Investment Management

Perspectives

The future of pensions: A global overview JULY 2004

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The future of pensions: A global overview

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Globally, there is much discussion about the 'pensions time-bomb'. What is this and what are the implications for governments, financial services institutions and those reaching retirement age? This edition of Investment Management Perspectives explores* some of these issues.

Foreword

by Simon Jeffreys

Improved longevity and declining birth rates across the developed world, and to a lesser extent in developing countries, have resulted in an ageing population. The pace of change varies, but even countries in the intermediate stages of development, such as Mexico, have experienced lower birth rates, as well as longer life expectancy, due to rising prosperity.

The implications for retirement systems are profound. Several countries face a contracting workforce over the next 20 years, beginning with Italy, Japan, Sweden and Switzerland. Even Australia, Ireland and the US, which should enjoy relatively high labour-force growth rates in the near term, will see the pace of expansion halve during the 2010s.

A contracting labour force (assuming steady productivity growth) may lead to slower economic growth, and the growth in living standards may stagnate. Retirement systems are highly political, as they determine which parts of the population will bear the brunt of any slowdown.

The pressure on the provision of pensions is of immense importance to global financial markets and to the investment management and insurance industries. There will be both opportunities and challenges presented by the 'pensions time-bomb'.

Pension systems take many forms, but in every case they are the mechanism by which a country's wealth is allocated between retirees and workers. Their principles, structure, disclosure, governance and management will therefore come under intense scrutiny in the years ahead.

In our first article, Andrew Evans explores some of the issues affecting the worldwide pensions industry. In response to the trends outlined above, for example, governments are encouraging people to continue working past the age of 65, and are taking steps to make pension savings more attractive.

Regulatory oversight of pensions is rising, as public trust has suffered from a series of scandals in the insurance and investment industries. Louise Sylva outlines the recent developments in pension-scheme governance, arguing that, given the potential impact of schemes on their corporate sponsors, as well as on the companies in which they invest, professional disciplines are essential.

International Financial Reporting Standards (including IAS 19 on pensions) will be mandatory for EU-listed entities from 1 January 2005 and will also be adopted in countries beyond the EU from 2005. The transition will be difficult for some companies. Brian Peters suggests ways of managing the implementation of these standards and considers some

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fundamentals of pension cost reporting that need to be thought through over a longer time period, such as asset valuation, measurement of liabilities and choosing a discount rate.

The recent three-year bear market in equities has sharpened the debate on asset allocation. John Shuttleworth argues that finance theory gives fresh insights into the murky world of pension fund asset allocation.

Michele Weldon provides an overview of alternative investments – hedge funds and private equity vehicles – and their growing popularity among US pension schemes. Before considering alternative products, trustees should gain a complete understanding of all the relevant pension laws and their own responsibilities under these laws, and be prepared to conduct thorough ongoing due diligence over investee funds.

The European Union's directive on pan-European pensions, meant to be introduced into member states' national legislation by 23 September 2005, is the culmination of 12 years of effort. In the article titled "Negotiating the maze of pan-European pensions", Sonja Barendregt-Roojers explores the benefits of pan-European schemes and outlines the pooling methods currently being used by multinational companies.

Ellen Kelleher considers the opportunities for pension fund administrators as companies adopt human resources portals (e-HR portals), which will integrate all HR functions. Medium-sized and large pension funds could become e-HR operators, focusing in the first instance on direct remuneration and benefits.

Finally, a variety of retirement systems exist in Asia, and David Richardson describes how Singapore has recently made sensible changes to its Central Provident Fund in order to cushion economic downturns. The resulting structure may offer a way forward for other countries around the world.

Retirement systems will come under increasing pressure during the next decade, putting pension-fund practitioners in the spotlight. Changes in regulation and governance, as well as ongoing debates about asset allocation, will present major challenges to plan sponsors and investment managers.

Please use the enclosed reply card to give us your views on this issue of Perspectives, and tell us the topics you would like us to cover in the future.

Simon Jeffreys

by Simon Jeffreys, Partner, simon.jeffreys@us.pwc.com, tel: +44 20 7212 4786

With global retirement assets now worth over US $15 trillion, developments in the pensions arena will have a dramatic impact on financial markets, as well as on companies and individuals. Governments, driven by demographic and financial pressures, are shifting the task of supporting retirees to the private sector. This trend could have significant implications for investment managers, presenting opportunities and challenges, both in the products they offer and the pressure to keep fees to a minimum.

The future of pensions: A global overview

by Andrew Evans

In a range of countries from Italy and Germany to Japan and Singapore, an ageing population and low birth rates have increased the pressure on state pension schemes. Governments are studying and, in some cases, implementing a variety of solutions such as reducing state benefit, raising the retirement age and shifting the burden to private providers.

Occupational pension assets grew strongly in the mid to late-1990s, driven by rising equity markets and healthy returns from bonds, as interest rates continued their decline from the 1980s. Asset growth exceeded liability growth, and many schemes enjoyed surpluses. In some cases, pension funds expanded at a faster pace than the sponsoring company's core business.

March 2000, however, marked the beginning of a three-year slump in global equities. The combination of declining asset values and rising liabilities resulted in under-funding. Surpluses have turned into deficits at a time when governments expect occupational schemes to support people during retirement. The problem is particularly acute in continental Europe and selected Asian countries.

Asian retirees have historically relied on their children for support, so there has been little interest in government and occupational pensions. Low birth rates, however, mean that this pattern cannot continue. In Singapore, for example, the current birth rate of 1.2 to 1.3 is well below the replacement level of 2.1.

Fortunately, however, Asian state pensions tend to be funded, unlike most continental European schemes, which are pay-as-you-go (PAYGO). The exceptions in Asia are Japan and Korea, whose relatively high state benefits are, similar to Europe, financed by younger workers via PAYGO systems. In Japan, the ratio of working people to retirees (the dependency ratio) is projected to fall from 2.2 in 1990 to 1.7 in 2025. Japan's occupational schemes, most of which are defined benefit (DB), are massively under-funded.

Even so, governments worldwide face budgetary constraints, and private companies are reluctant to shoulder open-ended responsibilities for retirees. As a result, several clear trends have emerged, many of which have implications for investment professionals.

In Europe, birth rates are below 1.2 in Italy and Spain, and below 1.4 in Germany. One solution is to attract foreign workers, thus reducing the dependency ratio, though this may be politically controversial. In order to compensate for low fertility, some countries would have to increase their current immigration rates by several times their current levels: Germany by 2.5 times, France by 4.4 times and Japan by 11 times. These countries may not even be able to attract skilled foreign workers, if taxes (to fund pensions, among other things) are high and citizenship is not offered.

Australia, on the other hand, accepts around 100,000 immigrants a year. The country's current fertility rate is 1.7, and the population will not have the same age structure as Europe until 2020. In the US, fertility rates are at replacement levels and immigration is high, so the population will remain considerably younger than those of most other developed countries.

Even so, governments worldwide face budgetary constraints, and private companies are reluctant to shoulder open-ended responsibilities for retirees. As a result, several clear trends have emerged, many of which have implications for investment professionals.

Governments will encourage people to work past the age of 65, and will also permit more flexibility in post-retirement investment.

In 2000, labour-force participation for the over-65s ranged from 1.3% in France to 22.7% in Japan. Participation rates are linked to the average retirement age: 58.8 for Frenchmen, compared with 66.6 in Japan. Such differences can have a major impact on government finances. In Belgium, where men retire at 58, the average retiree costs the pension system 60% more than in Iceland, where men work until age 69.

For many governments, therefore, the key question is no longer "How do we fund people's pensions?", but "How much output has the country lost because this person is not working"?

Australia is considering ways to encourage such employment. The Government has recently introduced changes which provide fund members with greater flexibility in accessing their retirement benefit, even if they continue in part-time or casual employment with their employer. If you are over 65 and have a part-time job, some suggest that your earnings should be excluded from the state-benefits means test.

Pensions must be significantly more attractive than other forms of savings.

Raising the retirement age might nevertheless have negative effects in countries with high unemployment or other structural constraints. In Japan, where salaries are based on age, business costs would rise in line with the average age of the workforce, and companies would struggle to compete internationally.

Post-retirement investment is another area of reform. In Australia, people receive a lump sum when they retire, but, unlike other countries, this money is rarely invested in an annuity. Instead, people make an investment of their choice, and can draw down the money (the original amount plus the returns) each year until they reach 80 or later. If their investment declines in value, the amount they are allowed draw down each year falls. If they lose their investment entirely, they must rely on state benefits, which are less generous than those in continental Europe.

In the UK, annuities are popular, and the government is considering dropping the requirement that, in certain cases, they had to be linked to inflation. Inflation-linked annuities provide lower starting pensions than non-linked products, and also deliver a smaller lifetime payout to all but the longest-lived pensioners.

Another proposal in Australia is to set a limit, say 50 cents on the dollar, to the amount of an individual's retirement savings and earnings the state can claw back, hence encouraging prudence. The government believes that, due to enhanced incentives to work and save, the proportion of retirees receiving full state benefit will fall from 54% today to 33% in 2050, with the percentage receiving no state benefit at all rising from 18% to 25%.

Pensions must be significantly more attractive than other forms of savings.

Tax incentives on pensions are particularly important in Europe since pension contributions must be locked away, providing no flexibility and pensions cannot be passed down the generations.

The same is true of Australia, where only high earners (on high marginal tax rates) have a real incentive to take out pensions. The average worker needs stronger reasons to divert money away from current consumption and/or other financial products into retirement savings. The Government has now expanded its co-contribution plan where low to middle earners can receive an annual contribution of up to AUS $1,500 from the Government for a personal contribution of $1,000 per annum towards their retirement savings.

Scandals in the pensions and investment industry have stoked public mistrust, which will result in tighter regulations governing pension funding, accounting standards and disclosure.

Some governments have actually been reducing the tax advantages of pensions. In the UK, for example, Chancellor Gordon Brown abolished ACT (advanced corporation tax) credits on share dividends, which had benefited pension schemes. He also reduced the attractions of ISAs (a personal savings product) by abolishing share-dividend tax credits, but the remaining incentive to buy pensions is still not enticing people away from other products.

In Russia, middle-class interest in investment vehicles is rising, and pensions must compete. In Asia, by contrast, there are few savings products competing for investors' money. In addition, Asian pensions are not locked up until retirement. If an employee leaves a company, he/she will receive a cash benefit (stipulated by government), representing his/her pension contributions.

Regulatory oversight of pensions is rising, as people have lost confidence in the investment/insurance industry.

Scandals in the pensions and investment industry have stoked public mistrust, which will result in tighter regulations governing pension funding, accounting standards and disclosure.

Employees of the US company Enron, for example, lost their pensions when the company went bankrupt in 2001. Equitable Life, which was the UK's second largest life insurer and its largest mutual insurer, reneged on guaranteed payments to policyholders, and around 800,000 customers lost money. The US Securities and Exchange Commission's investigations into mutual-fund trading and brokers' research have also made people wary of the investment management industry.

In order to regain public trust, firms must have a simple charging structure, explain investment returns clearly, and communicate efficiently with members or clients. Investors must also be protected by a sound compensation scheme, or they will keep their money in the bank.

The US safety net, the Pension Benefit Guaranty Corporation (PBGC), which is allowed to invest in equities, revealed a record $11.2 billion deficit in January 2004. The PBGC is now shifting more of its assets into bonds.

