‘Their house is on fire’: the pension crisis sweeping the world

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Jan-Pieter Jansan, a 77-year-old retiree from the Netherlands, had high hopes for a worry-free retirement after having saved diligently into a pension during his working life.

But Mr Jansan, a former manager in the metal industry, has been forced to reappraise his plans after receiving notice from his retirement scheme, one of the Netherland’s biggest industry-sector funds, of plans to cut his pension by up to 10 per cent. Understandably, the news has hit like a sledgehammer.

“This is causing me a lot of stress,” says Mr Jansan, who retired 17 years ago and hoped to use his pension pot to treat his grandchildren and afford good hotels on holidays. “The cuts to my pension will mean thousands of euros less that I can spend on the family, and the holidays we like. I’m very angry that this is happening after I saved for so long.”

Mr Jansan is not alone in experiencing pension pain. Tens of millions more pensioners and savers around the world are facing the same retirement insecurity as Mr Jansan as plunging interest rates since the financial crisis wreak havoc on the funding of schemes. Pensions have become a defining political issue in countries as diverse as Russia, Japan and Brazil.

General Electric, the US industrial conglomerate, recently announced that it is joining a growing list of companies that are ending guaranteed “final salary” style pension schemes, affecting around 20,000 of its employees. In the UK, tens of thousands of university academics are preparing to take strike action over steep rises in their pension contributions.

Teachers and civil servants in the UK protest against changes to their pensions © Jenny Matthews/Alamy

A common factor in this global pension upheaval has been suppressed bond yields.

Bonds have historically provided a simple match for the cash flows needed to be paid out to the members of retirement schemes such as Mr Jansan's. But decades of declining bond yields have made it far harder for pension funds to buy an income for their members, pushing them more into equities and other riskier, untraded investments, such as real estate and private equity.

Buoyant financial markets have so far ensured robust investment gains for pension plans on their existing holdings. Yet given their long-term liabilities, the dimming outlook for future gains is causing anguish.

Funding status of pension plans sponsored by S&P 1,500 companies

Surplus or deficit ($bn)

Source: Mercer

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“Their house is on fire,” says Alex Veroude, chief investment officer for the US at Insight Investment, which manages money on behalf of many pension funds. “And rates can and probably will go lower from here. Even if the house is on fire, it’s still only the first floor. We think it can hit the second and third floor as well.”

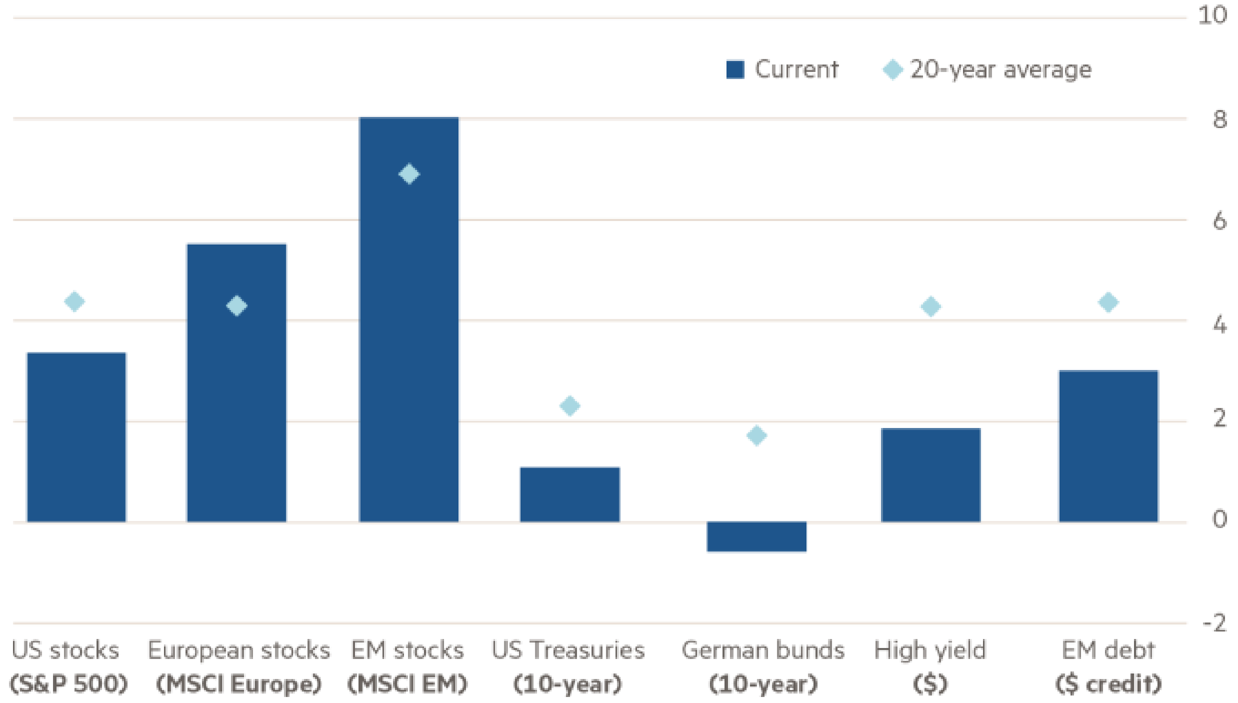
This is not merely a danger to individuals like Mr Jansan who may see their pensions cut — it could also have a wider impact on the economy. If people set aside more money for retirement, it may hamper economic growth by reducing consumption — the opposite of the intention of central banks when they cut rates. The Swedish Riksbank hinted obliquely at this when it recently signalled it would lift interest rates back to zero by the end of the year, saying that “if negative nominal interest rates are perceived as a more permanent state, the behaviour of agents may change and negative effects may arise.”

