Media Comments 2016

OECD: Governments must boost financial literacy to improve retirement outcomes, by Michael Klimes, Professional Pensions, 8 December 2016

Policymakers must do more to boost basic financial literacy so people can make good decisions and adequately plan for their retirement.

In its *Pensions Outlook 2016*, the Organisation for Economic Co-operation and Development (*OECD*) said people faced increased pressure to be self-reliant.

It argued the estimation of income needs, assessment of risks related to long-term investment and selection of an appropriate retirement product are made harder by a lack of education.

During a presentation on 8 December at **Cass Business School**, OECD policy analyst Chiara Monticone said:"There is increasing need for people to have the financial skills and resources to take the difficult decisions when planning for retirement.

"Even in markets where the pensions industry is developed and you have large funds, people can find it challenging to shop around."

The state of financial education in the UK is not as underdeveloped as some other countries as it is part of the national curriculum, she added.

However, Monticone warned financial education is not a "silver bullet" and suggested other tools such as default strategies also had a part to play in the overall system governments wanted to build.

To help nations address this problem, the OECD has made a number of suggestions that policymakers could consider for implementation:

1. The development of a national strategy or education system so people learn about finance and become literate in the subject from a young age
2. All those that provide information about pensions ensure it is clear, simple and standardised to avoid complexity
3. The government and employers co-operate to ensure everyone has access to some type of basic financial planning so they can act on the information they receive
4. If that is not enough, the government and other parties work on the expansion of all types of retirement planning to ensure people have access to as many resources as they need

Study finds active global equity funds outperform, by Attracta Mooney, FTfm, November 21, 2016

Research shows international stockpickers beat the market by 1.2 per cent annually

Portfolio managers who promise expertise in actively selecting shares have long been accused of failing to beat the performance of cheaper funds that track an index, but a new study argues that some stockpickers do add value.

According to academic research seen by FTfm, actively managed global equity funds outperformed the market by between 1.2 per cent and 1.4 per cent annually on average between 2002 and 2012.

The findings are likely to provide comfort for some active fund managers who have come under repeated attack from academics, campaigners and research providers for underperforming their benchmarks.

Earlier this year, research by S&P Dow Jones, the index provider, found that 99 per cent of actively managed US equity funds sold in Europe failed to beat the S&P 500 over the past 10 years.

However, the authors of the latest research, which will be published online in the Financial Analyst Journal today, argued that in specific circumstances active management can pay off.

They wrote: “Our results suggest that active management is worth considering in global equity markets.”

The research did not subtract the fees investors are charged from the performance figures, but it said pension funds and other big investors typically pay fees of around 0.75 per cent. This would leave those investors with a net gain of at least 0.45 per cent annually over 10 years.

Retail investors often pay higher fees.

David Gallagher, lead author of the study and a professor at the Australia Business School at the University of New South Wales, said the study shows active equity funds that invest globally “generate an economically significant outperformance”.

According to the study, the excess returns of global equity funds primarily came from managers’ stock selection skills, while allocations to emerging markets also helped boost performance.

Professor David Blake, director of the Pensions Institute at London’s Cass Business School, said he was “a little surprised by the results, in particular the size of the outperformance”, but he cautioned that the study could be prone to so-called selection bias — where only good funds report their performance.

Prof Gallagher’s study, which was co-written by Graham Harman, Camille Schmidt and Geoffrey Warren, included 143 global equity funds that were managed for institutional investors. The funds were assigned a benchmark of either the MSCI World index or the MSCI All Country World index.

Tim Edwards, senior director of index investment strategy at S&P Global, said: "If you have the ability to pick a skilful manager and they are going to charge you a low fee, then that is clearly a better option.

"But there are two big challenges. In most markets the average manager is not enough. Most of the time you have to have a good one and it is often really hard to find a good manager. You also need to have a low fee for this to work. You can't ignore fees."

S&P's research found that few global equity funds available for retail investors outperform the market after fees.

The index provider's research, as well as numerous academic studies, have heaped pressure on active managers and driven the rapid growth of the passive fund industry, which can provide lower-cost exposure to markets, in recent years.

Figures from Morningstar, the data provider, showed that, in the nine months to the end of September, investors put $35bn into passive equity funds that invest globally but pulled almost $20bn from actively managed equivalents.

Stephen Mitchell, head of strategy for global equities at Jupiter, the UK-listed fund manager, agreed investors benefit from active stock picking when it comes to global equity funds.

