The **Financial Inclusion Centre**

Financial markets that work for society

WORK AND PENSIONS SELECT COMMITTEE INQUIRY INTO DEFINED BENEFIT PENSION SCHEMES

Introduction

1. The Financial Inclusion Centre is a non-profit organisation which undertakes research and develops policy on financial markets. We are pleased to make a brief submission to the Committee's Inquiry on Defined Benefit Schemes.

2. We have restricted our comments primarily to prudential regulation, conduct of business regulation, investment performance, and the risks arising from chasing high investment returns in an effort to close pension scheme deficits in the new economic reality of low interest rates and subdued investment returns.

Background

3. The future of employers pension schemes – particularly defined benefit (or 'final salary') schemes – has been a major concern for regulators, employers and, of course, workers and pensioners who rely on these schemes to provide an income in retirement.

4. A recent report from the Pensions Institute makes clear the scale of the potential liabilities facing these schemes[1]. There are over 6,000 pension schemes in the Pension Protection Fund (PPF)[2] Index of private sector DB schemes. Together, these schemes are responsible for paying the current and future pensions of around 11 million members and their dependants.

5. The assets of these schemes are valued at around £1.2 trillion. But, the liabilities are estimated to be valued at £1.5 trillion using the PPF valuation measure[3]. This equates to an aggregate deficit of 20%. But, this conceals a wide range of situations. Over 1,000 schemes are in surplus and if these schemes are excluded the aggregate deficit is actually closer to 25%. However, the true position may be even worse. Experts suggest that if the full value of the pension benefits is included, the liabilities are closer to £2 trillion – an aggregate deficit of 40%.

6. It is important to note that underfunded schemes are effectively an unsecured creditor to the company providing the pension which may have a poor credit rating.

[1] The greatest good for the greatest number, A Pensions Institute discussion paper for DB trustees, sponsoring employers, advisers, policy-makers and regulators, Debbie Harrison, David Blake, December 2015, http://www.pensions-institute.org/reports/GreatestGood.pdf - note, Debbie Harrison is a trustee of the Centre

[2] The Pension Protection Fund pays compensation to members of eligible defined benefit pension schemes, when the employer goes bust and there are not enough assets in the pension scheme to cover Pension Protection Fund levels of compensation.

[3] As at September 2015, based on cost of paying out pensions at PPF levels. The actual liabilities are even higher

7. The PPF's view is that 10% of employers that sponsor schemes in its index are unlikely 'ever' to pay off their pension scheme debts - around 600 schemes. But the Pensions Institute experts estimate that 1,000 schemes are very unlikely to pay future pensions in full. Many of these are expected to become insolvent in the next five to ten years including some which will face insolvency due to the pension scheme deficit.

8. The problem is exacerbated by the behaviour of some sponsoring firms who have been accused of using dubious techniques to get rid of or sidestep their scheme's deficits or exploit surpluses – what is known as 'milking and dumping'[4].

9. So, we agree with the view that there is a major problem in the defined benefit pension scheme sector which will become a full blown crisis if action isn't taken to mitigate the risks.

Options for dealing with deficits

10. This presents us with an apparent dilemma about what to do to safeguard these pension entitlements. If action isn't taken, many scheme members (and dependants) will not get the pension they expect. But, if employers are required to put more money into the pension scheme to close deficits, some claim that this could affect the economic viability of sponsoring firms. However, as others have pointed out the risk of this has been overstated and there is scope for sponsoring employers to take alternative action – for example, by cutting dividends.

11. Of course, the alternative is that sponsoring employers and scheme trustees can hope that, rather than increase the level of contributions into schemes, the fund managers who invest the assets on the scheme's behalf will produce better investment returns to close the deficit.

12. However, this then creates the risk that, to generate these better returns, trustees will be advised by financial intermediaries to adopt much higher risk investment strategies which are not properly understood by pension scheme trustees or which fail to deliver. Fund managers and intermediaries do not have a good track record on selecting the right asset allocation and sustaining consistently high returns. Relying on this escape route is not sensible.

13. For example, as we highlighted in our research paper, according to OECD data UK pension funds have underperformed badly for long periods against OECD counterparts[5] - not even keeping pace with inflation.

14. Moreover, we have seen alternative investment strategies – such as absolute returns or diversified growth strategies (DGFs) - which claim to offer good returns *and* minimise risk become more popular as investors such as pension schemes search for yield to close scheme deficits in the new economic and financial reality defined by low interest rates/ subdued returns. There has been a fourfold increase in DGF funds under management over the past five years, from £25bn in 2010 to £115bn in 2015. Furthermore, DGF funds under management are forecast to rise to £200bn by 2020[6].

