

Written evidence from Redington Ltd (PPF0051)

Executive Summary

- 1.1. We welcome the opportunity to contribute a written submission to the Committee on the important questions regarding defined benefit ("DB") pension funds. This is especially relevant and timely given DB pension funds face a challenging macro-economic environment, and the sponsors of DB pension funds face tough choices regarding their allocation of capital.
- 1.2. You may be aware that the Pension and Lifetime Saving Association ("PLSA") has recently conducted a Call for Evidence regarding the landscape facing DB pension funds, which we replied to in some length detailing our experiences and views from working with over 60 UK pension funds in the last 10 years. We attach our full response to the PLSA Call for Evidence as an appendix to this letter, and we understand that the end goal of the PLSA process is to produce a consolidated document for Parliament containing views and recommendations on which there is consensus across the DB industry.
- 1.3. Below we include our thoughts on the specific questions on which the Committee has sought comment. Before that we would like to set the scene by highlighting a few key considerations regarding the environment for DB pension funds:
- 1.4. As we put together the response to the questions the Committee laid out, it became clear there were three themes that we felt were the most important points we wanted to make. They are:

- 1.4.1. The **Member Benefit** perspective

There are a number of stakeholders within the UK corporate DB scheme system, and regulatory context should weigh their objectives against each other to some extent, acknowledging key tensions that may exist. We think it is important to remember that the single overriding goal of each DB scheme is to pay the members' benefits as they fall due. Prioritising this objective could help align stakeholders and improve their decision-making process. As we discuss further below, there are important cases where even further prioritisation of objectives within this is required: for example in the case of severely -

funded schemes and weak corporate sponsors, where the objective of protecting accrued member benefits (capital preservation) may conflict with the objective of investing to try and pay the full benefits to members (reaching full funding). It is precisely such cases where regulation needs to be used effectively to help guide the difficult choices that must be made.

1.4.2. Look at the success stories ...

There are considerable challenges facing DB pension schemes. However the picture is more nuanced than is commonly presented - some schemes have been able to navigate from positions of poor financial health, to much stronger positions. A thorough analysis of what has created the conditions for this to happen within these schemes is equally as important as the broad picture facing all schemes.

1.4.3. Governance is key

Our experience and research suggest that better governance is a key determinant of better outcomes among pension schemes. The shortcomings of the governance of UK DB schemes has been well analysed and documented. Despite that, decisive change and improvement have been elusive and certainly are not visible across the industry. Best practice is far from universally applied and is conditional on the vision, experience, and enlightenment of certain Trustee Board chairman and/or the corporate sponsor. One of the reasons for the lack of progress in this area are Pensions and Trust Law regulations that are too prescriptive with respect to the make-up and composition of DB pension scheme trustee boards.

2. Specific questions from the Committee's request for contributions.

2.1. The adequacy of regulatory powers, including anti-avoidance provisions

- 2.2. We believe the regulatory powers could and should be strengthened, including the anti-avoidance powers.

2.3. Given the current (low) funded status of many pension schemes, covenant risk (the risk that the sponsoring employer may not be able to make good on their promised deficit-recovery contributions) will be a key concern for and a threat to member benefits. One way of helping trustees to manage this risk could be to allow them enhanced powers to negotiate with the sponsoring employer for security against specific assets in the sponsoring company, or priority over dividend payments (both of which appear to have been absent in the BHS case).

2.4. The application of those powers, including in specific cases other than BHS

2.5. We do not have sufficiently detailed experience with the application of these powers in practice to offer meaningful comment here.

2.6. The level and prioritisation of resources

2.7. If the powers of the pensions regulator were strengthened, this would very much need to be accompanied by an increase in resources and expertise within TPR. If TPR is required to step up its engagement with sponsoring employers, particularly in merger & acquisition scenarios then it is not unreasonable to require TPR to turn round case work in relatively short windows of time, which, we understand would require significantly greater resourcing than what TPR has currently.

2.8. Whether a greater emphasis on supervision and pro-active regulation would be appropriate

2.9. Broadly we believe that a more pro-active regulatory stance would be beneficial in improving the security of member benefits. However a balance does need to be struck here. Were the regulatory regime to become hugely more burdensome and draconian this would likely compromise the goodwill that a large number of corporate sponsors show toward their pension schemes, which is an outcome that should be avoided.

2.10. We would suggest a “strengthening of the hand” of trustees, in relation to negotiations over the recovery period, contributions, and asset security of the pension fund with the corporate sponsor. Accompanied by explicit guidelines and parameters for reasonable levels of these relative to other schemes and frameworks for trading one off against another.

2.11. Whether additional measures for schemes of private companies or companies with complex and multi-national group structures are required

2.12. Given the complexity in assessing the value of guarantees, security or default risk of large, complex or privately owned companies, it would make sense to us that TPR would have the requisite skill set and experience in house to achieve this (or the budgetary resources to procure the same on commercial terms from the marketplace). However we would have thought that a “one-size” regulatory approach is quite unlikely to work. Additionally, and maybe more importantly, the rules on the structure and composition of Trustee Boards should be reviewed, to allow more effective boards to run pension schemes.

