Pensions Policy:
What are the liabilities and how should government and business respond?

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The Slides follow the text

Good evening.

It is a pleasure and a privilege to be on the same panel as Lord Turner and Alison O'Connell, discussing what is clearly one of the most challenging social policy issues that is facing us today. Both Lord Turner's Commission and the Pensions Policy Institute have made significant and thoughtful contributions to the debate, and I, for one, have been interested to hear their reflections following the publication of the White Paper.

As the Chairman has said, I am presently the Chief Executive of BP Pension Trustees, which undertakes all the trustee activities for BP's main UK pension fund. Prior to that, though, I held a number of senior financial roles in BP, and it is from these two perspectives – of a trustee responsible for an open final salary pension scheme, and of a sponsor considering the impact on its financial circumstances – that I want to add to the debate.

[I cannot resist saying in passing that there is a particular irony in my giving this presentation at the Royal Society. When I was doing research in theoretical chemistry it was, of course, one of my ambitions to speak in this building one day. Well it is an ambition achieved, but I could little have imagined that the topic would be pensions.]

As I say, BP has an open final salary scheme. It has something like 70,000 members, of which nearly 20% are current employees presently. With assets of some £12bn currently, it is more than fully funded on an FRS17 basis. This makes it somewhat exceptional, because there is no doubt that there has been a trend away from final salary schemes over the last ten years. And many of the schemes that remain face considerable financial challenges.

Some commentators have attributed this to irresponsible companies taking contribution holidays: in turn others respond by attributing the problem to the removal of ACT relief and suchlike. Whilst this is doubtless good knockabout, I would venture to suggest that the sources of change have been many, but in essence they amount to a fundamental and profound systemic shift in the environment in which companies are considering their remuneration and pensions offer.

In Chapter 3 of the First Report of the Pensions Commission there is an excellent annex which details the rise and fall of final salary schemes. Among the many factors cited are:

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- statutory improvements in benefits
- real improvements in life expectancy
- the economy in general, eg trends in inflation
- the investment cycle in particular, notably asset values and interest rates
- developments in actuarial and accounting practice, which arguably are engendering greater caution
- and, of course, regulation.

These changes have had the cumulative impact of imposing real economic costs on schemes.

Firstly, because the cash outflows have increased – improved benefits are being paid for longer.

Secondly, because administration and regulatory costs have increased – the increased focus on pensions and the additional compliance dimensions, all have a direct price – and we have to add the additional time burden on those charged with responsibility for pension schemes.

And finally, there are very real indirect costs imposed by the loss of flexibility, an aspect to which I will return.

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In BP's case, the impact of all these changes is illustrated by comparing the valuation of our liabilities over the past eight years. At the end of 1997, we valued our liabilities by discounting projected cash flows using a government bond interest rate – we now use AA corporate bond rates in line with accounting standards. At the time the liabilities were valued at just over £6bn: on the same basis they more than doubled by the end of last year.

Note too that, notwithstanding the falls in 2002-3, the assets rose too – from around £9.5bn to over £12bn – but the asset cover, as calculated, fell by 50%. The BPs of this life can stand the strain because the liabilities are a relatively small proportion (10%) of market capitalisation. But as we know, they are more significant for small and medium-sized companies.

But wait a minute. Is this a fair representation of the problem? And if we look at it in a different way, might we draw some different conclusions? I have mentioned already the developments in actuarial and accounting practice. In turn they have influenced regulatory principles, within which schemes are expected to operate. And in turn too, this is starting to influence trustee behaviour.

What we are talking about, of course, is a specific instance of 'what gets measured, gets done'

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The valuation methodology we are dealing with has at its heart the view that pension liabilities are debt-like, and that they should be simply consolidated with other corporate obligations when trying to establish the financial health of the sponsoring enterprise. Hence we compare the value of projected payments to beneficiaries, discounted using an appropriate bond yield, with the values of assets we see in markets. This is an apples and pears approach, based on founding presumptions which are not without controversy.

It is true that the obligations are more like inflation-linked debt as a result of legislative changes, but they have some characteristics which are clearly not debt-like. And we have the buffer provided by the assets, for management of volatility. By reducing the discretion to manage such volatility, for example by leading and lagging contributions, we create the risk of over-funding – tying up corporate assets which could be used for investment. Bear in mind that it is a lot easier to put money into a scheme than get it out, a weakness in the present legal framework. Flexibility has real economic value. Taking it away destroys value.