[4] The Pensions Institute, Milking and Dumping: The Devices Businesses use to Exploit Surpluses and Shed Deficits in Their Pension Schemes, August 2016 http://www.pensions-institute.org/reports/MilkingAndDumping.pdf
[5] Financial Inclusion Centre briefing paper: Performance of UK and OECD pension funds, December 2014
[6] Pensions and Lifetime Savings Association, Diversified Growth Funds, Made Simple Guides, October 2015, see p9

15. The more ‘dynamic’ DGFs in the sector take active management to another level using active *asset allocation* decisions, not just active stock selection, to try to achieve the ideal of good returns and low risk. There has been a huge debate about the wisdom of investing in high charging, actively managed funds as opposed to cheaper, passive investment strategies. The evidence seems conclusive. It is not worth the risk paying for active fund management.

16. But, do active DGFs deliver where active stock selection funds have failed? We do not have the same historical evidence of DGF performance to draw upon. Not enough DGFs have sufficient track records to allow us to draw the same definitive conclusions. However, what evidence there is does not look good for DGFs.

17. Take, for example, the performance of absolute return funds. Absolute return funds claim to be able to produce a positive return even in the most difficult market conditions. But, as the FT reported recently, UK domiciled absolute return funds are on course to register record net inflows but two-thirds have delivered negative returns in 2016[7], failing to deliver on the basic promise of preserving capital even in difficult market conditions.

18. A report published by Willis Towers Watson this year was very critical of the value provided by the DGF sector and prospects for the future[8]. To be fair, DGFs did appear to provide some relative downside protection during the financial crisis. But, since then the comparative performance has been disappointing. Over a period of nearly seven years, the average DGF has only managed to perform in line with a simple 60/40 equity/bond portfolio, before fees are taken into account. Once the higher fees associated with DGFs are taken into account, this implies that DGFs underperformed a simpler strategy.

19. Indeed, Willis Towers Watson found that most traditional, liquid DGF managers have actually detracted value through tactical asset allocation. The conclusion was that the fees charged by DGFs are ‘*generally not commensurate with the alpha achieved’* and that many DGFs have ‘*created the illusion that their insights and active management are valuable, whereas so far most have only delivered market beta (which is almost freely available) through long-term strategic asset allocation’*. The report went on to say that the managers of most funds demonstrated low skills in tactical asset allocation, with many actually destroying value through idiosyncratic trading. In the new economic and financial reality, defined by low returns, it remains to be seen whether DGF managers have the skill to add value – particularly if the growth in assets under management continues.

20. So, there are real questions about the added value of alternative strategies such as DGFs. But, there are other concerns. It is critical that pension fund trustees (who have been treated wrongly in our view as ‘sophisticated’ investors) understand the risks of investing in alternative investments including the higher costs involved.

21. As explained, DGFs can provide what seems to be a beguilingly simple offer to investors such as pension fund trustees. However, the strategies underpinning these offers can be very complex

[7] Financial Times, https://www.ft.com/content/077fcff8-6081-11e6-b38c-7b39cbb1138a
[8] Towers Willis Watson, Diversified Growth Fund Investing: is there a better way?

and are not guaranteed to deliver. The more complex the strategy, the greater the risk of misselling and conduct of business in the asset management sector has been under the spotlight attracting the attention of regulators and consumer campaigners[9]. Justified confidence and trust is a pre-requisite if we are to encourage pension scheme members to stay committed to their pension scheme.

22. So, we do not have confidence that pension schemes can rely on asset managers to produce the necessary returns to close these deficits. Indeed, higher risk investment strategies could exacerbate the problem with deficits. Trustees may put off taking more direct action in the hope that these high risk strategies will deliver. At a future point, the scheme would still have the same liabilities. But if the hoped-for investment returns do not materialise, the scheme's assets could be worth even less – increasing the deficit.

The way forward – better prudential and conduct of business regulation

23. None of the escape routes for pension schemes in difficulty look particularly attractive. But, the worse option in our view would be to wait and hope that this will resolve itself over time and/or relaxing the rules to make the problem look less serious. These are not sensible options and creates their own risks.

24. Resolving the problem with pension scheme deficits requires some tough decisions by employers and regulators. One thing that can be done to address the issue is to reform the regulatory framework for defined benefit pension schemes. We make three main high level recommendations for improving the regulatory framework and would be happy to provide more detail to the Committee if required:

- The prudential regulation of defined benefit schemes should be tightened up;
- Conduct of business regulation as it applies to defined benefit schemes should be toughened up; and
- Linked to the previous point, the 'architecture' of pension regulation should be redesigned and clarified so that we have a more explicit 'twin-peaks' regulatory architecture.