"Active management has had a relatively bad press. But we still believe that stock picking is key to active management and it will add value," he said.

British Steel is a missed opportunity to reform DB pensions, by Kerrin Rosenberg, FTfm October 31, 2016

The defined benefit market is in a state of crisis, says Cardano's Kerrin Rosenberg

Last month, this paper reported that government proposals to change the law to help salvage Tata Steel and the British Steel pension fund are to be shelved. This would be a huge shame. The defined benefit pension market is in a state of crisis and desperately needs reform.

The government may shy away from dealing with the problems at British Steel, but over the coming years we will see more and more cases of insolvent pension funds limping into the Pension Protection Fund, the lifeboat for capsized corporate pension plans.

Companies will be forced into bankruptcy and members will lose substantial portions of their pension. Not dealing with this delays the inevitable and simply bequeaths a bigger problem to future generations to try to solve.

In May, the government announced a consultation on a series of "exceptional" measures they were considering in the British Steel case. Two proposals went against a previous taboo; the consultation openly discussed how the trustees might be able to cut accrued pension rights without members' consent.

True, the government was at pains to point out that any legislative change would single British Steel out due to its "unique circumstances". It would also be subject to many limits on how far the trustees could go with cuts. It is fairly obvious, though, that British Steel is not unique. According to a report by the **Pensions Institute** at London's Cass Business School, a worst-case scenario could see 1,000 more pension funds enter the PPF.

Much more interesting was the tacit acknowledgment that UK law does not necessarily provide the best outcomes for members of pension funds associated with almost insolvent companies. This recognition is a vital first step in the path to reforming UK pension law.

Struggling businesses should not be allowed to offload their pension liabilities and leave pensioners high and dry. However, the law only provides one option to a business that cannot afford its pension promises: go bankrupt and pass the pension fund to the PPF. As the government consultation acknowledged, this is a lose-lose situation as the members take a heavy haircut to their pensions and shareholders suffer a complete loss of equity.

It is not legally possible for trustees to renegotiate the pension contract before a bankruptcy in order to salvage value on behalf of their members. However, a restructuring could provide members with a better pension outcome than the statutory PPF route. It would also allow the company additional breathing space to find a solution that might save thousands of jobs.

For many underfunded schemes with weak sponsors, it is a question of when, rather than if, a haircut will be applied. The members should not have to wait and watch the pension fund enter the PPF, resulting in reduced benefits.

Trustees should have the power to negotiate with the sponsor and consider other options. These should include cutting guaranteed benefits, thereby alleviating the financial burden, and introducing risk sharing through, for example, a defined contribution top-up. This would allow the members to continue to save for their future. Instead of locking into the reduced benefits the PPF offers, it would be possible to provide members with a higher pension by taking controlled investment risks.

The British Steel consultation did not go quite this far. Proposed benefit cuts were limited to future pension increases and the proposed solutions would still have been reasonably onerous to any sponsoring company. But it seemed that the government was thinking seriously about how to release Tata Steel from its pension obligations.

That may not have been enough to save this company, but more flexibility in the law would be very helpful in providing more options for other corporates in similar circumstances. With the right regulatory oversight, pension restructuring could be a win-win for both the company and pension fund members.

Shelving the British Steel consultation is a huge missed opportunity, but the pensions crisis isn't going to go away. At some point, hopefully sooner rather than later, all those responses to the recent consultation will be aired and discussed with the seriousness they deserve.

Kerrin Rosenberg is chief executive of Cardano, the consultancy, in the UK

DB pensions have been regulated 'out of existence', By James Fernyhough, October 12, 2016

One in six defined benefit pension schemes will not be able to pay members their full benefits, thanks in part to misguided regulation putting too much pressure on schemes, MPs on the Work and Pensions Select Committee have been told.

Speaking at a committee hearing today (12 October), Pensions Institute director Professor David Blake said out of the approximately 6,000 DB schemes in the UK, 1,000 would not be able to meet their promises to members in full.

This, he said, was in part a result of regulation, which had increasingly treated pension promises as guarantees.

"DB started as a promise on a best efforts basis, and it's been turned into a guarantee. As a result, it's been over-regulated out existence," he said.

"You simply can't have companies delivering promises over 30 years," he added.

He told MPs the DB deficit - which recent calculations have put as high as £1trn - would be a "permanent problem" that would have ramifications beyond private sector schemes.

"My view is DB is dying in the public sector, and that could change attitudes to pensions in the public sector," he said.