What we can say about the models - which are the foundations of corporate scheme valuations, accounting representations of pensions obligations, and regulatory policy - is that by collapsing what is a sophisticated problem of risk assessment into a single number, in the way present models do, we lose critical information and thereby we create an outcome which is

(a) likely to overstate the problem, and
(b) produce a result which is unstable.

Let me illustrate these points in two simple ways.

Firstly, it is interesting to look at the projections of cash flow – both assets and liabilities – and to understand the dimensions of risk which influence them.

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This picture is a variant on this theme. I have projected the value of future cash flows from accrued liabilities within the BP scheme, using the FRS17 accounting basis. I have not included future liabilities so the value declines as members age until eventually, of course, there are no more obligations to meet. I have compared the projection with values of assets, with different overall return assumptions, and assuming that cash is transferred each year to meet annual outflows. A number of things are apparent:

* The lifetime of this fund, even if we accrue no new obligations, is 50 years. How many companies are able to incur debt-like obligations of that longevity, in other contexts?
* If assets earn returns consistent with AA bonds, their value tracks the liabilities as one would expect.
* If assets earn 2% per annum less than AA bonds, the scheme still has cover for over 25 years – that provides a lot of flexibility to recover.
* If assets earn 2% more than AA bonds – and here I should point out that the BP scheme is largely invested in equities which on average earn more than corporate bonds – look what happens. Even when the scheme is paid out we still have assets of over £10bn, such is the impact of compounding.

This is a simplified example, and there are many other factors to consider, but I hope I have illustrated just how broad the range of outcomes might be. And it is not all bad news. So when we see the newspaper reports of black holes of £60 - 70bn, do at least question the basis on which such numbers are founded.

There is a second factor – volatility. If we stick with the funding level, we are relying on a number that is inherently volatile.

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To illustrate this point, I have plotted on this next slide, stock market indices over the last nine months and index-linked bond yields, which some argue are the right reference for liabilities.

There are three phases. Whilst stock markets were rising very strongly over last year, bond yields were falling, raising the value of liabilities. Trustees saw limited improvement in their funding position. Note that this sensitivity to interest rates is a function of discount rates, not real increases in liabilities. Nevertheless, this has led some commentators to propose hedging solutions which match this exposure. Whilst I don't believe that many trustees have adopted such a policy, there was certainly speculation in January that they might – which had the consequence of driving yields lower, and liabilities higher – a self-defeating spiral, with potentially material cost for schemes which were inclined to follow such a policy, and with real market impact.

But then yields reversed, whilst the stock market continued its rise. This led The Times in a slightly tongue-in-cheek article on its Business page to conclude that the pensions crisis was over – even though the liabilities were still the same. And finally, markets fell back, by 10%, whilst yields fluctuated, suggesting that in part, at least, the crisis was back. The latest Deloitte's estimate still suggests that funding deficits for the FTSE100 have halved since January, though.

I am teasing somewhat but this background highlights some real dilemmas for regulators and trustees

Firstly a brief look at regulation.

This has two dimensions: The Pensions Regulator and The Pension Protection Fund. Their activities are framed within the 2004 Pensions Act.

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The Pensions Regulator's purpose is defined as:

- to protect benefits of members
- to reduce the risk of claims on the PPF
- to promote good administration.

The breadth of the resulting activity is considerable. In the context of this presentation I would emphasise two aspects:

(a) the Scheme Funding principles, and

(b) the framework for Notifiable Events.

In commenting on these areas, I want to acknowledge that David Norgrove and his team do try to listen to the feedback they receive, but they are, of course, bound by the decisions of Parliament. David has said that he wants to be a 'referee not a player' but as we saw a couple of weeks ago, referees can influence outcomes more profoundly than the efforts of players. In particular, while he has tried to avoid the setting of rigid standards, he has sent signals which place a lot of weight on prudence.

And how do we judge prudence? Well, by the same measurement systems that I have commented on. And in some corporate restructurings, the need to crystallise the pensions position, rightly or wrongly, is inevitably acting as a new constraint.

The question we should ask is how we judge costs and benefits – the trade off between competitiveness and the protection of beneficiaries that this regulatory framework has been designed for.

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While not of equal significance for companies like BP, the PPF should not be spared from equivalent scrutiny.

Again, we must recognise that Lawrence Churchill and his team are implementing the intent of Parliament. But what we have is a flawed structure. By trying to set up a self-contained pool limited to eligible defined benefit schemes, it has introduced an element of cross-subsidy which I do not recall seeing in regulatory frameworks in such a pronounced way.

