PENSIONS NEED NEW DISCOUNT RATE

PRESS RELEASE

NEW PUBLICATION ON DEFINED BENEFIT PENSIONS STATES THERE IS ONLY ONE CORRECT DISCOUNT RATE – INTERNAL GROWTH RATE – SADLY, NOT A RATE REGULATORS USE

"Keep Your Lid On
A Financial Analyst's View of the Cost and
Valuation of DB Pension Provision"
by Con Keating, Ole Settergren and Andrew Slater

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There has been growing discontent among the sponsors and trustees of defined benefit (DB) pension schemes over scheme valuation regulations and practices. This is evidenced by the calls for smoothing from the NAPF, CBI and Association of Member Nominated Trustees, and, indeed, by the DWP's call for evidence on the subject of asset and liability smoothing and the Pension Regulator's responsibilities. There is an ongoing debate about the use and relevance of market prices and yields in scheme valuations, as these form no part of the pension contract between employer and employee. Different ways are used and several have been proposed to evaluate the state of pension funds for reporting and management purposes. None is satisfactory.

Long Finance is pleased to publish a ground-breaking paper by Con Keating, et al., on a better method for calculating fund discount rates. The paper introduces a method, the Internal Growth Rate (IGR), which is accurate, stable and entirely consistent with fair value accounting, though it does not rely on market prices or yields. The authors show that discounting using IGR meets reporting objectives. The many alternatives in current use (risk free rate, Gilts, expected asset return, …) are shown to lead to over or under estimates, bias and volatility. The IGR avoids over or under estimates by considering an element of the system overlooked in current arrangements, contributions. Contributions are primary inputs for the process that delivers the output, pensions. The IGR enables accurate and consistent evaluation of the state of the pension system when applied to the income and expense projections.

Added benefits of IGR include stability of reporting and elimination of spurious external effects in pension fund reporting. With IGR, it is possible to avoid unnecessary and costly interventions in scheme management. Current (misleading) standards are aimed at improved reporting of problems rather than on improving fund dynamics.

IGR calculations incorporate the entire fund design, including funding arrangements with sponsors and the use of insurance and guarantees. The IGR may be used to assess and compare pension scheme performance, and to measure the impact of management interventions such as liability driven investment and closure of schemes to new participants. IGR sheds new light the debate on the affordability of DB schemes. Professor Michael Mainelli of Long Finance, said, "We are delighted to publish our third report on pensions reform. The authors show that the biggest obstacle to bringing back our most effective retirement savings vehicles, DB schemes, is our lack of intellectual rigour in valuing them over the long term. This report raises serious questions about regulation and valuation for actuaries and accountants."

IGR provides the correct incentives for both funded DB scheme provision and long-term socially useful investment. The many criticisms of current standards have lacked a coherent description of a simple, viable and accurate substitute; this is it.

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Notes to Editors

Con Keating is currently a member of the steering committee of the financial econometrics research centre at the University of Warwick and of the Societe Universitaire Europeene de Recherche en Finance. As a research fellow of the Finance Development Centre he published widely on the regulation of financial institutions and pension systems, and also developed new statistical tools for the analysis of financial data, such as Omega functions and metrics. From 1994 to 2001 Con was chairman of the committee on methods and measures of the European Federation of Financial Analysts Societies and is currently a member of their Market Structure Commission. Con has also served as an advisor and consultant to the Organisation for Economic Cooperation and Development's (OECD) private pensions committee and a number of other international institutions. In a career spanning more than forty years, Con has worked as an infrastructure project financier, corporate advisor, investment manager and research analyst in Europe, Asia and the United States. He has served on the boards of a number of educational and charitable foundations and as a trustee of several pension schemes. He is currently Head of Research for the BrightonRock insurance group.

Ole Settergren is an expert in the Swedish government's investigation of work incapacity benefits, director of the Department of Pensions, Swedish Social Insurance Agency from 2004 to 2008 and Lead Economist at the National Social Insurance Board from 2001 to 2003 where he coordinated the research on pensions. Prior to that, Ole was responsible for developing the standard for the annual report of the Swedish Pension System and was its editor from 2001 to 2008. As an expert to the Pensions Reform Group at the Swedish Ministry of Health and Social Affairs from 1995 to 2000 he penned the legislation on the indexation and automatic balance mechanism of the new Swedish pension system. Ole obtained his MBA from the Stockholm School of Economics.

Andrew Slater is a Fellow of the Institute of Actuaries, a CFA Charterholder and Alumni of Cambridge University and London Business School. He has worked in the field of DB pensions for consultancies, asset managers and insurers in the UK, The Netherlands, Germany, US, Canada, Hong Kong and South Africa. He is a specialist in investment and asset liability management for institutional investors, particularly defined benefit pension schemes, with a penchant for challenging orthodoxy.

About Long Finance – www.longfinance.net

Established in 2007, Long Finance aims to improve society's understanding and use of finance over the long term by hosting and promoting a series of lectures, discussion events and research publications. The initiative began with a question – "when would we know our financial system is working?" – and seeks to challenge a financial system that revolves around short-term thinking and practices.

About Z/Yen Group – www.zyen.com

Z/Yen is the City of London's leading commercial think-tank, founded to promote societal advance through better finance and technology. Z/Yen 'asks, solves and acts' on strategy, finance, systems, marketing and intelligence projects in a wide variety of fields. Z/Yen manages the Long Finance initiative.

Long Finance has published two previous reports on pensions reform:
Don't Stop Believing: The State and Future of UK Occupational Pensions, Con Keating (2011)

Don't Stop Thinking About Tomorrow: The Future of Pensions, Con Keating (2010)