Responsibility for financing retirement will continue to shift from governments (and increasingly companies) to individuals, via DC schemes.

In the UK, actuaries have suggested that the new Pension Protection Fund must meet rigorous supervision and solvency criteria, or run the same risk of failure as the pension schemes it is meant to support. In Australia, a compensation scheme reimburses investors who have lost money under certain circumstances (e.g. fraud). In many countries, such as the UK and Australia, company pension plans are not allowed to invest more than 5% in the company's own shares.

In Russia, companies are supposed to establish pension funds that do not invest in employer-related enterprises, but there are still several exemptions to the law. Having said this, many pension funds and asset managers are moving towards best practice, which includes greater transparency. This could involve AIMR/GIPS guidelines, SAS70 and FRAG21/94 reports on controls, and audits under international financial reporting standards.

Asians also lack confidence in their investment management industry, due in part to the lack of independent advisers. Middle to low-income earners tend to deal only with bank salesmen, who push their own products and are paid commissions. Also, in many Asian markets there is not well developed capital markets and trusted corporate governance.

Singaporeans have been allowed to make their own investment decisions within the Central Provident Fund (CPF) framework since 1994, but over 90% of these self-directed investors have earned lower returns than the CPF's guaranteed minimum rates of 2.5% and 4% p.a. There is clearly an opportunity for investment professionals to help trustees choose a sound range of options for their members. In Australia, defined contribution (DC) trustees tend to give people a few default options, ranging from 100% cash to 100% equities, as well as more esoteric choices, such as vehicles for socially responsible investing.

Cost is a further issue. In Singapore, any locally registered fund is a candidate for CPF investment, resulting in wide bid/offer spreads and high fees. Reducing the number of options would not only assist investors, but also enable trustees to negotiate better terms with fund managers.

In countries that have, in the past, focused on DB, a move to DC might require employee approval, possibly through works' councils or union representatives. Negotiations may be difficult, resulting in legacy agreements that differ from the arrangements for new joiners.

Responsibility for financing retirement will continue to shift from governments (and increasingly companies) to individuals, via DC schemes.

In Europe, occupational trustees are likely to favour a blend of DB and DC. The DB element will provide a basic, guaranteed level of retirement income and reduce people's reliance on the state, while the DC tranche will permit people to top up their savings if they wish. In the UK and Australia, almost all DB schemes are closed to new members, and any start-up schemes are likely to be DC.

Singapore has, in the past, required companies and employees to contribute 20% of salary to the CPF, with a contribution ceiling of around three times average earnings. However, Singapore has recently moved into technology industries that are more volatile than its previous specialities such as shipbuilding, and the government realises that earnings and retirement benefits must be more flexible.

CPF contribution rates were reduced in October 2003 and will decline significantly during the next two years. Cutting the contribution rate during downturns is not always the answer, however, since companies are affected in different ways by economic cycles. Private occupational plans, particularly DC schemes with fluctuating contributions (the Chilean model), are seen as the way forward in both Singapore and Hong Kong. This should result in opportunities for the investment management industry.

In China and India, pensions are mandated by central government, administered by the provinces (China) or states (India), and funded by companies and employees in a DC arrangement. Contribution rates are fixed, and the money is invested in government bonds. Any new voluntary schemes will probably be DC.

In countries that have, in the past, focused on DB, a move to DC might require employee approval, possibly through works' councils or union representatives. Negotiations may be difficult, resulting in legacy agreements that differ from the arrangements for new joiners.

New schemes established in countries such as Russia and Chile have tended to be entirely DC. Will governments conclude that these plans provide sufficient retirement income, or will there be a partial shift back to DB?

Governments may tinker with pension policies, but long-term solutions will involve major changes to labour laws (to increase participation rates and reduce unemployment) and product markets (to promote innovation and competition).

In the US, around 80% of large companies still have DB schemes, based on either final salary or career average. Most firms also permit voluntary contributions called 401K. Unlike the UK, however, the US does not allow people to contract out of the government scheme, so the level of DB benefit provided by companies is relatively low. The overall cost of a US plan is around one-third that of UK companies' and employees' joint contributions to their final-salary schemes.

It should be noted that these plans also permit members to borrow from their pension savings, i.e. they are accessible! That makes them a very different form of savings.

Within DB, there will be a shift away from final-salary to career-average schemes.

Career-average plans have so far been popular in only a few countries, such as the Netherlands (for industry-wide schemes), Switzerland (until the minimum BVG requirements were introduced), the US and Canada.

Crucial to the design of career-average plans is how a person's previous years' salaries are indexed. If the index is price-based or a weighted blend of prices and earnings, these schemes should be less costly for employers than those based on final salaries.

Finland, for example, changed its mandatory occupational plan a few years ago. After a transition period, pensions will be calculated on an employee's average salary during his/her final ten years of service (rather than on his/her final two years, as had been the case).

Salaries will be revalued for all years (except the final two), based on a 50:50 blend of the Consumer Prices Index and the National Average Earnings Index. Finland also tightened its conditions for early retirement, a move that some analysts believe will achieve even greater cost savings than the switch to career-average.

Investment management fees will continue to come under pressure.

Public scepticism regarding investment fees in some countries has been fuelled by press reports of fund managers' large compensation packages. This, combined with government ceilings on charges for certain products (such as the 1% cap on UK stakeholder pensions), puts pressure on the margins of all products.

...the pressures on government pension schemes will intensify by 2010, when the oldest baby-boomers begin to leave the workforce, thus reducing their countries' productive capacity.

Investment firms can manage index-trackers for a 1% fee, but it is difficult to run active funds on this basis. Low fees also make it unprofitable for the industry to provide advice to buyers, so people are not encouraged to take out pensions.

In summary, the pressures on government pension schemes will intensify by 2010, when the oldest baby-boomers begin to leave the workforce, thus reducing their countries' productive capacity. Retirement systems are likely to spark political debate, particularly in the absence of structural economic reform, as they will be the means of allocating slower improvements (or perhaps even declines) in living standards across the population.

Governments may tinker with pension policies, but long-term solutions will involve major changes to labour laws (to increase participation rates and reduce unemployment) and product markets (to promote innovation and competition). Only then will productivity improvements offset the fall in the supply of labour, so that all segments of society can continue to enhance their quality of life.

by Andrew Evans, andrew.evans@uk.pwc.com, tel: +44 20 7804 3887

Pension schemes can significantly influence the health of their corporate sponsors, as well as the governance of companies in which they invest. It is therefore imperative that the schemes themselves are effectively governed, either by a trustee board or an equivalent structure. Legislation and expectations around the globe are moving in this direction.

Good pension scheme governance: Does it matter?

by Louise Sylva

Effective pension scheme governance has two components: the structures and processes for operating and managing the scheme, and the effectiveness of the trustees' decision-making process. Communication to all stakeholders, including the regulator, the employer and members, must also be professional.

The linchpin of good governance is vigorous debate. The scheme's governing body must critically analyse the issues, use all available information, and investigate exceptions and any evidence of failure in the scheme's processes.

A pension scheme's financial position and credibility can have an important impact on its corporate sponsor, particularly when the scheme is a defined benefit (DB) plan. Schemes also affect the companies in which they invest, through their ability to influence governance and management decisions.

Impact of a pension scheme on its sponsor

The reputation of a UK company is linked to that of its pension plan, due to full disclosure under enhanced accounting standards, the Pensions Bill (introduced to parliament on 12 February 2004), and a growing focus on governance. Under new international accounting standards, a scheme's surplus or deficit will be much more apparent from the financial statements. A significant deficit may affect the company's credit rating and attractiveness to investors.

In Canada, the federal pension regulator 'stress tests' pension plans and puts those of low quality on a watch list. The impact can be serious. Air Canada, which is now in bankruptcy protection, claims that the pension regulator's demands contributed to its demise. The Office of the Superintendent of Financial Institutions (OSFI) concluded in early 2003 that the airline's pension plans were imperilled by funding deficits. The OSFI demanded that Air Canada end its contribution holiday, make a $200 million contribution immediately and file a new valuation report. At the time, Air Canada estimated its pension deficit to be $1.3 billion.

Pension schemes can, through their shareholdings, have a significant impact on companies. In many OECD countries, privately managed pension plans are among the largest institutional investors, holding almost 30% of OECD financial assets in 2000.

Pension issues have impeded the airline's restructuring plans. Trinity Time Investments, for example, pulled back from a deal that would have injected over $600 million into the company, because the airline unions refused to exchange their DB plans for defined contribution (DC) arrangements.

In Australia, the regulator requires DB scheme sponsors to eliminate any deficit over a specified period, typically three years. A term of over five years is rarely granted. In the UK, the Pensions Bill currently before parliament will require trustees to 'obtain the agreement of the employer' on how a scheme's liabilities should be calculated and on the speed at which any deficit must be cleared. When the trustees and the employer cannot agree, the regulator may decide. Trustees must also be 'conversant' with certain defined items and have the 'knowledge and understanding' of matters that enable them to do their job properly.

This legislation, combined with the UK regulator's advice to trustees to get the scheme fully funded as soon as possible, means that trustees may push the employer for the highest possible funding rate, one that may exceed the employer's willingness and capacity to pay. Trustees, wary of being sued by members, are unlikely to take a soft line with regard to their funding obligations.

DC plans do not directly affect company balance sheets, but a poorly governed scheme can still harm employee morale and a company's standing in the community, thus posing reputational risks. Governance failures may also create legal liabilities for plan sponsors if, for example, members claim that the scheme failed to provide appropriate or adequate investment opportunities or investment education. If the benefits of DC schemes do not match retirees' expectations, people may try to recoup any perceived losses from the scheme and the employer.

The problems of DC plans are particularly present if there is no member investment choice or fund choice. If there is member investment choice, members can invest their money that complements other savings or desires and take greater ownership of the results.

Impact of a pension scheme as an investor in a company

Pension schemes can, through their shareholdings, have a significant impact on companies. In many OECD countries, privately managed pension plans are among the largest institutional investors, holding almost 30% of OECD financial assets in 2000.

The UK government is currently reviewing the voluntary adoption of these recommendations. Initial findings indicate that pension schemes have failed to implement some of the measures,...

It could be argued that trustees have a responsibility to members and beneficiaries (and to the shareholders of the sponsoring employer for DB schemes) to take an active interest in the companies in which they invest. They should ensure that they receive the highest possible return, in view of the risks, and should therefore see that the companies are well managed and financially sound.

Pension schemes can influence a company's management directly and also by voting. A scheme's ability to do this will be influenced by the rigour of its own internal governance. A poorly governed scheme cannot effectively influence the governance of companies in which it invests.

Standards of pension scheme governance

In March 2001, the Myners Review of Institutional Investment in the UK (Myners) made several recommendations to improve pension scheme governance.

Summary of Myners recommendations

Effective decision-making	Skills, knowledge, structures, information and resource needed; critical evaluation of advice; business plan
Clear objectives	Overall vision to take account of all relevant issues
Focus on asset allocation	Identification of priorities
Expert advice	Contracts for advice should be open to competition
Explicit mandates	Delegated responsibilities to be clearly understood
Activism	Managers should have an explicit strategy on activism
Appropriate benchmarks	No systematic bias to sub-optimal results
Performance measurement	Evaluation of the performance of trustees, advisors and managers. Measurement of the performance of the fund.
Transparency	All strategic and operational matters to be documented
Regular reporting	Openness with scheme members

Pressures on trustees to raise governance standards have resulted from these legislative developments, as well as from the recent three-year bear market in equities and the changes to international financial reporting, under which a company's financial position is affected by its pension scheme's results.