2.13. The pre-clearance system, including whether it is adequate for particular transactions including the disposal of companies with DB schemes

2.14. We are not sufficiently familiar with the details of the pre-clearance system to offer a useful opinion here.

2.15. Powers relating to scheme recovery plans

2.16. In our experience better enforcement of recovery plans, and limitation of the sponsor’s scope to weaken the recovery plan either in terms of length or underlying assumptions would catalyse better decision-making relating to DB pension funds and reduce the ultimate risks in the system. However, there does need to be some flexibility in the system to accommodate sponsoring companies experiencing a temporary period of bad financial health, as it would generally not be in the members’ interests to tip a firm into insolvency that would, if given a slightly longer recovery plan, be able to make good on the contributions.

2.17. TPR could be automatically involved where sponsors push to lengthen or otherwise weaken recovery plans in the case of an underfunded pension scheme and / or weak corporate sponsor.

2.18. The impact of the TPR’s regulatory approach on commercial decision-making and the operation of employers

2.19. We do not have a strong view on this question

2.20. The Pension Protection Fund (PPF), including:

2.21. The sustainability of the Pension Protection Fund

- 2.22. In our view the PPF has done an excellent job of managing its markets risks in a tough environment. Indeed it has provided an excellent case study for how a pension scheme can be effectively risk-managed. We have no concerns over the sustainability of the PPF from a market perspective. The main concern over sustainability has to be the impact of severely under-funded schemes of weak sponsors falling into the PPF. This is a real concern in this environment but is very hard to quantify without access to more data. One well-known academic paper¹ published in late 2015 put the number of schemes likely to fall into the PPF at around 1,000 (out of a universe of 6,000). Given market moves since then this estimate is only likely to have increased.
- 2.23. One reason that this is a real concern is the lack of guidance for trustees on how they should behave in the case of a very underfunded scheme, with a weak sponsor (say one that is likely to fall into the PPF).
- 2.24. Should they carry on pursuing “full” benefits at the risk of further damaging the coverage ratio on the PPF basis? The priorities are unclear, and while there are no easy choices, a system without clear guidance is likely to lead to haphazard results.

2.25. The fairness of the PPF levy system and its impact on businesses and scheme members

- 2.26. No view

2.27. The role and powers of pension scheme trustees

- 2.28. Pension scheme trustees perform an important, and difficult role in a tough environment. One of the issues we raised in our response to the PLSA was the availability of sufficiently skilled and experienced trustees, especially at the smaller end of the pension scheme scale. Larger funds can usually command sufficient skills and resources, but there is a real concern at the smaller end which argues, in our view, for some consolidation in the space.

2.29. Relationships between TPR, PPF, trustees and sponsoring employers

¹ The Pensions Institute: The Greatest Good for the Greatest Number. Blake, Harrison 2015
<http://www.pensions-institute.org/reports/GreatestGood.pdf>

- 2.30. In our experience the relationship between trustees and sponsoring employers is critical to successful management of the pension scheme. For the vast majority of schemes the relationship with TPR and the PPF is much more distant.
- 2.31. It is our experience that many sponsoring employers do take a collaborative approach to addressing the pension deficit, along with the trustees. Indeed in many ways it is in their interests to do so (ie, to remove an unrelated risk to their underlying business, which in many cases the stock markets have begun to penalise them for). A recent report by Mercer² suggested that corporates had contributed c£75bn to pension schemes in aggregate over the last 5 years, but overall schemes are now less well funded than 5 years ago. As the report notes, in most other areas of a firm's operations such a large underperformance and value-destruction would not be tolerated - or at least addressed as a matter of urgency.
- 2.32. The balance between meeting pension obligations and ensuring the ongoing viability of sponsoring employers, including:**
- 2.33. TPR's objective to "minimise any adverse impact on the sustainable growth of an employer"
- 2.34. In our view the key balance that needs to be struck from a regulatory perspective is that between (i). being firm on contribution schedules with employers on the one hand (to protect the security of members' pensions) while (ii). trying to avoid putting out of business fundamentally sound companies who experience a few years of difficulty, but where more flexible terms could strengthen their ability to honour their payments. The goal here is to maintain the company a going concern for as long as possible.
- 2.35. We believe that in most cases it is, on balance, in the interests of schemes to continue to exist with a corporate sponsor even if that means somewhat weakening the terms of the recovery plan. There will be plenty of nuance to individual cases however which makes a "catch-all" regulatory system very difficult. We do believe it is possible to improve on the current system though, for example by:

² Mercer: Defined Benefit Pensions, A Corporate Perspective <http://www.uk.mercer.com/our-thinking/defined-benefit-pensions-a-corporate-perspective.html#contactForm>

