

FTSE firms celebrated as their combined pensions shortfall shrank by £20bn last year. However, as Pam Atherton finds, factors such as rising life expectancy mean that many final salary schemes face a precarious future.

# pensions and longevity risk

■ **Recent analysis of UK final salary schemes by the Pension Protection Fund (PPF) and the Pensions Regulator (TPR) showed that 58% of these schemes are now closed to new members and that their total deficits stand at £33.8bn.**

The report, titled *The Pensions Universe Risk Profile* or 'Purple Book', (based on 5800 schemes, representing 85% of the UK's pension liabilities) was designed to provide comprehensive information to help identify and manage the risks faced by final salary schemes.

While the fall in the overall deficit of these schemes was welcome news, final salary schemes face an uncertain future as they remain vulnerable to future changes in inflation, interest rates and the longevity of their members.

According to the report, a decrease of 7.5% in equity returns and a reduction of 0.3% in gilt yields would increase deficits in aggregate by £74bn, while each year added to longevity assumptions would add around 3% to scheme liabilities.

Some pension schemes have tried to manage their investment risks via liability driven investment (LDI) strategies, whereby they switch out of equity and bonds and into derivative-based products, such as inflation and interest rate linked swaps.

But although a number of investment banks are working on producing the Holy Grail of a longevity bond that might help pension schemes inoculate themselves against longevity risk, the perfect product has yet to be invented.

Despite relatively benign investment conditions in 2006, the seriousness of the impact of longevity risk was brought home recently, when WH Smith announced in January 2007 that it was closing its final salary scheme because of the difficulty and cost of managing the various risks associated with it.

This was despite the fact that WH Smith was one of the first UK pension schemes to try to limit its large and fluctuating pension deficit by adopting an LDI investment strategy in 2005. But it decided to close its final salary scheme because it could not protect it against the cost of the rising life expectancy of its members.

## longevity assumptions

Its scheme actuaries had been required to raise their estimates of how long each member might live in retirement in each of the past three years. Furthermore, despite the company making pension contributions of £282m to its scheme over the past four years and agreeing to inject a further £10m a year over each of the next five years, the scheme still has a £41m deficit.

WH Smith's decision to close its scheme serves to underline how the rapid increase in life expectancy improvements, particularly for the baby boomer generation, can undermine even those pension schemes that have made efforts to eliminate their investment risks, via LDI, currency hedging and so on.

The international accounting standard IAS19, unlike FRS17, requires disclosure of major pension scheme assumptions, including longevity, and more than 30 FTSE 100 companies now provide this.

BT was one of the companies to provide its longevity assumptions for the first time in 2006. As at September 2006, its IAS 19 pension liabilities were £39bn, the largest in the UK, compared with its market cap of only £25bn.

But following the massive reduction in the BT scheme's pre-tax deficit from £9bn in March 2003 to £2.8bn as at September 2006, questions are being asked as to whether its longevity assumptions are realistic.

For instance, its longevity assumptions are less conservative than

those used by the Royal Mail scheme, which has a number of similarities with the BT scheme. Both have a retirement age of 60 and both use the same actuarial firm, Watson Wyatt.

But BT assumes that a 60 year old man will live, on average, to 83.8 years and a woman to 85.4 years, more than two years less than Royal Mail's assumptions. However, both schemes use the same figure for improvement in future longevity – namely one year for each 10 years, meaning that today's 40 year old will live two years longer than today's 60 year old.

As an indication of the sensitivity of pension scheme deficits to longevity expectations, Royal Mail's longevity assumptions used to be weaker than those used by BT, but in 2006 Royal Mail increased these by four years. This drove up Royal Mail's deficit to £5.6bn in 2006. If it had not increased its longevity assumptions, its deficit would have fallen.

Furthermore, the assumptions used by Royal Mail are those recommended by the Pension Protection Fund when a scheme is calculating its valuation for the purposes of the risk based levy (which all final salary schemes have to pay towards the running of the PPF).

The PPF's assumptions are based on the 1992 series mortality tables allowing for 'medium cohort' projections of future longevity improvements.

#### increasing deficit

BT says that each one-year increase in longevity assumptions increases its IAS 19 liabilities and pre-tax deficit by £1.5bn, while a two year increase in longevity would increase its liabilities by £3bn (or 8%) to £42bn, and would more than double its latest deficit to £5.8bn.

Clearly, the scale of longevity risk for BT and other major FTSE 100 pension schemes is massive and on current trends will continue to be a moving target for some time to come.

The actuarial profession has recently adopted new updated mortality tables based on UK insurance company experience during the period 1999-2002. Using these tables would increase BT's pension liabilities and deficit by a further significant amount.

While longevity risk is a major issue driving the flood of final salary schemes to close to existing members, a number of other factors is expected to exacerbate the trend.

These include the increased costs associated with complying with new anti-age discrimination legislation (which came into force in December 2006); expected increases in the PPF levy; and the advent of a National Pension Savings Scheme in 2012 that may encourage some employers to level down to the NPSS's minimum employer contribution level of 3%.

That said, not all is doom and gloom. Remarkably, the 'Purple Book' showed that 17% of schemes are in surplus, with an aggregate surplus of £42.6bn, and that 43% of final salary scheme members belong to a scheme that remains open to new entrants. ■

Pamela Atherton is a freelance journalist.