The UK government is currently reviewing the voluntary adoption of these recommendations. Initial findings indicate that pension schemes have failed to implement some of the measures, particularly those concerning the assessment of the performance of advisers, delegates and trustees.

Figure 1: What is good pension scheme governance?

PricewaterhouseCoopers recently surveyed large UK pension schemes to obtain a view of the current state of governance. Our results confirmed that some Myners recommendations have not yet been implemented. Trustees seem committed to good governance, but are finding it difficult to introduce change across the industry.

Several other countries are taking steps to improve governance. The Australian parliament has introduced a requirement that superannuation fund trustees be licensed. Trustees will, among other things, be required to meet certain standards of skill and knowledge and to implement a risk management plan for their scheme. In Canada, each scheme must have a policy for identifying and addressing conflicts of interest.

In the Netherlands, pension scheme boards must have sufficient knowledge to carry out their responsibilities. Schemes must assess the board members' knowledge in eight areas, including governance, risk management, investment and performance assessment. At least two board members must have sufficient knowledge of each area. Any deficiencies must be corrected, and an education plan submitted to the regulator.

Pressures on trustees to raise governance standards have resulted from these legislative developments, as well as from the recent three-year bear market in equities and the changes to international financial reporting, under which a company's financial position is affected by its pension scheme's results.

Areas where pension scheme governance should improve

In order to improve governance, schemes around the world should:

- Have a clear governance policy
- Identify all risks and introduce risk management
- Ensure that the scheme's trustees (or the relevant governing body) have the required knowledge and skills
- Develop and implement objectives and performance assessment for trustees (or the relevant governing body)
- Develop and implement performance assessment for advisers and delegates
- Develop principles for recognising and addressing conflicts of interest.

Well-managed companies generally follow these policies as a matter of course, but we do not yet demand the same standards of pension schemes. Given the influence of pension schemes, however, such standards are essential. Legislation and expectations around the globe are moving in this direction.

by Louise Sylva, louise.c.sylva@uk.pwc.com, tel: +44 20 7804 5399

The move to International Accounting Standards, mandatory for EU-listed entities from 1 January 2005, will have profound implications for users of company financial statements and all those involved in their preparation and audit.

International accounting for pensions: Asset or liability?

by Brian Peters

As capital markets become more global, the lack of comparability between the existing nationally based standards causes wasted time and effort and increases the risks of poor investment decision-making. Users are demanding change and the European Commission wants to see commonality among member states. International Accounting Standards (IASs) have existed for many years, but until very recently they were often the least prescriptive of any standard, seeking to accommodate most national approaches. The International Accounting Standards Board (IASB) has recently been given much needed fresh impetus and has embarked on an ambitious project to review all standards ahead of 2005. 33 out of 39 are well on track; the revised pensions standard has some way to go.

The existing pensions standard, IAS 19, is arguably more deficient than most other IASs because there are several alternative interpretations allowed in some areas leading to wide variations in reported profits, for example in the spreading of surpluses and deficits. Even the underlying objective may need to be reconsidered given the increasing emphasis on the balance sheet than has until now been the case.

Imminent changes

Understandably, the present emphasis of the IASB is understandably to provide the appropriate framework to meet the EU requirement for IAS compliance by listed European entities in 2005. The US remains somewhat sceptical of how robust IASs will be, and needs to be kept fully on side if the momentum towards international corporate reporting is to be maintained. There is so much on everyone's plate at present that the most likely pensions revisions before 2005 look to be just a few tweaks to the existing IAS 19, as set out in the Exposure Draft issued late April 2004. One of the changes will be to allow the immediate recognition of actuarial gains and losses to be kept out of the P&L, a treatment that present IAS does not permit. If implemented, at least entities already having adopted FRS17 in the UK will not need to revert back to a spreading approach.

IAS 19 uses a market basis for asset measurement and some feel that a smoothed basis would be more useful to users of financial statements. This doesn't seem to be the majority view of the users themselves.

At present, IAS 19 would require Defined Benefit (DB) accounting in subsidiary companies participating in group pension plans even where there are cross-subsidies of costs between the various employers. This would lead to balance sheet entries that would be largely meaningless and difficult for directors to justify. Another IAS 19 amendment proposed in the Exposure Draft is to permit subsidiaries to use Defined Contribution (DC) accounting under certain specific circumstances. Several territories, including the Netherlands, will welcome this change.

These changes to IAS 19 won't address the more fundamental issues – are market values appropriate for long term assets and liabilities such as pensions? If so, is a true market value obtainable? Is it right to anticipate future salary increases when assessing pension obligations for accounting purposes, when such increases are far from guaranteed? Is discounting at the AA Corporate Bond rate clearly appropriate or just a convenient pragmatic solution without sound foundations? Is spreading of surpluses and deficits helpful to users to avoid excessive volatility or an arbitrary smoothing mechanism distorting the balance sheet?

Asset valuation

IAS 19 uses a market basis for asset measurement and some feel that a smoothed basis would be more useful to users of financial statements. This doesn't seem to be the majority view of the users themselves. A market basis is seen as providing transparency to investors. So, notwithstanding its inherent volatility, investors are able to make judgements based on more reliable information; market values are disclosed so people can compare one entity with another.

Recognition and measurement of pension obligations

The projected unit credit actuarial method is presently used in IAS to calculate the Projected Benefit Obligation (PBO). This includes estimates of future increases to salaries and pensions.

The IASB considered, in the Basis for Conclusions of IAS 19, whether estimates of future increases in salaries, benefits and medical costs should only affect the measurement of plan assets and liabilities when they are granted, on the grounds that future increases are future events and/or such estimates are too subjective.

Future salary growth, however, is usually not a company commitment at a given balance sheet date and is not recognised elsewhere in the accounts as a company liability.

The IASB, however, concluded that the assumptions were used not to determine whether an obligation exists, but to measure an existing obligation on a basis which provides the most relevant measure of the estimated outflow of resources. Thus, IAS 19 requires measurement of pension liabilities to take account of estimated future salary increases, but ignores future income from investments held to fund such payments.

Future salary growth, however, is not usually a company commitment at a given balance sheet date and is not recognised elsewhere in the accounts as a company liability. The employer can grant pay increases but is under no obligation to do so. Many would argue that the accounts should recognise what has been promised, not what may occur in the future. This would imply an Accumulated Benefit Obligation (ABO) basis.

Increasingly too, entities are considering total reward. Increases in reward may be made which are not pensionable, for example bonus plan enhancements.

The use of the ABO seems to be supported[1] by the IASB's own framework that sets out definitions of assets and liabilities. This states "A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably". As future salary growth is not normally a present obligation, arguably it should be excluded from the calculation of pension-plan liabilities. This approach would reject the IASB contention that future salary increases are included as a measure of an obligation that has already been incurred. Instead, the ABO would be used as the measure of plan liabilities.

If only life were that simple. Unfortunately, there is not a complete consensus internationally at present on a definition of the ABO. For example, in the US, which uses the ABO for a minimum liability calculation, two different approaches are allowed.

The most logical basis would be to include full revaluation of the benefit entitlement assuming employees left at the balance sheet date, using statutory or established practices in each territory. Where benefits increase, for example, fully in line with price inflation from the date of leaving service to the date of commencement of the pension, price inflation should be included in the ABO. There would need to be a charge to P&L within operating profit for the full capital cost of the past service benefit when salary increases were granted, but this would only be the difference between the salary

[1] *Paragraph 91*

Other assumptions about the future are also made in the calculation of both the PBO and ABO, such as the rate of future increases once benefits are in payment.

increase actually granted and any increases already incorporated within the ABO eg. price inflation.

Some may consider that this could be overly volatile. This would surely be the case where there was a history of, say, collective bargaining agreements taking place less frequently than annually or where bargaining agreements included salary increase commitments over more than one year. Some years may show a credit whereas others could show a large debit. This may not be an insurmountable problem but would certainly need to be considered further.

In principle, the P&L would show the true past service cost as a charge to profits in the year when the increase was granted. For entities with regular annual review dates, the year-on-year past service costs would be broadly consistent unless salary inflation departed markedly from assumed price inflation. Even if it did, perhaps it would be reasonable to assume that some dampening effect on reported company profits would occur if increased costs were passed on, at least in part, in price increases to customers.

Future increases to pensions in payment

Other assumptions about the future are also made in the calculation of both the PBO and ABO, such as the rate of future increases once benefits are in payment. These may also only be discretionary and it could be argued that they cannot be measured reliably and should therefore be excluded from any calculation of pension liabilities.

IAS 19 requires that future benefit increases should be assumed only if they are set out in the terms of the plan (or result from any constructive obligation that goes beyond the formal terms) at the balance sheet date. In practice, constructive obligation has been widely interpreted, and future pension increases are usually included even where they are discretionary. This approach makes sense, not least because, unlike future increases to salaries of current employees, the entity will derive no economic benefit from increases granted to former employees. It would seem, however, that the present IAS 19 requirements are consistent with an ABO basis for the measurement of liabilities that includes an allowance for estimated increases to pensions in payment.

If future salary growth is excluded from the measurement of plan liabilities, it may be logical that a discount rate closer to a risk-free rate should be used, as the scope for variation in the liabilities for matters within the employer's control has been reduced.

Discounting future liabilities

The choice of the most suitable discount rate is influenced by the practical difficulty of finding a rate that best takes account of the risks associated with the plan's liabilities. The present AA corporate bond rate is a rate that encompasses the risk-free rate (for the time value of money) and a small risk premium (for the risk associated with the plan's liabilities). This is an arbitrary rate specified for expediency, recognising that the employer has some control over future salary increases and, sometimes, pension increases too.

If future salary growth is excluded from the measurement of plan liabilities, it may be logical that a discount rate closer to a risk-free rate should be used, as the scope for variation in the liabilities for matters within the employer's control has been reduced.

There is a rationale that interest rate swaps provide a better discount rate for valuing liabilities determined on an ABO basis. An interest rate swap is a contract between two parties to exchange one set of interest rate streams for another based on the same underlying notional basis (usually an exchange of a fixed rate for a floating rate). There are several reasons for using a swap-based discount rate:

- Largely as a result of recent trends towards more robust collateral arrangements, swap spreads over government bonds have contracted substantially. Consequently, swaps have become a better measure of risk-free rates than bonds.
- The swap market is more liquid than government bonds. It is therefore likely to be less exposed to distorting influences.
- The swap market has better breadth, both in terms of duration (swaps trade out to about 80 years) and intermediate points.

Spreading versus immediate recognition

IAS 19[2] states that "in the long term, actuarial gains and losses may offset one another. Therefore, estimates of post-employment benefit obligations are best viewed as a range (or 'corridor') around the best estimate".

Under IAS 19 it is possible to defer recognition of actuarial gains or losses indefinitely; only amounts in excess of 10% of the greater of plan assets or benefits obligations must be amortised, and over a period not longer than the average remaining service

[2] *Paragraph 95*

The IASB seems willing to listen, although it is likely now to be 2007 or 2008 before any substantial revision to IAS 19 takes effect.

lives of employees. Amortisation is inevitably arbitrary smoothing with no theoretical justification other than to dampen volatility. It provides users with a less volatile P&L but leads to primary financial statements that hide the real position and are more difficult for investors to interpret. It can also be difficult for less experienced users to interpret, for example a balance sheet prepayment (i.e an asset) may be shown, yet the plan may have been in deficit for many years.