The fact is that some schemes are simply uninsurable in any conventional sense. It is the risk-based element which determines 80% of the levy payable. As I said in commenting on the consultation documents, there are real issues with the factors and the way they are combined in the calculations, which could undermine confidence, especially if a scenario were to eventuate whereby the quantum of the levy was much higher than today.

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Lastly, where does this leave the trustees?

The goalposts have been fundamentally moved for them too. They are no longer simply managing a flow of contributions, investments and benefits, but are being asked to make sophisticated financial judgements, and to challenge the very sponsors of the schemes they have been appointed to administer. Adding this agency dimension, on behalf of the regulators, pushes the concept of a trust to its limit.

So what does this mean for the role of companies in the pensions provisions mix going forward, and what are the questions we need to resolve?

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1. My experience suggests that responsible companies continue to believe that contributing towards employee pensions is an important part of their remuneration and benefits package. If circumstances are supportive they will continue to do so.

2. Financially-strong companies will sustain their final salary schemes for a good while yet, and in particular will honour accrued entitlements.

3. There is no doubt that costs have risen – both because of real increases in benefits, but also because of increased overheads and the loss of financial flexibility.

4. This conclusion is robust, but we need to be wary of the impact of our measurement approach. Ideally, we should look at the funding position, investment policy and sponsor strength together over the foreseeable future, with an objective assessment of risk, and avoiding bias in selection of specific parameters, such as discount rates.

5. In the circumstances described, companies are bound to reconsider their pensions offer to judge its cost-effectiveness. When put alongside changes in employment patterns, competitive pressures and employee preferences, we should expect further decline in employer commitment to final salary schemes [through

   - closures to new entrants
   - modifications to benefits
   - increased employee contributions
   - modifications or closure to future accruals
   - and possibly transfers to the financial marketplace.]

6. I cannot believe the regulatory framework for final salary schemes will continue in its present form for ever. Indeed, it may be transitional, as a means of catalysing financial recovery for those schemes for which this is possible.

7. And the strains on the trust-based model, while tolerable at present, could be amplified if, for example, there is a serious economic downturn.

Such conclusions should be considered in the context of the role that the corporate sector should play in the economy.

Companies are not natural holders of the risks created in sustaining the long-term living standards of their former employees. They have no natural sources of competitive advantage in so doing. So we get back to the White Paper.

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In discussion you might want to consider:

- What is the right role for companies and similar institutions in future?
- What roles should the State be playing, e.g.
  * in basic pension provision
  * in underwriting or moderating risk in occupational schemes
  * in creating savings institutions?
- What role should financial markets play, given their sources of advantage, and
- Where does this leave the individual
  * when employed
  * when retired?

In short, what is the ‘deal’ for citizens of the UK given what we have learnt so far?

Thank you.

Pensions: What are the liabilities and how should government respond?

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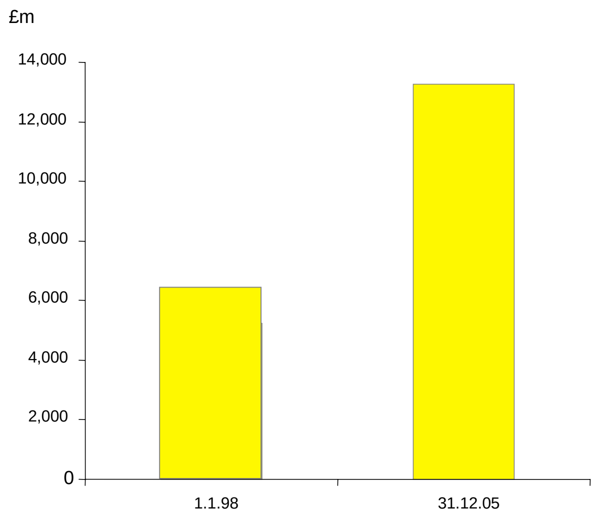
Pensions: The Changing Landscape over 10 Years

- Statutory improvement in benefits
- Real improvements in life expectancy
- The economy in general, e.g. inflation
- The investment cycle – asset values, interest rates
- Developments in actuarial and accountancy practice
- Regulation

[Ref. First Report of the Pensions Commission: Chapter 3, Annex]

BP Pension Fund – Change in Past Service Liabilities



152% **Asset cover** **97%**

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Valuation Proposition

- Pension liabilities viewed as debt
- Consolidate with other corporate obligations
- Liabilities: discount projected payments using appropriate bond yield
- Assets: mark to market
- BUT theoretical challenges
  - overstatement
  - instability

