says makes them seem artificially favourable. "It's a bit like someone trying to go on a diet and trying to change the weight on the scales. All of those things are plasters, really, to fix a problem that won't go away until interest rates start to rise."

Fundamental problems remain in DB deficit-ridden countries. As Cowling points out: "There's no easy way to say, 'we don't have enough money and we need to reduce benefits'. Even though the Dutch have a more flexible regime, it is still a challenge to manage member expectations."

Until interest rates rise and the funding situation improves for DB schemes, deficits will remain at the forefront of European policymakers' minds. ■