- 2.35.1. Specifically defining for trustees the circumstances in which flexibility on contribution schedule is acceptable
 - 2.35.2. Requiring the chair of trustees/ CFO to co-sign a letter to the TPR in cases where flexibility has been used describing the circumstances and providing metrics that the trustees plan to track to monitor the recovering health of the sponsor
 - 2.35.3. Requiring the company CFO to provide such metrics on a regular basis
 - 2.35.4. Giving a trigger for escalation/resolution, facilitated by TPR if the metrics move outside what has been agreed
 - 2.35.5. Requiring sponsor companies to make public details of extended pension recovery plans
- 2.36. Whether the current framework is generating inter-generationally fair outcomes**
- 2.37. As noted in a recent paper³ by the American Association of Actuaries:
 - 2.38. *"Intergenerationally fair outcomes are generated by full funding on a default-free discount rate"*.
 - 2.39. To the extent that the current regime does not require full funding on a default free discount rate, you can argue that it is not set up to deliver intergenerationally fair outcomes. However, to enforce such a strong basis for funding instantly could also be seen as unfair, given we are starting from an under-funded position.
 - 2.40. In our view, the obligation of DB pension funds is to pay the benefits that have been promised, and as long as this remains the case the need for inter-generationally fair outcomes is a secondary goal.
- 2.41. Whether the current wider environment, including very low interest rates, warrants an exceptional approach**
- 2.42. This is a big question and worthy of an entire consultation paper in itself. The nature of the current environment certainly demands a sustained focus on the workings of the current system, and the flexibility it affords. A key question being the balance being struck between ensuring benefit security for members and pressures on sponsoring employers.

³ <http://www.pensionfinance.org/papers/PubPrin.pdf>

- 2.43. We would note that the current regulatory regime does allow for significant flexibility in terms of the valuation basis, discount spread and recovery period.
- 2.44. We would note that market environments, even extreme ones can persist for long periods of time, and indeed worsen.
- 2.45. It certainly makes sense to us that all options should be considered and researched as potential solutions to the problem of the current under-funded status of the UK DB pension system. However we would urge against options that simply try and “ignore” current market prices (such as using a fixed, or smoothed discount rate on the liabilities). As this carries a large risk that the problem is simply shifted further down the line, in the case that the current environment persists for many years (or worsens further). In particular allowing significantly off-market liability valuations creates a wealth transfer from stronger to weaker firms, via the PPF. Which should be avoided.

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APPENDIX - RESPONSE TO PLSA CALL FOR EVIDENCE

Original call for evidence background document can be found here

<http://www.plsa.co.uk/PolicyandResearch/DocumentLibrary/0587-DB-Taskforce-Call-for-Evidence.aspx>

Question 1a: Do you consider the projected view of the future of DB schemes and the pensions landscape set out in this Call for Evidence to be broadly right?

Yes we would consider the view to be set out to be broadly right. We wouldn't dispute any of the facts presented. However we would add several additional considerations that we believe need to be added to make the picture complete, and make a few observations.

The taskforce sets out to examine DB schemes from four perspectives: sustainability, member benefit protection, the wider economy and intergenerational equity. These are ambitious and important aims. However in our view these should not be equally weighed against each other - it is important to remember that DB pension schemes have one aim which takes precedence over the others. Trustees have an important, fiduciary role which is first and foremost to safeguard the accrued benefit payments to members, indeed this is the primary and overriding goal of DB schemes. The other objectives should only be focused on to the extent that can happen without impacting this objective.

We believe the role of regulation is an important consideration to be borne in mind but this needs to be viewed objectively. While changes to benefit legislation have indeed been very impactful, we believe the changes to scheme funding rules have not driven behaviour as much as is commonly imagined. Indeed the current funding regime leaves quite considerable scope for flexibility. We believe that much of the asset allocation behaviour observed by pension funds comes not from regulatory pressures but by an understanding of the best way to manage a DB fund in order to secure members benefits, a point which we return to below. It has also been our experience that the trustee/sponsor dynamic is more nuanced than is presented: some companies have gained meaningful share-price benefits from addressing pension risk and funding.

The projected view of DB schemes and the pensions landscape set out in the Call for Evidence sets out the challenging circumstances facing DB pension funds today. Generating the returns and contributions needed to pay benefits and generate financial security for

members in retirement will remain a challenge for at least the next decade and probably longer. However we don't believe this problem is intractable. We believe with the right mindset, collaboration and advice it is possible for schemes to successfully navigate their way through these challenges and indeed we have a number of examples we can point to that demonstrate this. Data shows that while the **average** financial position of pension schemes is indeed challenged, there exist many schemes with above average and far more favourable financial positions, many of which started off from poor or weak positions. These schemes demonstrate that the challenges are solvable. The tools and expertise that pension schemes can use to place themselves on a more sustainable and stable footing have existed for a number of years. Their application however is far from universal. A key question must be, why has this not happened?