There may even be more systemic consequences. Last month the IMF warned in its annual report on global financial stability that the rush by pension funds into “illiquid” assets will hamstring “the traditional role they play in stabilising markets during periods of stress”, as they will have less money available to scoop up bargains.

The push into more unorthodox investment strategies is worrying some in the industry, who warn that they could exacerbate market downturns. “We’re seeing some really unusual behaviour, and we’ll see some payback,” says Con Michalakis, chief investment officer of Statewide, an Australian pension plan. “The trillion dollar question is when? I’ve been doing this for long enough not to want to predict when it will happen.”

Dimming expectations for asset classes

Real expected returns (%)



Sources: Bloomberg; MSCI, RIMES; Morgan Stanley Research
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When Christopher Ailman studied for a degree in business economics at the University of California in the late 1970s, Federal Reserve chairman Paul Volcker was ratcheting up interest rates, sending bond yields spiralling higher. Soon after he graduated in 1980 the 10-year Treasury yield hit a record of nearly 16 per cent — and the concept of sub-zero yields seemed preposterous.

"At school my textbooks said that there was no such thing as negative interest rates," says Mr Ailman, now chief investment officer at Calstrs, the $238bn Californian teachers' pension plan. "But here we are."

In the wake of the financial crisis, many central banks deployed unconventional new tools to reinvigorate the global economy once interest rates hit zero. At first this primarily meant massive, multitrillion dollar bond-buying programmes, but in 2009 Sweden became the first central bank to experiment with negative interest rates.

It was later followed by Japan and the rest of Europe, with the desperate scramble for bonds pushing yields lower. Growing concerns over the health of the global economy, a subdued inflation outlook and expectations of even easier monetary policy have now pushed the pile of negative-yielding debt to more than $13tn.

Pension plans invest in a broad array of asset classes, but with many stock markets at or near record highs, the prospect of gains are dimming across the board. AQR Capital Management estimates that the classic 60-40 balanced equity-bond fund might return as little as 2.9 per cent on average a year after inflation over the next decade, compared with an average of 5 per cent since 1900.

“Higher prices are simply pulling forward ever more future return to the present,”

Christopher Ailman, chief investment officer at Calstrs, the $238bn Californian teachers’ pension plan, says: 'At school my textbooks said that there was no such thing as negative interest rates. But here we are.' © Christopher Goodney/Bloomberg

says Andrew Sheets, a strategist at Morgan Stanley. “That’s great for today’s asset owners, especially those close to retirement. It is much less good for anyone trying to save, invest or manage well into the future, who face an increasingly barren return landscape.”