The IASB's position

There are three main issues which merit further consideration when calculating a plan's liabilities:

- whether plan liabilities should include an allowance for future salary growth, and
- whether a discount rate based on swap yields is an appropriate basis for discounting the resulting liabilities, and
- is spreading of surplus/deficit justifiable?

The IASB seems willing to listen, although it is now likely to be 2007 or 2008 before any substantial revision to IAS 19 takes effect. If the objectives and transparency of pension costs in corporate reporting can be made clearer, perhaps the understanding of pensions in corporate boardrooms will be enhanced. That would be good for everyone.

What are the implications for companies

The forthcoming adoption of IAS 19 will be a major change for many EU companies, even more so in those territories and for those entities that have not yet adopted the existing IAS 19 on pension costs. Many pension plans will need to be valued for accounts purposes for the first time, so actuaries will see an increase in demand for their services. Strong and effective coordination across territories within a major multinational company will be required. The track record from the companies in the UK and Netherlands already adopting the existing IAS 19 isn't encouraging – several very late adjustments were needed due to a lack of familiarity of the issues involved. Several plans previously thought within existing territorial standards to be DC will need to be accounted for as a DB plans under IAS.

The timeframe for the transition should not be underestimated. Work to identify which plans are DB under IAS 19 needs to commence as soon as possible. Some of the

The indications from companies already adopting IAS 19 are that pensions will have a much higher profile in boardrooms than previously.

required data may not even exist and financial systems may need updating. And don't forget that comparative (2004) figures will be needed in 2005's accounts. Indeed, for a company with a calendar year end, one of the most important figures will be the 31 December 2003 surplus or deficit, as this determines the adjustment to the company's opening reserves.

Of course, the potential for misunderstanding when any major change takes place will apply here. To guard against this, all parties involved will need to prepare users of financial statements for the implications, briefing analysts and anticipating the potential questions which scheme members may raise. Financiers, credit rating agencies and market makers must also get to grips with the new corporate reporting.

But it will be in the boardroom where the greatest need for education will arise, briefing both executive and non-executive directors. The indications from companies already adopting IAS 19 are that pensions will have a much higher profile in boardrooms than previously. This in itself will present challenges to the group pensions director or manager, but their profile and role should be significantly enhanced. To leave it all to the company accountants is a recipe for disaster.

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by Brian Peters, brian.s.peters@uk.pwc.com, tel: +44 20 7212 3353

Pension fund asset allocation is a science based on finance theory, not an art. The failure to accurately assess risk means that equity-oriented strategies only appear to result in cheaper pensions. £100 of equities is worth the same as £100 of bonds, namely £100. Pensions are bond-like but not perfectly so.
The residual, non-bond-like risks are neither positively nor negatively correlated with the returns of any other asset class, so trustees who wish to minimise the variability of their funding level, and who have exhausted the possibilities of bond matching, should build diversified portfolios.

Pension fund asset allocation: A UK perspective

by John Shuttleworth

The origins of most financial disasters can be traced to human error or greed, and often both. The sorry mess of Anglo-Saxon pension funds is no exception. The people in charge – trustees – should have aspired to dullness, as fiduciaries are meant to do. Instead their behaviour took three forms: cultists, ostriches and, as the deficits deepened, gamblers.

The equity cultists bet their shirts on the stock market, worshipping the totem that equities are safe in the long run (a false god). As markets tumbled, the ostriches stuck their heads in the sand and did nothing, paralysed. The gamblers, minus their shirts, proceeded to bet their trousers, in the erroneous belief that stormy stock markets today must mean sunny performance tomorrow (a mathematical howler).

Every trustee knows that insurance companies buy bonds to match their pension liabilities, but the average UK pension trustee holds less than 30% in bonds. In fact, trustees do not even bother buying bonds to match their pensions in payment, roughly 50% of their total liabilities. Why this disrespect for logic?

The trustee who wishes to minimise variability in his/her funding level, and who has exhausted the benefit of matching, should therefore build a diversified portfolio.

The UK Treasury believes that trustees lack investment expertise. In a very British attempt to protect the innocent, parliament will therefore mandate that trustees must have 'knowledge and understanding'. But how will this work? A few hours of training each year cannot give part-time amateurs the skills needed to make complex investment decisions on billion-pound portfolios. Trustees must not only learn finance theory but, far more difficult, they must also unlearn what they thought they knew.

The trite explanation for UK trustees' infatuation with equities is that many believe that £100 of equities is worth more than £100 of bonds. Presented with a list of investment options, trustees simply select the one (equities) that has the highest expected return, ignoring the fact that this higher expected return is merely the probable reward for risking a possible loss.

Having said that, trustees have always known that they should not put all their eggs in one basket, so they did have a small allocation to bonds and, before they lost their reason in the 1990s' bull market, an allocation to property. It is often forgotten that, at the beginning of the 1980s, UK pension funds had nearly 20% in property. Back then, with the 1974 crash still in mind, trustees did attempt to diversify risk. Sadly, the fact that equities slump from time to time is a lesson that each generation must learn anew.

First principles

Pension liabilities tend to resemble a portfolio of bonds. A known series of cash flows (fixed or inflation-linked) can be perfectly reproduced ('matched') with a bond portfolio. The bonds are chosen so that their coupons and redemption proceeds exactly equal each year's cash flows. As a result, it does not matter what happens to interest rates or inflation. Other investments, by contrast, are risky. It is a mathematical fact that pensions are bond-like, but this continues to be challenged by many trustees.

Pensions are bond-like, though not perfectly so. The part of pension liabilities that is not bond-like comprises the residual risks, such as unbudgeted pay rises and unexpected longevity. If non-bond investments are held at all, then ideally they should be positively correlated to these residual risks. These risks, however, are not obviously positively correlated with any available investments. Intuitively, zero correlation (neither positive nor negative) seems likely. The trustee who wishes to minimise variability in his/her funding level, and who has exhausted the benefit of matching, should therefore build a diversified portfolio.

Figure 1: The table below presents the characteristics of the main asset classes

	The ideal diversifier	Equity public	Equity private	Property	Hedge Funds	Commodities
Correlation with the lowest risk investment (long bonds)	high	low	low	low	varies according to type	low
Correlation with other investments (i.e. those that are not long bonds)	low	low	low	low	low	low
Volatility	low	medium	high	medium	high	medium
Liquidity	high	high	low	low	high	high
Costs	low	medium	high	high	high	low
Transparency/reliability of performance measurement	high	high	low	low	medium	high
Efficiency of market	high	high	low	medium	low	high

Trustees routinely do what no civil engineer would ever do: ignore the worst 5% of possible outcomes.

The perils of asset/liability modelling

Pension practitioners are not known for their obedience to the rules of logic, but even so, one of the stranger developments of the 1990s was trustees' use of pseudo-science – in the form of black box asset/liability modelling (ALM) – to justify their stock market bets. Or was it black art? History will not be kind to trustees who have inspected ALM's tea leaves and divined an optimal equity/bond split, such as 60/40 or 80/20. How did they conclude this? Like a tedious book on modern philosophy, understanding ALM requires so much effort for so little insight.

ALM abuse highlights the dangers of amateurs using powerful statistical tools. Examine the pitfalls. Trustees routinely do what no civil engineer would ever do: ignore the worst 5% of possible outcomes. If you view the world with one eye covered, of course it looks different. Risky investments appear less risky than they actually are. Magically, £100 of equities seems to be worth more than £100, but a ton of feathers must weigh the same as a ton of lead.

This failure to accurately assess risk means that equity-oriented strategies appear to result in cheaper pensions. It would be nice if this were so, but it is nonsense on stilts. Trustees should be guided by their common sense. If a model allows properly for risk then the deficit will be the same, regardless of the equity/bond split.

An asset/liability model can only tell trustees three things. First, it shows that a risky investment (say, equities) has an upside that is as valuable as its downside is costly. Obvious perhaps, but it is a sign of maturity in financial matters to realise that the precise size of the equity risk premium does not matter – it is merely compensation for equities' greater risk.

Second, and far from obvious, an ALM can tell trustees that the least risky portfolio is not 100% bonds but, for the typical pension fund, about 90%. Having only 75% in bonds, however, can seem attractive. Pensions are not perfectly bond-like. Risk does fall when one has more than 75% in bonds, but the reduction is often marginal and may not justify the smaller expected return. Risk can actually rise when one has more than 90% in bonds, because residual risks, such as longevity, cannot be hedged by bonds.

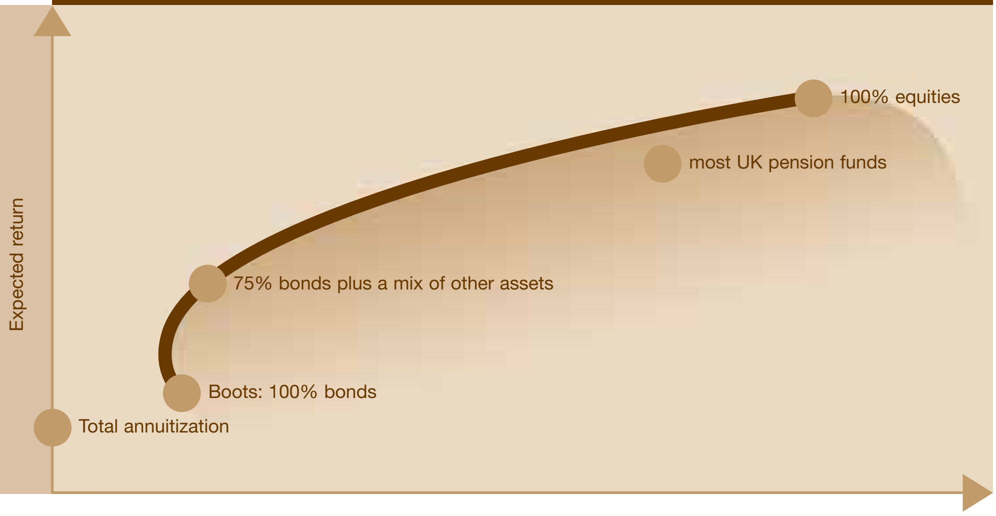
The third benefit of ALM is that trustees can rediscover Harry Markowitz's great insight of 1952 (made when the maestro was only 25 years old): combining asset classes that are weakly correlated (equities and property, for example) lowers the risk without

Figure 2: Most UK pension funds have inefficient investment strategies

The shaded area depicts where the various mixes of assets can be found.

The brown line is the "efficient frontier". There is no asset mix above it.

Below the efficient frontier, it is possible to find an alternative asset mix that is less risky but with the same expected return. Investors want an asset mix on the efficient frontier.



Risk (for example, the probability of having insufficient money to pay the promised pensions

The shape of Markowitz's chart depends crucially on the choice of risk measure. According to tradition (as opposed to logic), the standard measure is the variability of the investment return. For pension trustees, however, variability is less of a worry than the possibility of very poor results.

damaging the expected return. Therefore, the part of one's portfolio that is not in bonds should be in a mix of assets. Here is Markowitz's efficient frontier, compared with the position of most UK pension funds.

Trustees can take three easy steps to reduce the variability in their funding levels. First, bond portfolios should have more inflation-linked and longer-duration securities. Second, equity portfolios should be globally diversified, rather than biased towards the FTSE All-Share Index. Third, pension funds should have a higher allocation to diversifiers such as property.