To answer this question, we need to address three large "elephants in the room":

- The persistently large spread of governance capabilities of UK DB schemes and the acceptance of this spread,
- The nature of the commercial relationship between trustees and their advisers and how this perpetuates poor governance, and
- The spread of capabilities and expertise within the investment consulting market – both between firms and within the firms themselves.

The large spread of governance capabilities

The philosopher George Santayana famously said, "Those who cannot remember the past are condemned to repeat it". We have been here before – the 2001 Myners Report⁴ provided a clear and uncompromising analysis of the shortfalls in the capabilities and behaviours of UK pension fund trustees, e.g. training, expertise, overreliance on advisers and an inability to adequately evaluate their advice.

In short, whilst acknowledging these issues, the government of the day provided a pragmatic sop in the Pensions Act (2004) by requiring that trustees should have "knowledge and understanding" of key principles relating to the funding and management of pension schemes. Importantly, however, there was no adequate framework for addressing whether these standards were in place. Whilst we recognise that raising standards "overnight" would have been logistically impossible, imposing weak standards has simply deferred the problem.

Commercial relationship between trustee and adviser

⁴ <http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/media/2F9/02/31.pdf>

Whilst there has been no doubt an improvement in the management of most UK DB schemes over the last 15 years, we believe fit-for-purpose governance is the exception, rather than the norm. We believe that this problem is widely recognised by those who are closest to the problem and who can give the most qualified view, i.e. investment consultants and actuaries, however, there is no incentive or requirement for them to do anything about it. We contend that whilst most consultants and actuaries do their best to help their clients meet their objectives, in the vast majority of cases, they will not act in a way that will compromise their commercial relationship. For example, if they see their clients making poor decisions, they will dutifully try to help, but will not see it as their role to proactively have difficult conversations with the client suggesting that, for their members' sake, they need to improve their governance.

In the absence of a statutory requirement to report poor governance, there are strong commercial incentives for advisers to appear pragmatic and helpful, even if this might be, "straightening deckchairs on the Titanic". We believe that the industry needs to develop a stronger framework that recognises that although commercial contracting takes place with trustees, there is a moral and professional duty to consider the interests of scheme members.

We would argue that the pension fund community could learn from the model of governance seen in many educational institutions, where good practice requires governors to be "critical friends"⁵ to an institution. Professor John McBeath summarises the concept as follows:

'The Critical Friend is a powerful idea, perhaps because it contains an inherent tension. Friends bring a high degree of unconditional positive regard. Critics are, at first sight at least, conditional, negative and intolerant of failure. Perhaps the critical friend comes closest to what might be regarded as 'true friendship' – a successful marrying of unconditional support and unconditional critique. '

Creating an environment where advisers are required to be critical friends who need to honestly but supportively address poor governance would remove a fundamental challenge, i.e. trustees recognising that they have a problem.

The spread of expertise between and within investment consulting firms

Arguably the key factor that has driven the funding level of UK DB schemes has been whether they have adopted a liability driven approach to investment strategy, e.g. hedging uncompensated risks. Given the relative lack of expertise in most trustee boards, whether this approach has been adopted has been a function of two factors – the beliefs and expertise of each investment consulting firm and the ability of each client consultant to convince their clients to take their advice. Those firms who have expertise in this area and

⁵ A useful introduction to the concept can be found at https://www.aoc.co.uk/sites/default/files/Being%20a%20critical%20friend_0.pdf

high quality consultants will likely have clients with stronger funding positions and vice-versa.

Question 1b: If so, are there other factors which have contributed?

1. One very important factor is the view of risk from a member benefit perspective. We believe that the financial risks to member benefits are better understood and managed than they were a decade ago. The following two developments have been key to this:
 - a. The setting up of the PPF, funded by a levy on all DB schemes which pays the benefits (albeit at a reduced level) of schemes whose sponsoring employers become insolvent. This development has largely eliminated the episodes of widespread loss of benefits following sponsor insolvency that happened in the late 1990's and early 2000's⁶ and represents a significant enhancement to members' financial security
 - b. The reduction in financial risk to the funding status of defined benefit pension schemes in aggregate, achieved by less-risky asset allocations and increasing use of LDI hedging strategies (discussed further later). By our calculations⁷ these two changes have roughly halved the risk of large falls in the funded status of pension schemes. This development has also enhanced security for members, and has likely mitigated (to some degree) the impact of the current unfavourable macro-economic climate on pension schemes.

2. We would challenge the general use of the term "long-term" when describing the investment horizon of DB pension schemes. This is an easy generalisation to make and corresponds to historical theory, but is becoming less and less relevant in practice. Many schemes have maturity profiles that peak in the near future (or have already peaked) resulting in cashflow pressures that mean their investment horizon can not reasonably be described as long term. This becomes important when discussing the asset allocation that pensions schemes ought to adopt.

