

MFR gilt-matching: employer consultation

A recent court case involved a solvent employer, who gave notice to the trustees that it would terminate its defined benefits pension scheme. The trustees then adopted a gilt-matching policy, and the scheme actuary certified a debt on the employer on that basis. The employer refused to pay that debt, and the trustees brought a court action seeking payment.

The court found in favour of the employer, because the trustees had failed properly to consult the employer on the necessary change to their statement of investment principles (Pensions Act 1995, s35(5)). Allegedly the trustees gave the employer less than two days' notice of their change of policy, and the court ruled that 'consultation' required more than the mere giving of such short notice. (The court did not say what consultation did require to be valid, but just ruled that it was not demonstrated in this case.)

The ruling was therefore that the revised statement of investment principles was not valid, and so the actuarial certificate prepared on the basis of a gilt-matching policy was not valid either.

Levy rates for 2004/5

The Department for Work and Pensions has confirmed that the general levy rate for 2004/5 will remain unchanged. It will, however, be raising a compensation levy for the first time since 1997, set at 23p per member.

Amended winding-up regulations published

On 23 February 2004 the government finally laid before Parliament the amending regulations that impose the full cost of securing members' accrued benefits on a solvent employer where its defined benefit scheme is wound up. The regulations came into force on 15 March 2004 but, as expected, they apply to schemes which commenced winding-up on or after 11 June 2003.

Draft regulations were published for consultation on 11 June 2003 as part of the government's 'action plan' for pensions. Although the government was ostensibly targeting employers that chose to wind up the scheme, the draft regulations made no distinction as to how the wind-up commences. In other words, the full buy-out cost will apply whether it is the employer's or trustees' decision to wind up the scheme.

Despite representations about this during the consultation process, the final version of the regulations is largely the same as the draft. The

only difference is that for the purpose of triggering the full buy-out cost the date the winding-up commences is to be determined in accordance with Pensions Act 1995 rather than Regulation 2 of the winding-up regulations.

Deferral of state pension

Part 6 of the Pensions Bill (clauses 220–223 and schedule 10) makes changes to the state pension scheme. The most notable amendment covers deferral of the state pension. As previously announced, the government aims to make deferral more attractive by improving the annual increase and by allowing the increase to be taken in lump-sum form.

Current position

If people delay taking up their state pension at state pension age (SPA) they get extra pension when they do finally take it up. This covers both basic state pension and S2P. For each year of deferral, the recipient gets around 7.5% extra.

Also, people who are currently receiving a state pension can decide to stop claiming it, for example if they want to go back to work. They are then entitled to the increased pension when they finally take it up.

(Currently, only around 2% of pensioners defer (about 15,000 each year); average length of deferral is two years.)

Proposed change

At the moment, people can defer state pension for only five years. The government proposes to remove this restriction.

There will be two ways in which delaying taking up the state pension will give people extra money, when they do finally take it.

The increase factor for deferral will be improved. Currently, the increase is around 7.5% per year of deferment. From 2010, this will increase to around 10.4%. The government wants this measure to come in from 2005.

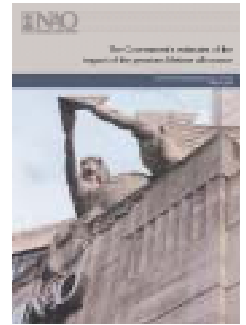
The deferral increase will be payable as a lump sum. By delaying for at least a year, people will get all the state pension due, plus lump sum 'interest'. They will then receive the normal weekly state pension entitlement going forward.

NAO report on tax simplification estimates

The National Audit Office (NAO) has published its report on the likely impact of the proposed lifetime allowance for approved pensions savings, and other issues put to it by the chancellor

of the exchequer. The NAO is broadly supportive of the government figures and this makes it overwhelmingly likely that the tax simplification proposals will go ahead.

The full report is available from the NAO website at www.nao.org.uk/publications/pensions_estimates_march_04.pdf.



Pension trusteeship 'is outdated'

Alan Pickering, former chairman of the National Association of Pension Funds (NAPF), has said that UK corporates should take the management of final salary pension schemes away from trustees, who have 'outlived their usefulness'. Pickering, who admits his view is 'heresy' given the current governance of UK occupational pension funds, added that future UK defined contribution pension provision will become close to a direct contractual commitment between employer and employees, where there is no place for trustees.

Pension fund trustees oversee the investment of more than £1.3bn of occupational pension assets in the UK. Mr Pickering is a partner in Watson Wyatt where he led the trustee training programme for many years. The former chairman of the NAPF from 1991, he is also author of a government-sponsored report into the simplification of the UK pensions system.