The shape of Markowitz's chart depends crucially on the choice of risk measure. According to tradition (as opposed to logic), the standard measure is the variability of the investment return. For pension trustees, however, variability is less of a worry than the possibility of very poor results. This suggests that a downside risk measure, such as the probability of the funding level falling below, say, 90%, is important.

The choice of risk measure can determine which portfolios are deemed low risk. For a scheme that is currently 80% funded, for example, the portfolio with the lowest risk of the funding level being below 90% in three years might well have a high equity content. But if the risk measure is a funding level below 70%, then there will be virtually no role for equities.

Sensible pension-fund investment strategies are therefore obvious when properly explained, but most trustees continue to peer through a glass darkly. Faulty learning accounts for much of the difficulty, and no one likes to admit their own ignorance. Worse, it is entrenched. As Wittgenstein lamented, why is there no English word for 'to believe falsely'? To poke fun, this may go some way towards explaining the typical trustee's very British conceit that a well-intentioned amateur can do as good a job as an investment professional.

Shareholders' perspective

Do shareholders want under or overfunding? Do they want low or high volatility investments? Finance theory trod this path a long time ago[1], and the answers are known. For shareholders, a mismatched pension fund is like a rollercoaster. The mismatched investments go up and down, dragging the company's share price with them.

[1] *Notably, Irwin Tepper, Taxation and corporate pension policy, Journal of Finance, 1981*

...a company's fundamentals are not changed by having more (or less) money in its pension fund, or by juggling the equity:bond split.

At first glance, shareholders do not greatly care how the pension fund is invested, because the investments are worth exactly what they are worth, even if liquidated for cash. A company's pension promises are like debt – IOUs that must be paid – and the pension fund's investments are similar in concept to collateral. To see this is indeed a light-bulb moment. The value of our house is not changed by whether we have a fixed-interest or an endowment mortgage. Similarly, a company's fundamentals are not changed by having more (or less) money in its pension fund, or by juggling the equity:bond split.

The big picture is easy to grasp, but the detail is tricky. Shareholders are not wholly indifferent to pension funding and investment strategies, due to four important second-order effects.

The first is tax. Pension investments are tax-exempt, but shareholders pay tax. It therefore makes sense to take advantage of the pension scheme's tax-free status by funding as much as possible and as early as possible.

Bonds are the best investment, because the individual shareholder gets the biggest reduction to his/her tax bill by buying bonds through the pension funds of companies whose shares he/she owns (rather than buying bonds directly). This is because fixed interest bonds produce more of their return in the form of income rather than (less heavily taxed) capital gains.

Another attraction of bonds is the well-known tax arbitrage first identified by Fischer Black[2] (of Black-Scholes fame). If a pension fund sells equities and buys bonds, that doesn't change the value of the fund's investments, but it does make the business less risky. Suppose further that, to keep the business's financial leverage unchanged, the company itself issues new debt and buys back its own shares. This is bad news for the tax authorities since less tax is paid, of an amount equal to the excess of the yield on the pension fund's new bonds over the business's new debt (after the tax relief).

This is not a free lunch, but it is something better still: it is paid for by the taxman. The beauty of Fischer Black's arbitrage is that the business still participates in a stock market rise. Thus, companies that are hesitating to reduce risk in their pension funds can proceed. They need not fear looking silly if they sell equities at what turns out to be the bottom.

[2] *Fischer Black, The tax consequences of long-run pension policy, Financial Analysts Journal, July/August 1980*

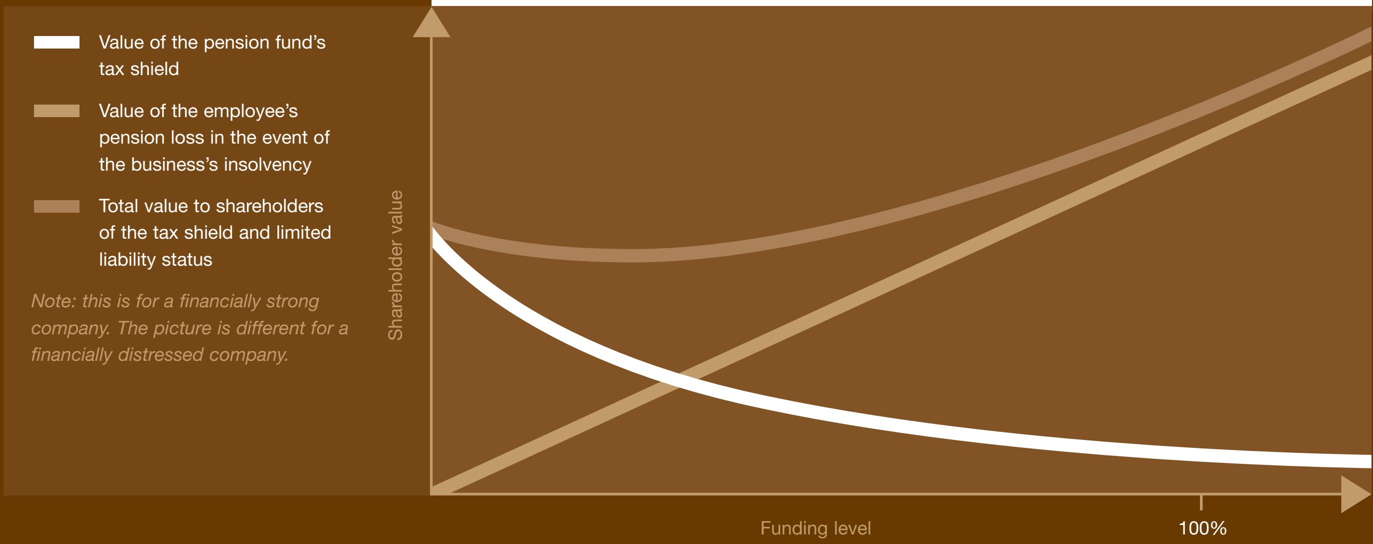
Ephemeral surpluses were often seen by human resource departments as ‘not real money’ (or, even worse, were seen as members’ money).

So, shareholders will prefer deliberate overfunding due to the tax advantage. There is, however, a potential disadvantage, in that overfunding can create pressure from members for benefit improvements. This is the second reason shareholders care about how much money is in the pension fund, and it is not theoretical. It happened in the 1990s when significant shareholder value was destroyed. Ephemeral surpluses were often seen by human resource departments as ‘not real money’ (or, even worse, were seen as members’ money). UK company management’s common guarantee that pre-1997 pensions accrual would be inflation-proofed was voluntary. The law insisted only that post-1997 pensions be inflation-proofed.

The third reason that shareholders have a view on whether to fund or underfund is that they may wish to under-collateralise the company’s pension promises, as they might any other debt of the business. Risk-taking in the pension fund (through, for example, equity investment) makes members’ pensions less secure, but for every loser there is a winner, in this case the shareholders.

Take the case of a financially distressed company. Its shareholders will be attracted even to those investment projects that have a negative present value. This makes no sense for the economy as a whole or for the company’s debtholders, but the shareholders can reap any profits and yet walk away in case of failure. This is the beauty of the limited liability company. It may be unfair, but it is the law.

Figure 3: Do shareholders want under or overfunding?



Finance theory is not some kinky game or wacky counterculture. It is how investment banks make money.

In a perfect labour market, employees will not subject their job and their retirement savings to the same risk: that of their employer going bust. In practice, this risk is difficult to manage (shorting your employer's equity is, to say the least, not easy). A clear-thinking employee should therefore demand higher wages to compensate for a poorly funded pension backed by mismatched investments. This rarely happens, so public policy requires either full funding (seen in the fiasco of the UK's minimum funding requirement), or some kind of pension protection fund (the UK's second attempt).

The imminent UK pension protection fund is the fourth (and last) area which may mean that shareholders are not indifferent to trustees' funding and investment strategies. If the size of the levy properly reflects risk, then every company would pay its fair share. But in real life, low risk companies are likely to subsidise high risk ones. If you doubt this, look at the mess in the US, where the current shambles was long predicted.

The theory is illustrated diagrammatically at the top of this page in figure 3.[3] It is instructive to examine extreme situations, which mathematicians call 'corner solutions'. The shareholders of a financially distressed company, for example, will want the pension fund to be deliberately underfunded, and will want the trustees to take risks by, say, investing in equities. At the other extreme, the shareholders of a strong company will want the pension fund to invest in bonds (in order to avoid unexpected surpluses which are then claimed by employees), and to be fully funded (to maximise tax concessions).

Hubris is always punished

Finance theory is not some kinky game or wacky counterculture. It is taught at our universities, and it is how investment banks make money. Although it carries the imprimatur of numerous Nobel economics prize-winners, it was wilfully ignored by UK trustees and company management. As ever, hubris has been punished, in this case spectacularly.

[3] *The theory is further explored in Bicksler & Chen, The integration of insurance and taxes in corporate pension strategy, Journal of Finance, July 1985*

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by John Shuttleworth, john.shuttleworth@uk.pwc.com, tel: +44 20 7212 4812

In May 2003, after 12 years of effort, the European Union Council adopted a directive establishing a framework for pan-European pensions. Member states are meant to introduce the provisions into their national legislation by 23 September 2005. Significant obstacles must be addressed, however, before true pan-European pensions, under which a company's EU workforce will belong to a single scheme, become a reality. In the meantime, multinationals can use other structures to make cross-border pensions more efficient.

Negotiating the maze of pan-European pensions

by Sonja Barendregt-Roojers

Pensions in Europe are very different in each country, for historical and cultural reasons, different tax systems, different social security systems and different state pension levels. So, company pension schemes are very different. Multinational companies that work in different European countries have to cope with these differences. This is a problem for employees moving countries because they experience all kinds of barriers when they move from one country to another and from one pension system to another. It is also a problem for companies as they have to set up and run all these different pension plans.

On the whole, Europe has an ageing population that is forcing governments to take action. For example, more pension provision in companies and employees instead of state pensions. This is not popular and progress has been relatively slow. Companies may be under pressure to pay a lot more for the pensions of their employees in the future.

Over the last few years, companies have realised how big the financial risks are for salary-related pension promises when investment returns are falling. They want more control. This is supported by another development: new accounting principles that are requiring them to show deficits and surpluses in all these different countries. Multinational companies that work in different European countries therefore need more monitoring and coordination of their pension plans in order to achieve risk management and cost control.

A single pool of assets and liabilities would make it easier to meet solvency and capital requirements.

Pan-European pension schemes could be a very good solution for all these problems and the needs of companies.

The key features of a pan-European pension fund should be as follows:

- Portability: mobile employees of a multinational can remain in the same pension scheme, despite moving countries.
- Tax deductibility and efficiency in all European states.
- No need to run small pension-fund operations in certain countries.
- Consolidated actuarial valuations and accounts.
- Assets are pooled, with no need to match them to specific countries' liabilities.
- One solvency measure for the entire fund.

Pan-European pensions would offer multinationals several advantages. Some of these are discussed below.

Enhanced investment returns

A single pool of assets and liabilities would make it easier to meet solvency and capital requirements. Asset management could be organised more efficiently and more professionally, with a larger fund permitting wider diversification. Multinationals could also choose from a greater number of financial services providers.

Cost savings

Savings due to economies of scale should be possible in investment management; manager selection; transaction costs; control, monitoring and reporting; administration; compliance (actuarial, accounting); expatriate pension plans; and governance.