We believe one significant piece of context which is missing from the description is the growing body of academic and theoretical evidence, starting from the late 1990's⁸ that applied techniques of Financial Economics to pension schemes. This concluded among other

⁶ See for example <http://news.bbc.co.uk/1/hi/programmes/panorama/2467083.stm> and http://www.rosaltnmann.com/pdf/DB_Schemes_are_not_Safe.pdf

⁷ <http://redington.co.uk/articles/redviews-january-2016-the-great-de-risking-or-is-it>

⁸ THE FINANCIAL THEORY OF DEFINED BENEFIT PENSION SCHEMES BY C.J. EXLEY, B.SC., S.J.B. MEHTA, M.A. & A.D. SMITH, B.A. [Presented to the Institute of Actuaries, 28 April 1997] <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.195.7553&rep=rep1&type=pdf>

things that pension scheme liabilities were bond-like, and that the matching asset class for such liabilities was bonds. This led to increasing adoption of what came to be known as Liability Driven Investment ("LDI") strategies from 2003 onward, including the well-known transactions by the Boots and Friends Provident pension schemes, and others.

3. We would agree that sponsoring employers of many pension schemes face tough decisions, as they do in many areas of their operating business. We would add a couple of observations. Firstly, that effective collaboration and alignment of sponsor and trustee stakeholders has correlated heavily in our experience with better outcomes for the pension fund (higher levels of funding and lower risk). It is quite possible for both sponsor and trustees to find common ground in the desire to get the pension scheme to a financial position where it can pay out the benefits with a high degree of certainty, and with minimal recourse to the corporate sponsor. This satisfies the trustees' fiduciary duty to deliver the members' benefits, it also fulfills a business need for the sponsor of no-longer being saddled with the financial uncertainties of running a large benefit scheme, bringing multiple financial risks alongside their core business. It is frequently in neither party's interest to aim for a situation where large amounts of investment risk are run for decades into the future.

Secondly, there are examples of pension scheme related actions having meaningful positive share-price benefits, as the market removes a discount they were applying to reflect the risk and uncertainty posed by the pension scheme⁹.

4. One consideration missing from the forward projections mentioned is a more detailed perspective on scheme liabilities. The actuarial bases backing most schemes' regulatory recovery plans are generally not strong enough to represent a satisfactory end goal for most pension scheme trustees. A more prudent view of liabilities is usually necessary, and under this view, and by our calculations we would expect deficits on average to be closed over the next 20 or more years, rather than the 10 year figure implied by regulated recovery plans.

5. Finally, we believe that reference to the Myners review of 2001¹⁰, and in particular the principles listed in chapter 11 of this document which codify what the review believes are

⁹<http://www.pensions-expert.com/DB-Derisking/Smiths-uses-escrow-to-help-slash-250m-from-scheme-deficit?ct=true>

¹⁰ <http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/media/2F9/02/31.pdf>

best practice for pension fund decision making, is an important addition to the general background presented.

Question 1c: If not, what other factors should be taken into consideration?

Question 2a: What are the specific regulatory factors that impact the efficient running of DB schemes?

We believe that the most significant regulatory factors relate to the strength of the regulatory environment in relation to pension fund governance. Below we provide a sketch of the UK pension environment and regulation relative to the Dutch market and also to a similar area in the UK – the insurance industry. Our conclusion is stark – that the industry is under regulated and this, in combination with factors that we have mentioned earlier, has contributed to poor outcomes for many pension schemes.

The UK pension fund industry

1. UK pension assets (2015): \$3.2trn – relative to UK GDP: 112%. 68% in DB Schemes, 32% in DC Schemes – 10-year CAGR: 6.8%[1].
2. 50% of the working population contributes to a workplace pension i.e. c 15.5m persons[2].
3. There are 21m individual pension policies in force².
4. The UK pensions industry regulator, The Pensions Regulator (TPR), was set up in 2004. Its main objectives are:
 - a. “work with trustees, employers, pension specialists and business advisers, giving guidance on what is expected of them.”
 - b. “prevent problems from developing.”
5. The members of the Board of TPR are appointed by the Secretary of State for Work and Pensions: there have been 10 different pensions ministers over the past 15 years.
6. The number of DB schemes in the UK is over 6,000.

The UK insurance industry

1. UK insurance assets (2015): \$2.8trn – relative to UK GDP: 96%².
 2. The UK insurance industry has 2 regulators:
 - a. The Bank of England through The Prudential Regulation Authority: “promotes the safety and financial soundness of insurers and protects policyholders by ensuring
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continuity of cover so that valid claims are paid when they come due.” In short, a capital regulator

- b. The Financial Conduct Authority: focusses on the fair treatment of customers
- c. There have been 3 BoE governors over the past 23 years.