After declaring his views at a bond investor conference in London, Mr Pickering said: 'I really don't think the Anglo-Saxon form of trusteeship has a future. The original promises made by pension schemes have become much closer to guarantees over the years. It is the sponsor which has to meet them and it is the sponsor, not the trustees, who should logically have control of decision-making.' Alan Pickering believes that lay trustees are being expected to deal with too many complex issues, including investment issues, which have a direct impact on the sponsoring company. He said: 'The role of the trustee will change as corporate treasury departments become involved with a view to containing future liabilities.'

 GORDON SHARP

CIS allows its customers to influence the direction of its ethical investment policy

CIS has announced that its social investment policy is to be defined by its customers. This innovative move will enhance CIS's share of the ethical investment market and will be a useful differentiation tool for customers increasingly concerned with the consequences of their investments.

The Co-operative Insurance Society has invited its 5.4m customers to choose how their money is used once invested. Many companies have an ethical investment fund in place, however CIS is the first to offer its customers the chance to reveal the issues that most concern them and use these to define its social investment policy.

The announcement comes at the beginning of Fairtrade Fortnight, a movement that has increased public awareness of the effect their actions have on the environmental and social conditions of people across the world. CIS has recognised the growing importance of corporate responsibility in social and environmental issues, and established a system whereby investors guide the ethical framework of the investment fund.

Prior to CIS's move, the most innovative ethical investment strategy on the market was Standard Life's Ethical Funds. These are chosen by a committee, which is made up of ethical investors as well as senior management. Involving the investors themselves in these decisions has proved successful for Standard Life in terms of new business as well as fund performance.

Pension funds in 2003

The weighted average return for UK pension funds in 2003 was 16% according to latest Russell/Mellon CAPS UK pension fund analysis. Despite the strong performance this year, the poor performance of the previous three years means that over the longer term pension funds only start to get back into positive territory when looking at five years and above. Over three years the weighted average return was -2.7% pa, while over five years pension funds returned 1.8% pa.

As in previous years, there has been a trend for pension funds to move towards scheme-specific benchmarks. Over 2003 the proportion of funds with a scheme-specific benchmark rose from 77% to 85%. Consequently only 15% of funds still compare themselves against a universe as their primary comparison. At the same time there has been an increasing trend towards passive investment. The proportion of funds that incorporate some element of passive investment in their fund has increased from 3% at the end of 1993 to 32% by the end of 2003. Ten years ago, at 31 December 1993, pension funds invested 3% of their assets passively, whereas today passive investment stands at around 15%.

Average UK equity weightings have

fallen year-on-year since the end of 1999. By the end of 2003, UK equities had fallen to an all-time low of 41.5%. By contrast, the overseas equity weighting at the end of 2003 was at its highest ever year-end position of 26.7%. Holdings in UK bonds continued to rise this year while overseas bond weights continued to fall. The average UK bond weighting of 19.4% at the end of the year was the highest level seen since 1983/84. At the end of 2003 around 95% of all bond investment was in the UK. This is the highest level seen since the end of 1987.

Over the course of 2003, Russell/Mellon CAPS measured the performance of 1,484 funds representative of 3,721 portfolios. At 31 December 2003, the total market value of these assets was £317bn.

Actuaries blamed for endowment shortfalls

The report of the Treasury Select Committee published 11 March concluded:

'Low-cost endowment mortgages became popular in the 1980s and 1990s, taking over 80% of the mortgage market at their peak. There are still around 8.5m policies in force. These mortgages carry with them the risk that the endowment policy might not repay the mortgage. As inflation and interest rates collapsed through the 1990s it became clear that actual investment returns were likely to be much lower than those originally assumed, implying that many policies would indeed fail to pay off the associated mortgage. The industry nevertheless responded slowly to the changing investment climate until regulators stepped in. This slow response raises questions about the role of appointed actuaries within insurance companies. It is important that the FSA's proposed reforms of the actuarial process within insurance companies succeed in delivering more proactive and independently minded actuarial advice.'

'The insurance industry has a poor track record for asset allocation and generally failed to cut back its equity exposure as the equity bubble inflated. The industry has thus been caught out by the recent fall in equity markets, forcing many companies to switch into low-risk, low-growth portfolios dominated by bonds. The result is that

around 80% of endowment policies are now unlikely meet their target of repaying the original mortgage, with an average shortfall across policies of £5,500. The shortfall on policies is likely to grow over time, but the current figures nevertheless suggest a collective shortfall across the endowment mortgage market that is already approaching £40bn.'

Lessons for the future

'Endowment mortgages have damaged public trust in the financial services industry. Many large retailers now have a higher level of public trust than some of the UK's largest financial institutions and there is an overriding need to rebuild public trust and confidence in the long-term savings industry. Reforming the way the long-term savings industry conducts its business should also help defend the UK's position as a major financial services centre.'

'Central to rebuilding trust is reforming the business model used by much of the industry. The debate on the Sandler price cap illustrates a continued focus on commission and sales that is unlikely to benefit the consumer. The challenge for both the industry and government is to develop a fee structure that rewards good investment returns and client retention rather than simply paying out high rewards for client acquisition.'