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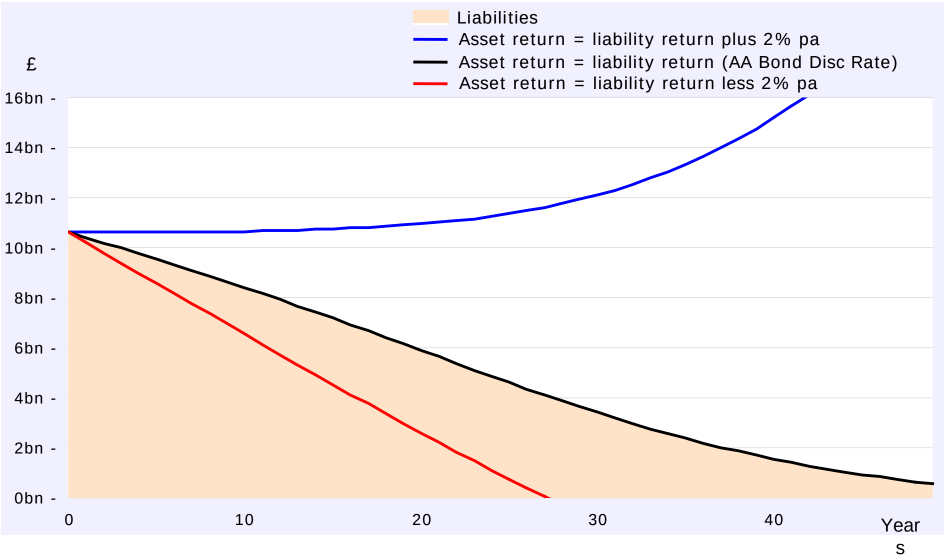
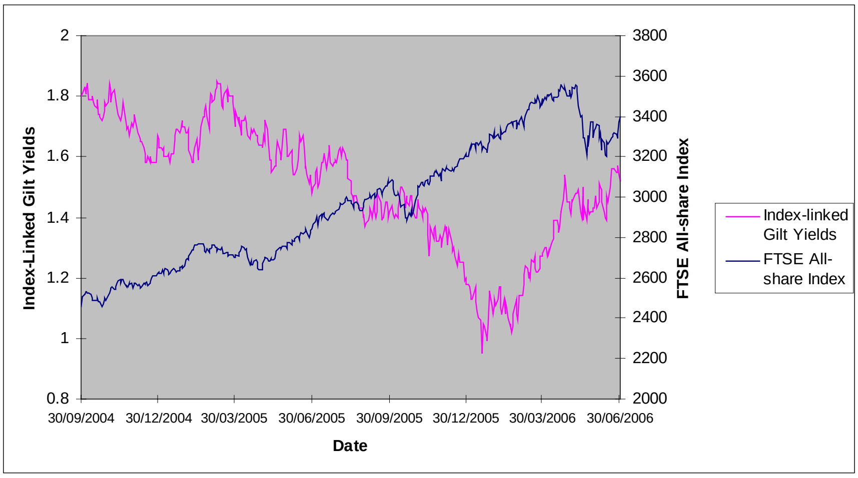
BP Pension Fund –
Projected assets and liabilities



FTSE All-Share Index vs Index-linked Gilt Yields



Regulation: The Pensions Regulator

- Purpose
  - To protect benefits of members
  - To reduce the risk of claims on the PPF
  - To promote good administration
- Key aspects
  - Scheme Funding
  - Notifiable Events
- ‘Referee not a player’

Regulation: Pension Protection Fund

- Purpose:

  To pay compensation to members of eligible defined benefit schemes
  - where qualifying insolvency event, and
  - insufficient assets for PPF compensation
- Issues
  - structure of insurance pool
  - risk-based levy calculation

Trustees

- Traditional view
  - receive contributions
  - invest moneys
  - pay benefits
- Have now added
  - sophisticated evaluation of sponsor risk, funding level and investment strategy
  - challenge element

Where does this leave companies?

- Continuing commitment to pensions as part of remuneration package
- Strong companies will stick with schemes, and honour accrued entitlement
- Costs have risen
  - real increases in benefits
  - increased overheads
  - loss of flexibility
- Measurement issues
- Changed context => continuing decline in final salary arrangements
- Future of regulation?
- Future of trust model?

Some questions for the future

- What is the role for companies and other sponsors?
- What role should the State play
  - in basic pension provision
  - in underwriting or moderating risk
  - in creating savings institutions?
- What role should financial markets play?
- Where does this leave the individual
  - when employed
  - in retirement

What is the 'deal' for UK citizens?