The Dutch pension industry

1. Dutch pension assets (2015): \$1.4trn – relative to Dutch GDP: 183% - 10-year CAGR: 7.3%
2. The pension industry is regulated by two institutions:
 - a. The Dutch Central Bank (DNB): examines the financial position of the pension funds. DNB assesses whether the pension funds are financially healthy and whether they can be expected to fulfil their obligations in the future. The DNB is also responsible for substantive regulation, such as monitoring that pension funds comply with the standards set for them.
 - b. The Dutch Authority for the Financial Markets (AFM): monitors the behaviour of pension funds, in particular regarding the obligations to provide information to members. The AFM also monitors the duty of care; pension funds, who offer pension products with freedom of investment, must actually provide this investment support to their (former) members
2. Coordinated consolidation of the industry by the regulator:
 - a. Number of pension funds in 2001: 900 - in 2011: 450 – in 2021: 50
 - b. This implies that within 5 years, the Dutch pension assets under management, expected to be c. \$1.8trn, will be concentrated within 50 institutions. That will create significant powerhouses that will be able to compete with the biggest Canadian funds, endowments, SWFs and other Australian SuperAnnunations.
3. Over 90% of employees are members of a pension fund – 75% of employees are members of industry-wide pension funds

Impact

The UK pension regulatory framework is not fit for purpose

In the UK, the pensions industry has significant societal impact: it manages the largest pool of capital in the nation (more than the insurance industry) and impacts over 20m people.

The pensions regulatory framework, however, does not reflect this importance and we would argue is not fit for purpose:

1. The regulator is not fit for purpose:
 - a. Its mission is light: "to prevent problems from developing"...
 - b. Its remit and powers are vague: pensions capital is not regulated, doubts exist around its ability/capability to intervene in a preventive way (British Steel, BHS, Nortel...);
 - c. Crucially, it has limited resources (compared to the banking and insurance regulators);
 - d. Its leadership is elected by government ministers, which have changed 10 times in 15 years;
2. The size and importance of the pensions regulator is not representative of the importance of the industry to the nation;
3. The regulator has limited powers (in absolute terms and relative to the regulatory bodies overseeing the insurance and banking industry in the UK or relative to the Dutch pensions regulators);
4. Pensions regulations have not significantly improved since 2004 – only guidance or codes are published.

Impact on Governance

Pension scheme governance is therefore not fit for purpose:

1. Ever increasing disengagement from corporate sponsors: pension funds in the UK are now mostly seen as legacies of past times from a corporate sponsor perspective. Sponsors used to provide great resources for the management of the scheme, which is not the case anymore. Pension funds are therefore reliant on the goodwill and performance of trustees.
2. The law doesn't allow pension schemes to hire/attract the right persons for the job (nomination of MNTs and ENTs heavily prescribed) – that is crucial in the current environment:
 - a. More complex financial and investments regulatory environments;
 - b. More complex capital markets;
 - c. Recent extreme interventions from policy makers, central banks, governments which have fundamental impact on capital markets, which requires experienced trustees to navigate their scheme through these unknown territories;
 - d. Less involvement from corporate sponsors;

- e. Most trustees are lay trustees with little business and technical expertise / experience.
 - 3. To increase the protection of pension scheme members, the regulations require that they hire investment advisers and seek sign off on investment matters – investment advisers ultimately provide a crucial “checks and balances” role for the trustees;
 - a. The industry is so fragmented however that most schemes are too small to have any investment and financial clout, therefore having to limit the extent of professional advice they seek;
 - b. Conflicts of interest: many UK investment advisers have set up fiduciary management (FM) businesses:
 - i. Because of the greater profitability of the FM business compared to the advisory business, there has been a talent drain from the advisory business to the FM business within these firms
 - ii. The checks and balances (audit) role of the advisers is compromised when another part of the same firm is performing the fiduciary role on behalf of the trustees (especially when the balance of power within that firm resides now in the FM business: that power always moves to the most profitable business line within an organisation).
 - 4. Intrinsically, pension funds are businesses; but they are not seen as such by their key stakeholders and regulator – most pension schemes rely on associations of non-executive volunteers (the trustees) to manage them: these trustees are often non-industry professionals, often have no prior business experience and spend 4 to 8 half days running multi-million-pound organisations.
- Comparing that situation with a Dutch context: Dutch pension trustees are confirmed by the Dutch Central Bank and must work, by law, a minimum of 1 day per week on pension matters.

Impact on performance

- 1. Numerous academics, professionals and professional organisations (Harvard Business School, R Urwin, K Ambachtsheer, Prof G Clark...) have demonstrated that poor governance negatively impacts performance, quantifying it within a range of 50bps to 150bps.
- 2. In the current historical low yield environment, this represents a significant impact on a scheme's total performance.
- 3. Additionally, poor governance might also impact the operations of a scheme.

[1] Global Pension Assets Study 2016 - WTW

[2] UK Insurance and Long Term Savings – Key Facts 2015 - Association of British Insurers

Question 2b: What financial and operational impact do they have?

See question 2a

Question 3: What are the governance issues, if any, that impact the efficient running of DB schemes?

See question 2a

Question 4: What issues, if any, impact DB schemes, achieving efficient and effective investment decisions and outcomes? How could they be overcome?

See question 2a

Question 5: Are there any other issues affecting the efficiency of pension schemes?

Question 6: Which specific economic or macro-economic factors are impacting DB schemes?