Prudential regulation

25. Better prudential regulation means regulators forcing sponsoring employers and pension scheme trustees to confront the challenges ahead of them. One option for dealing with dealing with scheme deficits, which is not sensible in our view, is to amend the rules relating to meeting pension promises. In our view, there already is too much flexibility with regards to statutory funding objectives. All this flexibility does is to transfer the risk to the future or to '*kick the can down the road*'.

26. We support the view that the current individualised statutory funding objective should be replaced with much tougher prudential regulatory standards relating to schemes involving:

- more consistent, robust rules for measuring pension fund deficits;
- defined recovery periods for all schemes (where relevant); and
- more robust supervision and enforcement of regulatory standards and rules by the pensions regulator including earlier intervention to resolve schemes which are clearly in an unrecoverable position.

[9] See for example the FCA's Asset Management Review

Conduct of business regulation

27. Trying to identify asset managers who will beat the market or complex ‘dynamic’ investment strategies which will deliver good returns with limited extra risk is not sensible for pension scheme trustees. However, charges are within the control of pension schemes and the more productive thing for trustees to do is to focus on bearing down as much as possible on costs by adopting simple investment strategies as a default – this has the additional benefit of being easier to understand.

28. But, investment consultants and asset managers exert significant influence over the decision making processes of pension scheme trustees who have been considered wrongly in our view as ‘sophisticated’ investors by regulators. Therefore, it is important that more is done to ensure that trustees understand the risks of investing in alternative investments (including the higher costs involved) and that those selling high risk strategies comply with the highest conduct of business standards.

29. Regulators should increase their supervisory focus on the behaviours of investment consultants and asset managers to mitigate the risks of pension scheme trustees being sold inappropriate, costly complex investment strategies to close pension scheme deficits.

30. In the retail pensions sector, one of the most successful interventions was the introduction of stakeholder pensions and the ‘RU64’ rule. RU64 required advisers to explain clearly why they were recommending a more expensive existing personal pension rather than a better value stakeholder pension. This had the effect of bringing down the charges on personal pensions to the level of stakeholder pensions producing real gains for consumers.

31. We argue that the same principle be followed in the institutional pension fund sector. In an era of subdued investment returns, it is imperative that investment consultants and asset managers recommend the most cost efficient and effective strategy. Investment consultants and asset managers should be required to justify clearly in writing why they are recommending more complex, risky, and costly strategies – using independent analysis to support recommendations. These justifications should be the focus of supervisory actions on the part of regulators along with more intensive scrutiny of disclosure of costs.

32. Moreover, it is important that investment consultants and the asset management sector understand the conduct risks involved in selling costly, complex strategies such as DGFs. To manage the conduct risks, it is critical that, when fund managers manufacture and distribute these products, they undertake proper stress testing with the target market to ensure clients understand the reality of offer and complexity of the strategies involved, and market these strategies in a fair and transparent way[10]. Unless asset management firms identify and manage these conduct risks, there is a strong likelihood of a major misselling scandal in the pension fund market involving complex products such as DGFs.

Clarifying the regulatory framework for defined benefit pension schemes

33. To improve the effectiveness of regulation, we recommend some adjustments to the regulatory framework to clarify the responsibilities of The Pensions Regulator (TPR) and the Financial Conduct Authority (FCA).

[10] The asset management sector undertakes financial stress testing but does not appear to be very good at stress testing investor understanding of complex products. The FCA found that only five of the 19 major investment firms investigated in the review undertook end-user testing to see if they understood the risks involved, Thematic Review, Meeting Investor Expectations, TR16/3, p9 https://www.fca.org.uk/publications/thematic-reviews/tr16-3-meeting-investors%E2%80%99-expectations

34. We recommend that there be a more clearly defined ‘twin peaks’ approach for regulating defined benefit schemes similar to that adopted for major banks and insurance companies. TPR remains the best place for ensuring proper prudential regulation of defined benefit schemes. The FCA already supervises much of the activities of asset managers. But, there is a lack of clarity as to who is responsible for supervising the conduct of business behaviours of investment consultants and asset managers with respect to their interaction with employers’ pension schemes. Therefore, it should be clarified that the FCA has responsibility for all aspects of conduct of business regulation – including advice, conflicts of interest, disclosure and marketing, investment strategy/ product governance and design, and reporting requirements. This would not only bring a greater degree of clarity but ensure that conduct of business in the employers’ pension sector received a higher priority for regulators.

This marks the end of The Financial Inclusion Centre submission