Risk control

Local managers often view their pension funds as autonomous, i.e. not subject to the control of the multinational's executives. Given the ramifications of poor administration and governance, however, a proper, structured framework is essential. Pan-European arrangements would permit central coordination and monitoring, thus reducing financial and operational risk.

Some countries have investment restrictions instead of investment freedom.

Consistent benefits policy

Multinationals might create one system (e.g. defined contribution, DC) for their company, or perhaps only for their mobile employees.

Globalisation

The use of a single structure would help multinational companies to reinforce their global culture.

European Union directive

The EU's directive (2003/41/CE) on pan-European pensions will only partially achieve these objectives. The framework is known as the IORP Directive, with IORP standing for 'Institutions for Occupational Retirement Provision'.

IORPs must be established separately from the sponsoring entity and provide retirement benefits on a funded basis. The directive does not apply to pay-as-you-go systems, book reserve plans, social security schemes, or plans that are covered by certain insurance-company directives. National governments will be able to exempt plans that are wholly local and have fewer than 100 members, as well as insurance company schemes.

Common standards for cross-border pensions mean that, in theory, an organisation need convince the authorities of only one EU country that it is suitable to become an IORP. The organisation will then receive a 'European passport', allowing it to operate in any member state.

Obstacles to pan-European pensions

Even with the directive, several obstacles to pan-European pensions remain.

Investment restrictions

Some countries have investment restrictions instead of investment freedom.

The Netherlands has noted that each country's savings industry has its own characteristics, and that governments may subject IORPs in their territories 'to additional requirements, in order to realise a level playing field'. Pension funds in

Companies will be reluctant to over-fund their schemes simply to enable them to be called pan-European, as this would diminish shareholder value.

countries such as Germany and Belgium must currently invest a certain percentage of their assets in their local markets. This runs counter to the spirit of the directive, which permits greater investment freedoms, but the framework does allow countries to apply certain restrictions on IORPs if they wish.

It is likely that some governments will implement only a few of the directive's provisions, and wait to be challenged in the European Court of Justice on the clauses they would rather not accept. Belgium, for example, has said that it cannot endorse the directive, as the framework's investment freedoms would jeopardise the security of pension benefits.

Finally, the country in which staff work (called the host country) may have more stringent investment rules than the pension fund's home country. In that case, the host government may apply its own rules to the assets that relate to its workers, thus ring-fencing the assets and necessitating separate investment management.

Funding

Another obstacle is that countries have different funding requirements. The directive may hinder adoption as it requires cross-border schemes to be "fully funded at all times" (purely domestic schemes must have a plan to rectify any under-funding). However, the value of pension assets (which is governed by financial markets) and liabilities (governed by discount rates) is volatile, so how will defined benefit (DB) schemes comply with this clause?

Companies will be reluctant to over-fund their schemes simply to enable them to be called pan-European, as this would diminish shareholder value. Many multinational firms with DB schemes may therefore avoid using the directive, and pan-European pensions may be predominantly DC schemes.

Taxation

EU members also tax pensions in different ways, and the potential cost of harmonisation is high. Only Austria, Belgium, Finland, France, Greece, Ireland, Netherlands, Portugal, Spain and UK conform to what is known as EET: Exempt contributions, Exempt investment income, Taxed benefits. The countries in figure 1 on page 45 do not.

Figure 1: Taxation of pensions

	Denmark	Italy	Sweden	Germany	Luxembourg
Taxation on contributions	Exempt	Exempt	Exempt	Taxed	Taxed
Taxation on investment growth	Taxed	Taxed	Taxed	Exempt	Exempt
Taxation on benefits	Taxed	Taxed	Taxed	Exempt	Exempt

In a low-inflation environment, a tax difference of only 50 basis points can have a significant impact on overall investment returns.

Additionally, some EU members' tax systems discriminate against pension schemes established in other countries (this is an obstacle!). The European Commission has, in the past, taken governments to the European Court of Justice on these issues.

Legacy systems

Countries with a strong tradition of occupational pensions may have trouble dismantling their current, often complex arrangements, in order to adopt the pan-European framework. The Netherlands may also find it difficult to move away from its multi-company industry-wide plans.

Portable pensions

The European Commission would like to encourage pension portability, enabling EU staff to move from country to country with no disruption. This would require greater consistency across the EU on complex issues such as vesting periods, transfer rights, and the inflation-indexing of previous employers' contributions. The Commission's consultation process on portability is focusing on company and sector-wide schemes, rather than on state and personal plans.

Issues for investment management companies

The prospect of pan-European pensions raises several questions for investment managers. First, in which country should a pension scheme be resident? Luxembourg and Ireland are the obvious choices for tax reasons, followed by the UK and the Netherlands, as the latter countries have expertise in pension fund management, plus reasonable tax regimes. On the other hand, new players, such as the EU accession countries, will not be burdened with legacy issues and may be able to provide a simpler regulatory system, along with sufficient investment freedoms.

An IORP (rather than the pension fund sponsor) may sometimes guarantee investment returns or a level of benefit. In those cases, the IORP, possibly an investment company, must satisfy capital adequacy requirements, thus making financial resource a barrier to entry for new participants.

For multinational sponsors, one attraction of the pan-European framework will be the ability to offset deficits in some DB schemes with surpluses in others.

In an effort to win business, investment firms may lobby their governments to ensure that local tax statutes are attractive. The same applies to regulation, with countries competing to provide the lightest regime. The European Commission has nevertheless said that it will try to limit such manoeuvring by countries with regard to tax, regulation and investment freedoms, and thus prevent ‘forum-shopping’ by pension schemes.

A final issue is the need for good communication with pension scheme members residing in multiple countries and speaking different languages. Pension schemes will have to maintain local offices, in order to facilitate the information flow. Although several financial services firms have strong back-office platforms, the administration of pan-European pensions may require new infrastructure. Will companies be prepared to make this investment, given the unknowns concerning business volumes and payback periods?

Issues for pension plan sponsors

For multinational sponsors, one attraction of the pan-European framework will be the ability to offset deficits in some DB schemes with surpluses in others. They might also be able to reduce risk by centralising asset-liability matching, though this could be problematic since countries will still be able to ring-fence the assets and liabilities of their workers. These drawbacks suggest that most cross-border plans are likely to be DC schemes.

Pooling

In view of the barriers to pan-European pensions, financial services providers are considering using innovative techniques to achieve financial benefits similar to those derived from the globalisation of investments into one single pension fund, namely pooling of assets through the use of the master-feeder concept.[1]

This technique uses the hub-and-spoke approach, under which local pension funds (and even cross-border funds) are the spokes that feed their assets into a common investment pool (the hub), which is established as a mutual fund. The local pension funds hold shares or units of the master vehicle rather than the underlying investments themselves.

In some cases, this ‘master’ fund is composed of several asset classes, e.g. European equities, US bonds, etc. The various pension-fund sponsors may have

[1] *Or by establishing “mirror funds”.*

On the cost side, the pooling structure adds the cost of setting up the pooling vehicle and the operating cost of such a structure to the operating costs of the individual pension funds.

different objectives (and a single sponsor may run several funds), so a number of pools with different asset allocations may be created. Local pension-fund sponsors decide their asset allocations, and 'best of breed' investment managers are selected. The same manager, say for US equities, is responsible for the US equity segments of all the pools. Consolidated reporting allows this manager to run the portfolios efficiently.

In order for such a "two-tier structure" to be viable, its benefits must offset the set-up and operating costs of the pool.

The main benefits of pooling the assets are obvious:

- The grouping of individual pension plans assets into a common pool makes it possible to take advantage of economies of scale in the processes related to the management, custody and administration of these assets.
- The pooling of assets can also allow small and medium size pension plans to implement more efficient asset allocation strategies and access more diversified multi-manager structures.
- As in/outflows are netted within the master fund, the volume of trades should decline, thus reducing costs at the level of all service providers (asset manager, custodian, administrative agent).
- Considering the importance of corporate governance requirements, the master feeder structure can also generate economies of scale in the oversight by the trustees of the asset management processes as this allows the monitoring and control of only one entity rather than the management of investments by each separate pension fund.
- The pooling structure also ensures consistency of the asset management performance between the individual pension funds.

On the cost side, the pooling structure adds the cost of setting up the pooling vehicle and the operating cost of such a structure to the operating costs of the individual pension funds. However, these costs are highly scalable and the benefits of pooling will outweigh its cost if the structure is large enough and if it is tax neutral.

Legally, the master fund should be considered as tax transparent in order to receive the same tax treatment as a pension fund investing directly. Withholding taxes on share dividends are generally determined by tax treaties between source states and investor (pension fund) states and most treaties offer favourable tax rates to pension funds.

Despite the obstacles to pan-European pensions, several techniques can help multinationals reduce costs and improve the efficiency of their asset management activities.

The tax transparent master-feeder fund would benefit from this. Standard collective vehicles, by contrast, can suffer considerable tax leakage. As an example, UK or Dutch pension funds investing in US shares will not suffer any withholding taxes on dividend payment while a collective vehicle may be subject to a 30% withholding tax on the same dividend payment. Tax strategy planning is therefore essential.

Despite the obstacles to pan-European pensions, several techniques can help multinationals reduce costs and improve the efficiency of their asset management activities. Some of these methods have been used for years in the investment fund sector and are now being extended to pensions. The consolidation of the liability side, however, has not yet been truly addressed on a cross-border basis.

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With consumers' demands seemingly continuing to spiral to heady new heights – faster, better, cheaper being the buzzwords of the day, how long will it be before their expectations focus on the benefit programmes offered by their employers whether it be on design or delivery? Those responsible may not have long to raise their game and, in some cases, raise it significantly, particularly if global economic activity gains pace and 'consumers' can see the benefits of moving to a new employer. The challenge that lies ahead, therefore, is what role technology can play in facilitating the required change.

To e or not to be?

by Ellen Kelleher

It seems that the typical consumer is now a smart and savvy individual, someone quite capable of looking around to get the best, quickest, cheapest deal. Spurred on by the advances that the internet has had to offer, they are now just a click away from more choice than ever before. That is until it comes to dealing with perhaps the single most important thing that enables them to be such demanding consumers, their pay and reward.

While it's fair to say that employers have generally invested in their HR function and recognise the importance of their benefit programmes, the experience of employees is still somewhat disappointing and, in many cases, well below what is, or should be, expected. This stems from a number of factors; the lack of imagination in terms of how the services are delivered, even where technology has been deployed. For example, it's well known and recognised that consumers dislike call centres (and that includes the employee). Processes are inefficient, involving a number of hand-offs or failure points that require manual intervention. The employee often has to go to multiple providers to source information or get questions answered about their benefits. And there's no holistic view of the employee's total reward/wealth. Thus the employee has difficulty in making well informed and educated decisions about how to plan for today and tomorrow.

Many companies and advisers agree that employees don't recognise the value of the benefits provided by their employer. Many employers are genuinely frustrated by this and are becoming more concerned as evidence suggests a global upturn is on the way, with the usual merry go round of job moves that comes with it. Retaining real talent and being the 'employer of choice' has never been such a challenge.

This one-stop gateway links the employer, employees and all outsource benefit providers, thus providing a seamless and automated communication channel, and one that can be branded to reinforce how much value the employer places on their key assets – their people.