The tumble in bond yields is particularly problematic for “defined benefit” pension plans, which promise members a specific payout. They use high-grade bond yields to calculate the value of their future liabilities, and every small move downwards deepens their funding challenges.

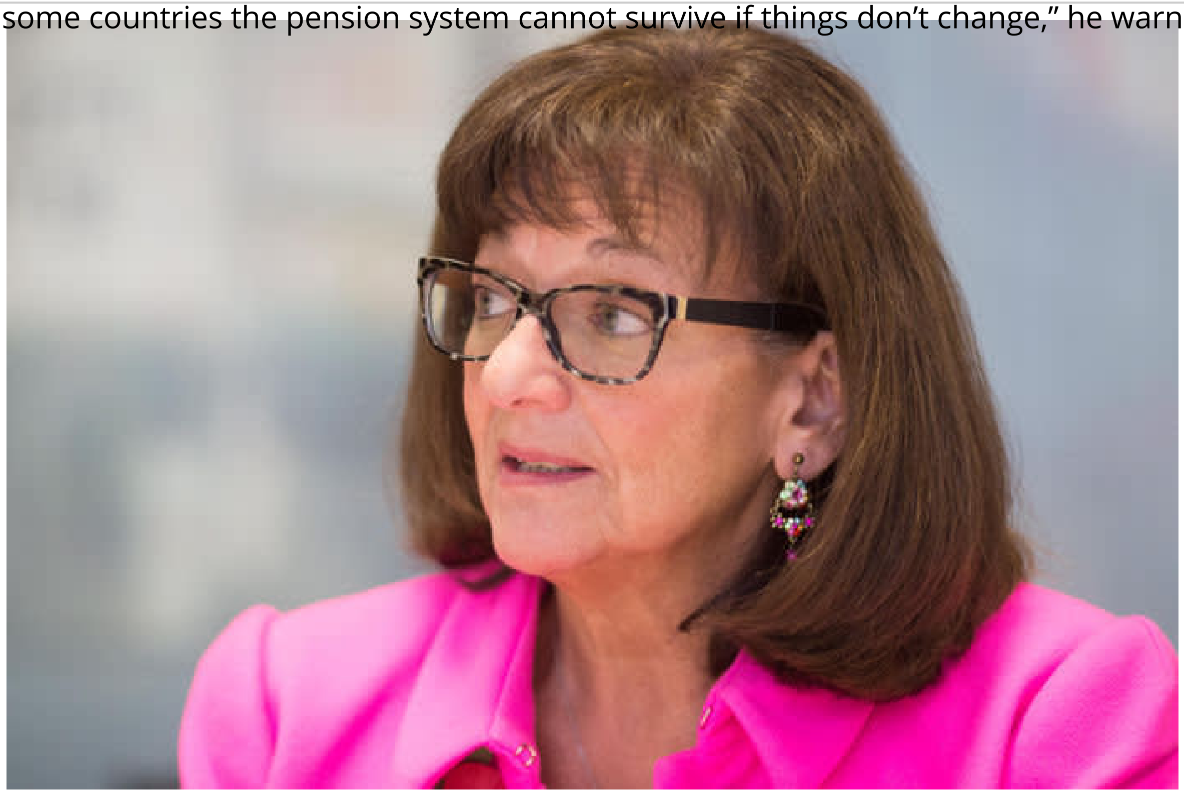
A one percentage point fall in long-term interest rates will increase liabilities of a typical pension scheme by around 20 per cent, but the value of their assets would only go up by about 10 per cent, estimates Ros Altmann, a former UK pensions minister. “Clearly, then, scheme funding will deteriorate and employers will need to increase funding,” she adds.

Many UK pension schemes are now using sophisticated “liability driven investment” strategies, hedging against the impact of lower rates on their liabilities. This has slowly started to catch on in Europe and the US as well.

But those schemes that have not taken steps to guard against interest rate risk now face huge increases in their deficits, and are having to make difficult decisions about how to bridge the funding gap.

