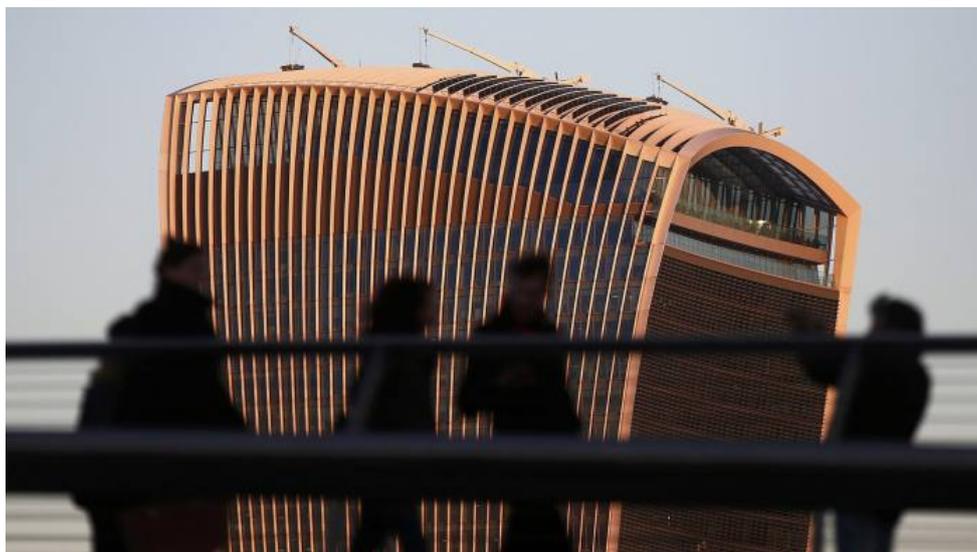


'Flaws' in valuations of pension fund obligations

Former regulator says companies need 'better ways' to assess their liabilities



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Josephine Cumbo, Pensions Correspondent DECEMBER 12, 2016

Companies are at risk of making a “significant misallocation” of cash from profits to [pension schemes](#) because of flaws in the way pension obligations are valued, according to a former regulator.

As employers come under pressure to reduce soaring pension deficits, Michael O’Higgins, who was chair of The Pensions Regulator from 2011-14, said “better ways” of assessing liabilities were needed to prevent companies from allocating money to apparently underfunded pension schemes when it could be better spent on other aspects of their business.

In Britain about 6,000 private companies sponsor traditional defined-benefit, or final salary-type, pension schemes. These pledge to pay an index-linked income for life to a member, based on salary

But the funding “black hole” for these schemes has almost doubled during the past year, largely driven by falls in gilt yields — which have had the effect of inflating pension liabilities — and in turn increasing calls on employers to plug shortfalls with more cash.

Mr O’Higgins said using gilts and corporate bonds to measure liabilities had “significant flaws” when yields on these assets were driven down by demand from both pension schemes and by the Bank of England’s monetary policy measures.

It is probably causing significant misallocation of resources — for example, from company profits to pension schemes rather than to investment or increased dividends

Michael O’Higgins

“We need to find a better way of examining pension fund liabilities, as this is not just an arcane accounting or actuarial issue,” said Mr O’Higgins, who is chair of the £12bn Local Pensions Partnership, a collaboration of two local government pension funds.

“It is probably causing significant misallocation of resources — for example, from company profits to pension schemes rather than to investment or increased dividends.

“It is also inhibiting M&A activity, either through concerns about the size of liabilities or fear of regulatory action.”

Mr O’Higgins said it was “economically nonsensical” for pension schemes to link their liabilities to bonds if a scheme itself had little or no investments in conventional fixed-income assets.

Mr O’Higgins’ comments to the Financial Times come as the total deficit of Britain’s 6,000 private sector DB schemes has climbed by almost £110bn to £580bn since the start of the year, according to JLT Employee Benefits, an actuarial consulting firm, as the [Brexit vote](#) and the BoE drove gilt prices up and yields down.

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Investors in the UK stock market have subsequently been warned to [expect £3.6bn](#) less in dividend payments, as companies divert cash to address

pension deficits.

Mr O’Higgins said a more “sensible approach” would be for schemes to assess liabilities based on the expected yield on the actual assets they held, such as equities or property.

“Whether in or out of the single EU market, our companies need resources for investment enabling a higher productivity economy,” he said.

His views were contested by some pension experts who believe bonds should remain the key reference for valuing pension obligations.

“In the real world, when insurance companies buy pension liabilities from companies, they use bond-based values,” said John Ralfe, an independent pensions consultant. “If [Mr O’Higgins] believes they are wrong, he should start a company to buy pension liabilities for less, and will have plenty of takers.”

Raj Mody, a partner with PwC, said existing rules allowed trustees and their advisers to consider alternative ways to assess liabilities but there was a reluctance to “break ranks”.

The government is expected to consider ways to measure liabilities in a green paper, to be published early next year.

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