The most significant macro-economic risks facing DB schemes are (in broad order of importance):

- Long dated interest rates
The level of long dated interest rates tells us the cost today of reserving for a future cashflow. It is therefore a relevant and important basis for the determination of pension scheme liability present values and the contributions made by the corporate sponsor. The risk is to the level of long-dated interest rates falling, (and the amount required today to provide for a future payment rising). This risk can be addressed with appropriate investment strategies, as of July 2016 data¹¹ suggests that this risk has been roughly 50% hedged, on average by UK pension funds.
- Inflation expectations

¹¹ <https://home.kpmg.com/uk/en/home/insights/2016/06/2016-kpmg-ldi-survey.html>

As most benefits carry inflation linked increases, future inflation expectations are a key determinant of the size of future cashflows

- Equity market levels

While allocations to equities by UK pension schemes have reduced, the biggest single growth asset allocation in pension schemes on average is equities. Increasingly these allocations are made on a global basis (as opposed to UK only). There remains a significant risk to schemes that equities may suffer a sharp fall, or equally that they might undershoot the return expectations that schemes have for them in their recovery plans (over 10-15 years say)

- Longevity

Schemes are sensitive to their underlying members living longer and receiving their pension for longer. This has been a significant driver of increasingly liabilities historically as actuaries have incorporated greater longevity improvements into their calculations of the scheme liabilities.

- Credit defaults

As schemes mature and/or look to defease their future liabilities with bonds a natural allocation is to high quality corporate bonds. The risk here is that a default, extension or restructure will result in the required cashflow not being received in full, or being received later than expected. Related to this are credit events relating to the sponsoring employer. This is discussed in more detail in the response on covenant risk.

Question 7: Do you think greater alignment between the allocation of pension scheme assets and the macro-economy is possible? How should it be achieved?

Yes, we do think that greater alignment between the allocation of pension scheme assets and the macro-economy is possible. It is important to bear in mind that from an investment allocation perspective, in our view the macro-economy exists to serve pension schemes, not the other way round.

Pension schemes in our view will continue to seek returns on their asset portfolios to fill their deficits (alongside sponsor contributions). This means investing in assets that offer a return for bearing risks and in many cases this means providing productive capital into the economy and seeking an appropriate return for the risk taken.

However, being a provider of **equity** capital comes with significant mark to market risk and does not provide the security of cashflow needed to meet pension benefits. Therefore equity investing has become fundamentally less suitable for pension schemes. On the other hand

debt-like instruments have become more attractive. This includes traditional investment-grade bonds, but also assets such as infrastructure debt, secured leases, ground rents and social housing all have characteristics that are attractive to pension schemes. In our experience the main problem in these asset classes to date is that the availability of assets has been insufficient to meet pension scheme demand.

With this in mind we do believe that greater alignment with the real economy is possible, and an important starting point is for enterprises seeking capital, and financial intermediaries to understand the types of asset that are likely to be attractive to pension funds and issue or seek assets that are likely to be more attractive to schemes.

Question 8: If not, why do you think this is not possible?

As described above, the alignment with the real economy is likely to be different than in the past.

Question 9: How do you make decisions about prioritising the allocation of your capital?

This question may be aimed at a corporate sponsor, and therefore not relevant to us. Below are a few thoughts on how we advise pension scheme clients on their allocation of assets.

When advising clients, our focus when it comes to asset allocation can be summarised as:

- Define the goals and constraints in terms of required return, and risk budget
- Hedge unrewarded risks and allocate assets to sources of return in a diversified way to meet the returns required to become fully funded, and pay the members the promised benefits
- Make use of cashflow generative assets where these are consistent with meeting the return requirement
- Monitor the strategy carefully and adjust course to take into account good or bad news.

Question 10: What are the consequences of these choices for your business, employees and your pension schemes?

This doesn't appear relevant to us as directed at the corporate sponsor of a DB scheme.

Question 11: What risks, if any, are there to the benefits promised in DB schemes being paid?

We agree with the Pensions Regulator in that the three broad categories of risk to the benefits DB schemes are: investment, funding and covenant

We have discussed some of the key investment risks above under question 6.

Given the reliance on many schemes on the corporate sponsor to pay contributions toward closing the funding deficit, the covenant risk to the corporate sponsor remains a key risk. Understanding and analysis of this risk has progressed in recent years, which is to be welcomed. One area that we believe requires work, and represents a challenge to the industry to develop a good solution is the integration of the financial and covenant risks in a meaningful way that leads to more useful, actionable information and better overall decisions from scheme trustees. Historically the fundamental differences in approach in these two areas (with financial risks approached through a stochastic or monte-carlo modelling lens, and covenant risks approached through the lens of financial statement and structure analysis) have not facilitated an easy fusion of the two disciplines in a really meaningful way. Connected to this is the fact that the expertise in the different areas have existed in quite separate "silos" which have generally not facilitated idea-sharing and a common problem solving dynamic.