Across the western world pension fund managers face similar challenges. The industry outlook is now as grim as it has ever been in Peter Damgaard Jensen’s two-decade stint at the top of PKA, a Danish pension fund.

“In some countries the pension system cannot survive if things don’t change,” he warns.



Roz Altmann, former pensions minister, says a one percentage point fall in long-term interest rates will increase liabilities of a typical pension scheme by around 20 per cent © David Parry/FT

“They either have to pay in more or cut benefits.”

In the Netherlands, the government has come under pressure to change retirement system rules so schemes can effectively shrink deficits, blown out by negative bond yields. With European bond yields hitting record lows in August, funding ratios — a measure of how much money a pension plan has compared with its liabilities — have collapsed to around 90 per cent, according to Anna Grebenchtchikova, a Dutch pensions expert. “The 90 per cent funding ratio means that benefit cuts are likely unless interest rates and/or equity markets rise substantially before the end of the year,” she says. “Consequently, many opposition parties and organisations for the elderly have called for a relaxation of the rules.”

One such fund is Stichting Pensioenfonds Zorg en Welzijn, the second-biggest Dutch pension fund. While it generated €39bn of investment gains in the first nine months of this year, falling yields have forced it to set aside an extra €54bn to meet current and future demands from pension holders. It now warns it might have to cut benefits for the first time in its half-century history.

“To avert a reduction, we urgently need help from politicians in The Hague,” Peter Borgdorff, PFZW’s director, wrote in a blog post earlier this month. “The clock is ticking.”

To counteract the fading outlook for returns from mainstream bonds and equity markets, many pension plans are ratcheting up their investments in "alternative" or "private" assets, such as private equity, real estate, venture capital, infrastructure and untraded loans.

For long-term investors who can accept the illiquidity in return for the promise of higher

People call for better pensions at a protest in The Hague © Koen Van Weel/EPA-EFE/REX/Shutterstock

returns, this makes sense. A housing project or toll road can produce a bond-like, steady income stream. Yet with almost every institutional investor exploring this avenue, it has led to froth in "private markets".

"There are some dangers," says Mr Damgaard Jensen. "It can create bubbles when people go into new areas. They're not the cheapest asset classes to go into. And there are a lot of fees. Often the only people that get rich are the fund managers. And you have to make sure you can hold on as it's hard to sell."

These private market investments involve allocating money to private equity or real estate funds, which will be "called" when their managers want to make a big acquisition. But this could reduce how much money pension funds have available. The IMF estimates that pension plans have doubled their allocations to illiquid assets over the past 10 years, and for about a fifth of funds these capital commitments amount to more than half their liquid assets.

"Given higher liquidity risks, pension funds will probably have to set aside more of their liquid assets to cover potential outflows during and after periods of stress, especially if market funding becomes more expensive," the IMF said in its Global Financial Stability

Report. “This would make it more difficult for them to buy assets traded at distressed price levels, limiting their ability to invest counter cyclically and thus play a stabilising role during periods of market stress.”

City workers walk over London Bridge on the way to the office © Dan Kitwood/Getty

Faced with a continued subdued outlook for investment returns, fund managers face the unpalatable prospect of inflicting further painby asking for bigger contributions from pension members and employers, imposing benefit cuts, or closing their schemes.

Baroness Altmann believes intervention is needed to limit the impact of pension pain spreading to the wider economy, as businesses divert cash from investment into paying more money to plug retirement scheme deficits.

“Government and regulators should be planning to help those pension schemes and their sponsors who may never be able to afford full annuity buyout, without becoming insolvent,” she says. “The development of a regime for ‘winding down’ rather than ‘winding up’, which does not require annuity purchase and which would see pensions paid out of a pooled fund of assets, would be more likely to deliver higher pensions overall.”

Without intervention, there are also wider risks to society as more workers could be shunted out of company-backed guaranteed schemes and into arrangements where their pension is at the mercy of the stock market.

“In 20 years we may find ourselves with a real global crisis where we haven’t saved enough money for retirement,” says Calstrs’ Mr Ailman. “Returns can fluctuate, but longevity has been extended dramatically . . . We just have to explain to millennials that their parents might have to move back in with them.”