Who would buy an annuity?

If it were not compulsory to do so, nearly 60% of people in the UK would not convert their pension savings into an annuity, according to research by Jonathan Gardner and Mike Wadsworth of consultants Watson Wyatt.

Based on a sample of over 3,500 individuals aged between 50 and 64 years of age, Watson Wyatt found the dominant reason for preferring not to annuitise is a preference for flexibility (cited by 74% of those unwilling to annuitise). Some respondents also indicated a lack of trust in the insurance companies providing annuities. Among those who would choose to annuitise there is, on balance, a preference for annuitising earlier rather than later, the ratio being approximately 3:2 in favour of annuitising earlier.

'We had expected that the improved rates of conversion of funds into income at later ages would have persuaded consumers to defer annuity purchase', said Mike Wadsworth. 'But these responses may indicate a concern over loss of value on premature death.'

The Watson Wyatt research, which was carried out by the YouGov polling agency in late 2003, suggests that the dislike of annuities reflects a low regard for the positive features of annuities – such as security and sustainability of income – alongside concerns about possible weaknesses – loss of flexibility and exposure to loss of value on early death.

Factors showing a significant relation-

ship with willingness to annuitise included:

- ◆ health (those in good health are more likely to annuitise);
- ◆ education (more likely to annuitise with higher attainment);
- ◆ household size (less likely to annuitise as household size increases);
- ◆ income (higher earners are more likely to annuitise);
- ◆ major pension provision is defined contribution or personal pension (more likely to annuitise).

Reasons given by respondents as to why they would prefer not to annuitise include:

- ◆ Would like flexibility – 74%
- ◆ Believe they could do better themselves – 46%
- ◆ Income too low – 45%
- ◆ Wish to pass on assets – 38%
- ◆ Not live long enough – 37%

The Watson Wyatt research report 'Who would buy an annuity?' can be found at www.watsonwyatt.com/annuities or requested from sue.morgan@eu.watsonwyatt.com.

Enterprise risk management in insurance

A PricewaterhouseCoopers (PwC) study, entitled 'Enterprise-wide risk management for the insurance industry', draws on the findings of one of the most detailed and far-reaching ERM surveys ever conducted in the insurance industry, with a total of 44 leading insurers participating from Asia, Europe, and North America.

Commenting on the study, PwC partner Mark Stephen said: 'As insurers enhance their ability to measure, analyse, and respond to risk, ERM is likely to play an ever more proactive role in identifying the strongest sources of earnings and strengthening the execution of the strategic plan. ERM is likely to become an increasingly important part of the competitive strength of insurers.'

To download a copy of the study, please visit www.pwc.com/financialservices.

New qualitative index

The growing number of investors wishing to measure and analyse non-financial risk will soon be able to use an innovative new tool from FTSE Group, a global index provider, and Institutional Shareholder Services (ISS), one of the premier corporate governance ratings agencies. The two companies announced this month that they will collaborate to create an objective and transparent set of global corporate governance indexes. The collaboration will allow investors to identify corporate governance risks more easily across a global portfolio and provide standard and customised benchmarks, which reduce investors' exposure to companies with poorer corporate governance performance.

This initiative, which will be launched in phases beginning in summer 2004, has been developed in response to the growing concern among institutional investors about the management of risks associated with poor corporate governance when investing in global equities.

FTSE and ISS have identified a set of globally accepted corporate governance principles, which will be applied to rate over 7,000 companies within the FTSE Global Equity Index Series. These ratings will enable investors around the world to compare the companies within global portfolios using a single, integrated index. The design and methodology of the new index will draw on ISS's experience in developing the successful corporate governance quotient (CGQ) database and ratings system, which ranks the corporate governance practices of 7,500 companies worldwide. ISS's CGQ is used by institutional investors as a governance-based risk-assessment tool.

Catastrophes in 2003

According to updated figures from Swiss Re, 60,000 people worldwide were killed by natural and man-made catastrophes in 2003. Over two-thirds of these were the victims of earthquakes. According to the latest *sigma* report published in March, overall economic losses from catastrophes in 2003 amounted to an estimated \$70bn. Property insurers across the globe had to contend with losses of some \$18.5bn.

There were 380 catastrophes registered in 2003 in which almost 60,000 people lost their lives. The number of fatalities has risen substantially from when *sigma* published

preliminary figures at the end of last year and is now considered the seventh highest in over 30 years. The most tragic disaster in terms of loss of life was the December earthquake in the Iranian city of Bam in which 41,000 people were killed. Globally, the earthquake was the fourth largest in terms of victims since 1970. In addition, the earthquake which hit the region of Boumerdès in northern Algeria during May claimed the lives of 2,260 victims.

The *sigma* study 'Natural and man-made catastrophes 2003' is available from Swiss Re's website www.swissre.com/sigma.