Question 12: What specific measures, if any, would help ensure scheme funding is more sustainable over the long-term?

- An overriding focus on the objectives of the scheme: the return required to meet a funding target consistent with paying members benefits to a high degree of confidence
- A risk-management mindset, whereby schemes focus on reducing the risks posed by the above-mentioned economic variables on the funding position, and take measured amounts of rewarded risk to close the deficit alongside sponsor contributions.
- A reduced reliance on assumptions such as mean-reversion of interest rates.
- More careful oversight and timely monitoring of the assets and liabilities to ensure asset strategy remains consistent with the overall objectives, and capitalise on unexpected good news.

- A stronger and better resourced regulatory environment, where both regulator and trustees were more empowered to put pressure on companies to increase contributions, work to offer alternative forms of security, or prioritise funding of the pension scheme in the event of corporate restructure.
- Clearer requirements in terms of expertise of key decision makers
- Consolidation at the smaller end of the pension scheme spectrum (eg of schemes below 1,000 members)

Question 13: What, if any issues are faced by companies or schemes regarding intergenerational equity in pension provision? How could these issues be addressed?

This is an interesting and important question and indeed could legitimately be the subject of an entire report by itself in order to do it justice. In the interests of time we have decided to focus on the questions relating specifically to defined benefit pension schemes.

Question 14: If you could resolve any of the issues you have raised in answer to the above questions, which would it be, and how?

- A stronger regulatory environment, where both regulator and trustees were more empowered to put pressure on companies to increase contributions, work to offer alternative forms of security, or prioritise funding of the pension scheme in the event of corporate restructure.
- A stronger framework for recognising and correcting sub-standard governance among pension schemes (the "critical friend" idea mentioned in the answer to question 1a).
- A better system for communicating clearly, specifically and widely best practice in pension governance, risk management, investment strategy. A system for sharing and socialising the industry's success stories.

Question 15: Are there any other issues affecting DB schemes that you wish to comment upon?

We would suggest that comparisons to DB schemes elsewhere in the world could be helpful, the most obvious examples being the US and the Netherlands.

We would draw attention to three additional sources of reading/data

1. An article we produced in December 2015 quantifying the de-risking of UK pension schemes and projecting assets and liabilities forward.

<http://redington.co.uk/articles/redviews-january-2016-the-great-de-risking-or-is-it>

2. The Annual Hymans Robertson survey of FTSE 350 pension schemes and their deficits relative to corporate sponsor

<http://www.hymans.co.uk/media/592258/ftse350-pension-analysis-report.pdf> - See more at: <http://redington.co.uk/articles/redviews-january-2016-the-great-de-risking-or-is-it#sthash.dOwHdXoy.dpuf>

3. An annual piece of work by UBS which contains data on pension scheme asset allocation back to the 1950's

"A long term perspective on pension fund investment"

<https://www.ubs.com/content/dam/static/epaper/index.html?id=a405deaa>

We would like to share our investment principles, which guide the advice we give to all our clients

INVESTMENT STRATEGY

1. All investment strategy starts with the clear goals, objectives & constraints of the client, including a defined and agreed risk budget
2. The success of an investment strategy is judged by meeting client objectives, not in predicting the direction of the market
3. Investment strategy should be as simple as possible but as complex as necessary to meet client objectives
4. Investment strategy only works if it is implemented; a strategy can only be optimal if a client will execute it
5. Manager selection should not drive investment strategy; rather managers should be chosen to fulfil the strategic asset allocation

EXPECTED RETURNS

1. For every return above the risk-free rate there is a risk; however some risks offer no or negative expected returns
2. Our assumptions where possible are empirically based
3. Using prudent expected return assumptions incorporates a margin of safety leading to better outcomes

4. Going strategically net short a risk premia should be subject to a much higher hurdle than being long
5. Illiquidity always increases risk relative to a liquid comparable asset and so needs to offer a higher expected return to be a part of an asset allocation

RISK MANAGEMENT

1. Risk management needs to be put in place in the good times to have the most effect in the bad times
2. Risks still exist if you don't measure them, but risks can only be controlled if you do measure them
3. Risk management and asset allocation are not an exact science; you need both qualitative and quantitative judgement
4. We accept that making mistakes is inevitable; we commit to acknowledging, correcting and learning from them
5. Diversification adds value over the long term but cannot be relied upon to protect the portfolio in all adverse conditions

STRATEGY IMPLEMENTATION

1. We accept that our clients may have strong market views but we will encourage them to right-size the risk they take in expressing these views
 2. Spend more time on things that will make a difference to goals and objectives and less time on those that won't
 3. Implementation costs (both trading and fund management fees) should be as cheap as possible but not at the expense of compromising client objectives
 4. Prioritise the "quick wins" first before worrying about how difficult the harder things are
 5. If you don't understand something, our advice is don't invest in it
- See more at: <http://www.redington.co.uk/who-we-are/about/redington-investment-principles#sthash.zrCqrz1c.dpuf>