It's a consumer's world

One possible solution to the issues highlighted above is to deploy a portal, or to be more precise an e-HR portal. An e-HR portal is a web-based single point of access, where information on an employer's full benefits programme is accessible. Some examples of services that can be offered from the portal include:

For the employee:

- Details on all aspects of an individual's remuneration package;
- Advice and ability to process transactions relating to any flexible benefit arrangement e.g. buying additional leave entitlement, changing the level of contributions to a defined contribution arrangement, etc.;
- Details of training programmes and the ability to 'book' on to them;
- Valuation of the total benefits package, summarised in a personal benefits statement;
- Ability to purchase other services from preferred suppliers at favourable prices;
- Ability to model various scenarios to support decision making around benefit choices;
- Registration of sick leave/leave entitlement.

For the employer:

- Real-time information on the popularity of certain benefit options;
- Analysis of sick leave and leave entitlement;
- Effectiveness of training programmes;
- Detailed information on the costs of each aspect of the remuneration package;
- Management of leaver processing.

This one-stop gateway links the employer, employees and all outsource benefit providers, thus providing a seamless and automated communication channel, and one that can be branded to reinforce how much value the employer places on their key assets – their people. Essentially, this creates a virtual value chain in which various specialist providers operate independently, but the consumer's perception is that of an integrated HR service.

While there are few organisations who can meet all the requirements, some are better placed than others to effect the changes required, including pension administration providers and investment managers.

This implies a number of key requirements for employers and providers alike. Firstly, and most obviously, they must web enable their services. This sounds straightforward in itself, but there are a number of challenges, particularly for the employer. For example, a clear strategy must be defined to move to the e-HR portal delivery model, the demographics of the workforce must be understood so that the return on investment is shared among the widest possible audience and the integrity and maintenance of data is critical, particularly when moving through the transition to e-HR. Cost will be another key factor. The investment required may be prohibitive to some employers and providers alike.

The second requirement is to be capable of providing an integrated offering. From a provider's standpoint, those with broad service offerings covering such activities as pensions administration, flexible benefits, etc. will clearly have an advantage in that the employer can effectively limit the number of providers it needs to integrate with and manage, and thus reduce the risks associated with ensuring seamless communication, integrated networks, security, etc, while maximising cost effectiveness through economies of scale.

Lastly, the providers chosen by the employer need to be commercial market players, with a proven ability to be innovative, demonstrate value for money, have a flexible service offering and provide a consistently improving level of service.

Who wants to run the race?

While there are few organisations who can meet all the requirements, some are better placed than others to effect the changes required, including pension administration providers and investment managers.

Pension administration providers have been around for a long time in many countries and have experience in providing administrative services, covering multiple employer schemes on powerful administration systems and communicating with a broad range of entities, ranging from the employer, trustees, employees, other providers and legal/regulatory bodies. These also have the advantage of dealing with the most complex of the HR processes – that of pensions. Some pension administration providers have recognised and indeed pre-empted this move by investing in the technology and expanding their service offerings ahead of the anticipated demand.

A decision not to move towards an e-HR offering will, in due course, result in a contraction and perhaps even ultimately the demise of an organisation.

Likewise, many investment managers are now well renowned for having invested significant sums into their administration capabilities, particularly to support defined contribution pensions administration and have adopted their industry's requirement for "straight through processing" into such operations.

From hype to hygiene and quickly!

A decision not to move towards an e-HR offering will, in due course, result in a contraction and perhaps even ultimately the demise of an organisation. As the hype dies down around e-HR, the 'e' element will be taken for granted; effectively becoming a hygiene factor for employees wanting to examine their total wealth or for when an employer selects a provider. To not have an e-HR offering will be like running a business without a tried and tested business recovery plan – quite simply providers without one won't make the shortlist.

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Hedge funds and private equity vehicles are the fastest growing segments of the unregistered investment market in the US. The story is similar in Europe and Asia as, increasingly, institutional investors such as pension funds and insurers, are investing in hedge funds. Should pension schemes allocate money to these asset classes? Before deciding, fiduciaries must have a complete understanding of the pension laws, conduct thorough due diligence to ensure the appropriate risk controls are in place, and ensure that their investments are continuously monitored. As hedge funds become a more mainstream form of investment, the influential role of the pension fund industry in how the hedge fund industry evolves and is regulated cannot be underestimated.

The quest for higher returns leads investors to alternatives

by Michele Weldon

Alternative investments have recently attracted a great deal of interest from institutional investors, including pension funds seeking higher returns and diversification. The average US pension allocation to alternative investments has more than doubled in the past five years, from 2% to 5%, and some analysts believe that target allocations may soon rise to 25%. Globally however, a very small percentage of pension money is being invested in alternative investments.

Several large US institutions, including the California Public Employees Retirement System and the Pennsylvania State Employees' Retirement System, have significant allocations to hedge funds, private equity and real estate. Large corporate plans, such as AT&T and General Motors, which were initially cautious, have also dipped more than a toe into alternative investments and many pension plans in Europe are allocating increasing amounts to such asset classes.

Known for their secrecy and exclusivity, alternative investments have long been the domain of high-net-worth individuals and sophisticated institutional investors, an elite group that generally understands and accepts the risks involved.

This trend raises important issues for the pensions industry and also for alternative investment managers. The nature of pension funds makes it problematic to invest in alternative products. Hedge fund strategies, for example, are difficult to understand and evaluate in light of the complex regulations governing employee benefit plans and their fiduciaries. The lack of disclosure in this market is also an issue and is something the hedge fund industry will need to address if it wishes to attract increasing allocations from pension funds. As a result, pension funds have lagged behind other institutional investors, such as endowments and foundations, in their interest in alternative investments.

Having said this, investors are clearly concluding that the upside of potential returns and benefits of greater diversification outweigh the administrative and legal challenges. When most other investments are giving relatively low rates of return (3.5% or less), investors are more likely to turn to hedge fund managers, despite the fact that hedge fund charges are very high, typically at 2% of value, plus 20% of return. Increasing the attraction of hedge funds yet further, prospective equity returns have been uncompromising for the last couple of years due to historically inflated levels of market valuation.

As institutional assets continue to flow into alternatives, the sheer size of pension fund investments and the resulting opportunities for alternative managers are already changing the character of the sector, the types of products offered, and the way these investments are governed, monitored and regulated. In the meantime, pension funds should be careful in doing their due diligence when choosing alternative investments.

An overview of alternative investments

Alternative investments – investments other than those generally available in the public markets – include hedge funds, private equity, real estate, derivatives and managed futures. Alternative investments have a low correlation with the traditional public markets, and can offer significant portfolio benefits through diversification and return enhancement, neutralising the movements of capital markets and interest rates.

Known for their secrecy and exclusivity, alternative investments have long been the domain of high-net-worth individuals and sophisticated institutional investors, an elite group that understands and accepts the risks involved.

These private vehicles are often domiciled in offshore locations such as the Cayman Islands, where the level of regulation is light. Even those funds that are domiciled in the US are generally not required to register with the Securities and Exchange

During the equity market rally of the late 1990s, pension fund managers were not concerned about meeting their growth targets, as almost any index fund satisfied the return requirements.

Commission, and are not subject to the constraints of the Investment Company Act and securities registration requirements although some of these rules may change in the near future. Compared with mutual funds, for example, alternative products can invest in a broader range of financial instruments and use investment techniques such as short selling, merger arbitrage, or betting on the impact of an event. Alternative managers are generally reluctant to discuss their investment process and portfolio details, as this might erode their competitive advantage.

Hedge funds and private equity funds are among the fastest growing segments of the unregistered market globally. Assets flowing into hedge funds have risen by approximately 13% per year for the past five years, and analysts estimate that global hedge fund assets will grow by 20% in 2004 to almost $750 billion. Around a quarter of US pension schemes currently invest in hedge funds, compared with 12% in 2000.[1]

US private equity funds now have approximately $700 billion under management, nearly double the level of five years ago, with much of the increase coming from public pension schemes. Public pension schemes raised their allocations to private equity from 1.7% in 1999 to 3.1% in 2003. At the same time, US pension fund assets invested in equity real estate increased from $175 billion to $192 billion.

The growth of alternative investing by pension funds

During the equity market rally of the late 1990s, pension fund managers were not concerned about meeting their growth targets, as almost any index fund satisfied the return requirements. Most US pension schemes have maintained a traditional asset allocation of around 60% equities and 40% fixed income.

Markets began declining in 2000, however, and corporate earnings growth slowed, thus affecting companies' ability to fund their pension schemes. The shortfall threatened corporate balance sheets and put pressure on the Pension Benefit Guaranty Corporation (PBGC), the US regulatory agency that supports companies that are unable to meet their pension commitments.

At the end of 2002, the PBGC found that a third of US single-employer defined benefit plans were underfunded, which led to reports of a widespread pension crisis. The rally in equities since the second quarter of 2003 has eased concerns, but the public markets are unlikely to replicate the returns of the past two decades. Companies must therefore fund any pension shortfalls from their earnings, and trustees have become more willing to accept higher risk than in the past. They are turning to alternative investments in order to boost returns and reduce portfolio volatility.

[1] *Greenwich Associates*

Many pension sponsors have hired consultants to help them understand the opportunities and challenges of alternative investing.

Only the largest corporate plan sponsors have so far invested in alternatives, with most plans limiting their exposure to 5%. Of the $5 trillion in US pension assets in 2003, only $11 billion was allocated to alternatives[2], representing 0.2% of total assets. Allocations in Europe remain similarly low.

The challenges of investing in alternative products

When considering alternative products, plan sponsors in the US should fully understand the federal pension laws, as well as their fiduciary duties and responsibilities to plan participants. The Employee Retirement Income Security Act (ERISA), passed by Congress in 1974, governs US private pension plans. Assets must be invested prudently and for the exclusive benefit of the plan's members. Trustees have legal liability, and have consequently been risk averse in their investment decisions.

Given the unpredictability of the equity and bond markets, however, plan sponsors are concerned that they might be violating their fiduciary responsibilities by not considering alternative investments. The Department of Labor's, ERISA Section 404(C) regulations require that beneficiaries and plan participants must be able to choose from a range of investments, including at least three diversified investment categories, each of which contain investment choices that have materially different risk and return characteristics.

Many pension sponsors have hired consultants to help them understand the opportunities and challenges of alternative investing. The ERISA framework prohibits certain transactions. For example, sponsors cannot invest in parties that have an interest in the plan, as this might pose a conflict of interest. Unregistered private equity and hedge funds are not required to disclose their holdings, however, so sponsors cannot know whether an investment in such a fund would violate the rule.

Some partnerships have received exemptions for certain prohibited transactions from the Department of Labor and the Internal Revenue Service, and use these exemptions to keep their holdings secret from the public. As a result, plan sponsors will not know whether a fund's investment strategy and risks (liquidity, market, credit, operational and legal) comply with ERISA.

ERISA 'looks through' the non-registered investments within an employee benefit plan, and applies its rules to the underlying assets. This rule does not apply to registered investments. For example, if a plan invested in a mutual fund, there would be no 'look through' to the make up of the mutual fund. If however, the plan invests in non-registered investments, such as a hedge fund, the general rule is that the plan is

[2] *Greenwich Associates*

Alternative groups generally have lean operations and they will struggle to meet the needs of this increasingly demanding type of investor.

considered to invest also in the underlying assets, unless the non-registered investment qualifies for exemption as an 'operating company' or because equity participation in the non-registered investment by benefit plan investors is "not significant".

