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'Cure' for UK pension funds deficits inflicts more pain

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Liability-driven investing is perverse, pro-cyclical and costly

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Do pension deficits matter? It may seem an odd question to ask at a time when the officially recorded shortfalls at Britain's remaining defined benefit (DB) schemes have never loomed larger, or looked more menacing.

Last week, PwC produced data showing that the collective deficits in those 6,000 schemes had risen by a whopping £100bn in just one month to stand at £710bn at the end of August. According to the figures, just 67 per cent of their £2.2tn of estimated future liabilities is covered by their assets. That seems to imply that an awful lot of pensions are now at risk.

The pensions industry has responded with predictable cries of lamentation. Understandably so, perhaps, as the numbers raise the worry that the authorities will demand ever-larger contributions from sponsoring companies whose schemes are in deficit. For the weakest, that could even push some over the edge. But before joining in the general breast-beating, it is worth considering whether these data really measure the underlying affordability of pension promises.

The first thing about reported deficit numbers that should give us pause is their very volatility. This has little to do with the underlying health of a pension scheme, or indeed the strength of the covenant supplied by its sponsoring company. It reflects rather the mechanical effect of using "risk-free" yields to compute the present value of cash that will be paid out to pensioners over many decades. As UK monetary policy has scrunched down government bond yields, deficits have obediently shot up.

Yet this discount rate may bear little relation to the income-bearing potential of the assets in which the funds have invested. Many of the UK's surviving DB schemes are closed to new entrants, or even accruals, so most of that cash has long been placed in assets whose returns may differ significantly from those of gilts.

If these pots can deliver returns that are adequate to meet the long-term commitments the scheme has entered into, it is not clear why swings in government bond yields should require an immediate response. Indeed, lower rates should drive up the value of assets in the fund and — all things being equal — strengthen the sponsor's covenant. That in turn should allow the scheme to bear more risk, not less.

True, some schemes are struggling to afford the returns to pensioners that they promised. But the UK system does not really get at this question. What it does do, after a fashion, is to assess solvency. It is a form of early-warning mechanism, designed to force companies to make prophylactic contributions to schemes that do not meet its somewhat arbitrary definition of soundness.

Does any of this matter? Well it has a Pavlovian impact on those who take decisions about pensions, for instance by mandating recovery plans that weaken sponsors' businesses by forcing them to chuck capital into schemes. Even worse is the "cure" that pension funds have come up with for dealing with the volatility of the system. Known as "liability-driven investment", this encourages schemes to "de-risk" by mirroring in their investment approach the flawed system that measures their solvency.

So instead of selecting assets for long-term growth, they protect themselves against increases in short-term deficits. They do this by purchasing bonds so they are hedged against future interest rate falls. It is hard to conceive of a more perverse strategy at present. Funding retirement incomes in this way is about the most costly method imaginable. Liability-driven investment is also insanely pro-cyclical. The more pricey bonds become, the more of them schemes must buy. It also defeats the thrust of the UK's monetary strategy, which aims to drive investors into riskier assets by reducing returns on cash equivalents. Pension funds should be among those responding to this stimulus, not sheltering behind mountains of low-yield gilts.

The depressing conclusion must be that deficits do matter — for all the wrong reasons. The UK's existing approach to measuring them is on balance unhelpful, encouraging the authorities into knee-jerk actions that can only cut returns and weaken sponsoring firms. If we want a pensions system that can deliver its promises, we must start first by asking the right questions of these participants. Until that happens, the lamentations will continue, as will the sub par returns.

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