As long as no more than 25% of the assets are held by employee-benefit-plan investors, including all ERISA plans, 401(k) plans, Keogh accounts, IRAs, state funds or any other employee benefit plans, there is an exemption to the 'look through' rule. If the 25% limit is breached, the ERISA framework applies. It is important to note that after every investment in or withdrawal from a hedge fund, the manager must therefore calculate the percentage of assets held by benefit-plan investors – a costly and time-consuming process.

Fiduciaries considering investments must ensure that the performance and other fees are reasonable, and that the manager's policies and procedures will comply with ERISA. Defined benefit sponsors will find it easier to analyse alternative investments, but some defined contribution sponsors are also considering the asset class. In the latter case, the plan participants make their own allocation decisions, thereby relieving the fiduciary of certain duties.

Fiduciaries must still evaluate the prudence of the options presented to plan participants, however, and sponsors must educate their employees about these investments, the fees and risks. This might be difficult, given the lack of disclosure by certain hedge fund managers. Furthermore, unlike mutual funds, which can be redeemed quickly, some hedge funds permit redemptions on only a few days each year.

Investment by institutional investors, particularly pension funds, is driving the alternative investment management industry to change the way it operates. Unlike traditional hedge fund investors, who largely invest their own money, pension fund investors are responsible for investing money entrusted to them by others. Many providers of alternative products are boutique businesses which generally have lean operational infrastructure, characterised by a high degree of outsourcing and an entrepreneurial culture. Such businesses may struggle to meet the due diligence needs of this increasingly demanding type of institutional investor which are likely to focus heavily on the control of non-investment, operational risks and to include close scrutiny of systems and controls. This topic is discussed in more detail in the March 2004 issue of Perspectives which focuses on hedge funds.

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A variety of pension systems exist in Asia, from mandatory central funds to competing private sector schemes. Central funds tend to be more efficient, and Singapore, in particular, has recently made sensible changes to the rules governing company contributions to its fund. The objective is to cushion future economic downturns, and the resulting system for financing retirement may be the way forward for other countries in Asia and, perhaps, worldwide.

Variety characterises Asian pensions funding

by David Richardson

In Asia, mandatory social security levels differ from country to country, and also vary according to which political party is in power. As government attitudes change, so does the scale and reach of social security, and consequently the popularity of voluntary company pension plans.

Social security exists in a number of guises in the region. A retiree may, for example, receive benefit from a mandatory central fund to which he/she and his/her employer(s) have contributed throughout his/her career. Companies may also be required to pay statutory severance benefits, based on service and final salary. Certain countries have laws under which companies and employees must contribute to a company fund. Finally, there are systems similar to those in Europe, where today's working population pays current pensions and post-retirement medical costs.

Low birth rates, longer life expectancy and the rise in medical expenses have hit Asian countries to varying degrees, though, in time, all will be affected. Historically, Asian retirees have relied on their children for support, but with birth rates now below population-replacement levels, this will be a waning source of retirement income. Consequently, there is an urgent need to ensure that people have sufficient savings to maintain their living standards in retirement.

Western countries have been switching from defined benefit to defined contribution schemes, but this has not occurred to the same extent in Asia, in part due to the payment of statutory severance benefits on retirement. In Korea, for example, companies with at least five employees must pay a lump-sum severance benefit equal to the average of a person's final three months' salary for each year of service.

In Taiwan, companies must pay twice the average of a person's final six months' salary for each year of service for the first 15 years of service, plus one times the average of a person's final six months' salary for each year of service thereafter – up to

A further defect of private sector schemes is that the administrator and investment manager tend to be the same company.

a maximum of 45 months' such salary. Thailand, Vietnam, Indonesia, India, Sri Lanka, Pakistan and Bangladesh have similar statutory severance benefits.

Single central fund versus competing private sector funds

In some Asian countries, companies and employees must contribute to funded central retirement schemes. Singapore, for example, has a mandatory pool called the Central Provident Fund. Malaysia and the Chinese provinces also have mandatory central schemes. In India, several states have such funds, but companies may establish company provident funds instead. In Australia, employees do not have fund choice and remain in their corporate or industry fund. Hence, the distribution issue is present but not dominant.

By contrast, Hong Kong, rather than requiring employees and companies to contribute to a central scheme, follow the Chilean model, under which private sector vehicles compete to finance people's retirements. The objective is to promote freedom of choice, but in reality, only funds with established distribution systems, such as those run by banks and insurance companies, have thrived.

Boutique investment firms, though they may have superior performance, do not have a large number of sales agents on commission, and so cannot compete. Commissions must be factored into the cost of a product, thus reducing investment returns.

One consequence of encouraging private sector pensions is the need for a regulatory authority, which is a charge on government revenues. Each fund must also pay audit, legal, administration and compliance costs. Finally, there are portability requirements and, perhaps, a levy in case of liquidation.

Contrast all this clutter with the simplicity of a mandatory central fund. There are no sales commissions, and the administration is done centrally at a fraction of the cost that the private sector would have to pay. There is no separate regulatory authority, no portability requirement and no levy in case of liquidation. Furthermore, if monies are pooled in a central fund, death benefit and disability benefit schemes, which are normally part of social security, can be managed efficiently.

A further defect of private sector schemes is that the administrator and investment manager tend to be the same company. The central funds in Singapore and Malaysia, however, permit members to choose from an array of fund managers, so the administrator and investment manager are different entities.

The Singapore model permits investment managers to focus on generating optimum returns over the long term, rather than having to meet unrealistic short-term expectations.

In Australia, many schemes have different administrators and investment managers. In fact, if there is a trustee board, they select the administrator and a group of investment managers. In some cases, however, a conflict of interest does arise.

The objective of mandatory retirement savings should be to provide the greatest benefit for the least cost. A central fund that minimises administration costs is therefore superior, in some cases, to the relatively cumbersome and expensive systems of Hong Kong and Australia.

Single central fund: the Singapore experience

Singapore's Central Provident Fund (CPF) provides medical, death, disability and retirement benefits, and also assists people who wish to purchase their own homes. Contribution rates have varied over time, but until recently the government's target was 20% of salary from the employer and employee. For contribution purposes, the salary ceiling was $6,000 per month (€3,000 or £2,000), which is around three times the national average earnings.

The interest credited to CPF accounts is pegged to the average 12-month bank deposit rate, with a certain minimum. Instead of accepting these returns, however, members may invest part of their accounts in over 300 investment choices permitted by the CPF, such as unit trusts and insurance products. This arrangement has consequences for the wider economy.

For example, many members have taken advantage of the housing support offered, and over 90% of Singaporeans own their homes. This is the highest percentage of any population in the world. Housing benefit is also provided by Malaysia's statutory central fund, called the Employees Provident Fund (EPF), as well as by China's provincial schemes and India's state provident funds.

In Singapore, the fact that the interest rate on CPF accounts is pegged to bank deposits, rather than to actual investment returns, has eliminated potential complaints from members. If people don't like the interest rate, they can invest on their own. Relatively few members take this option, however, so most are apparently happy with the guaranteed rates. The Singapore model permits investment managers to focus on generating optimum returns over the long term, rather than having to meet unrealistic short-term expectations.

Countries with low birth rates should also encourage foreign immigration, but high social security contribution rates may discourage newcomers.

In Malaysia, by contrast, the EPF has no interest-rate peg, and the rate paid is generally correlated with actual investment returns. These will vary, and members have been dissatisfied as the credited interest rate has fallen steadily from an historical high of 8.5% p.a. to the current 4.25% p.a.

In Singapore, for a global fund of around €52 billion (£35 billion), the government expects long-term returns to exceed considerably exceed the returns guaranteed to members. The difference is effectively a painless, hidden tax, since the authorities do not publish their investment returns. This cushion enables the government to lower corporate and personal income tax rates, and attract more business to Singapore. Indeed, most Singaporeans do not pay any income tax, and the corporate tax rate was recently reduced to 20%.

The CPF's dominance in Singapore means that few companies offer any other form of pension. The government lowered the mandatory corporate contribution rates in 1985 and 1999, in order to support the economy, but said the reductions were temporary and that the rate would revert to its long-term target of 20% when the economy picked up.

In 2003, however, the government announced a startling change. The corporate CPF contribution rate was reduced to 13%, and to only 9% for members aged 50-55. The salary ceiling for contribution purposes was also lowered and will be reduced further over the next few years.

Why did this happen? Singapore is increasingly focusing on industries such as electronics and biomedical that are more volatile than the country's older specialities of manufacturing and shipping. The government was concerned that the more volatile economy, coupled with a rigid wage system, would result in severe job losses during an economic downturn. This is particularly true for labour-intensive industries such as electronics. A system of flexible wages, however, under which a large part of an employee's compensation rises and falls according to corporate profitability, would preserve jobs to a greater extent.

It should be emphasised that, unlike Europe, where today's workforce pays for current pensions and post-retirement medical costs, Singapore has no cross-generational transfers. In European countries with low birth rates and long life expectancies, either benefits must fall or contribution rates rise, if the system is to remain solvent.

Given the absence of company retirement plans in Singapore, the question is: Who will fund the shortfall?

Countries with low birth rates should also encourage foreign immigration, but high social security contribution rates may discourage newcomers. More ominously, local talent may move to countries with less hostile tax regimes. The more employees move away, the more severe the rise will be in social security contribution rates, which will cause an even greater number of people to leave – a vicious circle.

The clearest consequence of Singapore's dramatic cut in contribution rates in 2003 is that the CPF will become a weaker provider of retirement income. For the average employee and their spouse to maintain their living standards, the replacement ratio (retirement income divided by final salary) must be around 66%. In the future, however, the ratio in Singapore will be only 20% to 30%, based on reasonable assumptions.

Given the absence of company retirement plans in Singapore, the question is: Who will fund the shortfall? Human resources practitioners suggest that employees themselves should bear the responsibility, but many people lack the will to save and may not even be aware of the need. In addition, a company savings plan, due to its collective nature, is much more efficient than an individual savings programme.

Section five of Singapore's Income Tax Act does permit companies to establish retirement savings schemes. Corporate contributions to such plans are tax deductible, with generous limits, and any investment income is tax free. The benefits to individuals are taxable on receipt, but people may mitigate or eliminate this tax by spreading their benefits over several years, or by taking out a lifetime annuity.

However, Singapore has not yet encouraged businesses to establish retirement plans where a company's contribution rate would vary according to profitability. If, for example, after-tax profits were 10% higher than in the previous year, the corporate contribution rate to the retirement plan would rise by 10%, or the reverse in a downturn.

If Singapore companies do establish such plans, then the country will have successfully replaced a rigid pay element with one that is cost-effective and variable. Equally important, the system will enable people to retire without suffering a huge drop in their living standards.

Singapore's experience may soon be regarded as the way forward by several other Asian countries and perhaps the world.

The lessons from Singapore's experience are, therefore, as follows:

- High mandatory social-security contributions do not suit an economy that, because of its skilled workforce and relatively high business costs, must gravitate towards volatile, higher-value industries such as biomedical and electronics.
- A shift into volatile industries increases the probability and frequency of economic downturns. In order to protect jobs, the government has logically asked companies to switch to a more flexible pay system, so that the variable component of salaries may be reduced during recessions. The higher a person's basic pay, the greater the variable component as a percentage of his/her pay. Downturns will therefore be borne predominantly by high earners.
- Mandatory corporate contributions to the CPF were reduced on 1 October 2003 and will decline steadily until 1 January 2006.

Singapore's experience may soon be regarded as the way forward by several other Asian countries and perhaps the world.

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