Professor Blake warned that the shift from DB to defined contribution meant individuals were now taking on all the risk. But unlike businesses - which "understand what's going on" - he said individuals are not aware of the risks they will have to bear.

The result, he said, would be an increase in poverty in old age.

"There's going to be a bigger crisis [than the current DB funding crisis] coming along, but it's going to be a very personal crisis," Professor Blake said.

Also speaking at the hearing, Rosalind Connor of the Association of Pensions Lawyers said changing attitudes towards DB schemes were misguided.

"We've all said they're dead and there's not very much we can do about it," she said, but insisted this wasn't necessarily the case, and that "DB schemes are good."

She said the real crisis was the fact that young people could not be members of DB schemes, meaning they would have to take all the risk themselves.

The hearing was the first since chair Frank Field announced the committee would be looking into the wider DB issue, following its more focused investigation of the failure of the BHS scheme.

Former pensions minister Steve Webb was the first to appear before the committee. He said allowing company schemes to reduce benefits if the company was in trouble should be a last resort, recommending instead that the committee look at making DB to DC transfers easier.

He also said it should look it dividend to pension contribution ratios before making any recommendations on benefit reductions.

james.fernyhough@ft.com

Chile pension reform comes under world spotlight, by Benedict Mander in Buenos Aires, Financial Times, 12 September 2016

The man who masterminded Chile's world-famous privatised pension system still calls it the "Mercedes-Benz" of retirement systems, but that has proved an enraging comparison when the average pensioner is eking out an income that turned out to be less than the minimum wage.

José Piñera created the scheme as social security minister 35 years ago when Chile, under the military dictatorship of Augusto Pinochet, was the world's free-market laboratory. His recent defence, attacked as arrogant and elitist, only fuelled the anger of protesters who have taken to the streets to demand the system's reform — or even its abolition.

For many years, institutions like the World Bank held up Chile's defined-contributions pension system as an example to follow, and it has been copied by more than 30 countries across Latin America, Southeast Asia and Eastern Europe, but its legitimacy is in question, and President Michelle Bachelet is promising reforms to try to shore up the system.

"The World Bank is terrified that the Chilean model will fail," says David Blake, a pensions expert at the Cass Business School in London.
David Bravo, who led a presidential commission on pensions reform last year, says it is a matter of "perfecting" the existing system. "Under Pinochet, Chile went from one extreme to the other. Now we are seeking something a bit more balanced," he explains.

Pensions saving was privatised in 1981, when Chile was one of Latin America's poorest countries and shunned by foreign investors, and the new scheme replaced a failing state-funded pay-as-you-go system. By requiring employees to set aside 10 per cent of their income, it provided a huge boost for savings, investment, employment and growth.

In particular, Chile's nascent capital market roared to life, and pension funds now exceed $170bn, or around 70 per cent of GDP. This played a key role in turning Chile into the richest country in the region, lifting millions out of poverty.

The problem is that most are not saving enough. The 10 per cent of pay that is sent to individual savings accounts is about half the total put into pension schemes in developed countries, according to Mr Bravo. The average monthly benefit is about $300, less than earnings from a minimum wage job. The problem is made worse because many people have made only inconsistent payments and there is a large informal economy. Women are especially hard hit.

Many also complain that a lack of competition has allowed the private companies, known as AFPs, that manage the pension funds to earn disproportionately high fees. Investment returns have averaged more than 8 per cent since the system was founded but after commissions, net returns are closer to 3 per cent, according to Mr Bravo's commission report.

"Initially the Chilean model appeared to be very successful, but the sting in the tail appears to be that charges extracted by the industry have resulted in pensions being much lower than otherwise would be the case," said Mr Blake.

Ms Bachelet implemented a first round of pension reforms in 2008 during her first term, moving towards a mixed public-private system by introducing a tax-funded "solidarity" scheme that supplemented the pensions of the lowest income workers.
The reforms under discussion now go further. They include requiring companies to contribute 5 per cent of workers' pay to the solidarity fund, the introduction of a state-run AFP to increase competition, and measures to keep fund managers' commissions under control.

If Chile's reforms are successful, countries that face pensions shortfalls thanks to ageing populations and historically low bond yields will continue to look to the country as an example.

Unlike many other countries where governments have racked up enormous debts to pay promised pensions to public employees, that debt does not exist in Chile. The onus of saving has been transferred to individuals, says Jonathan Callund, a pensions policy consultant based in Santiago.

"Pensions may be in crisis worldwide, but one place where they are not is Chile," he says, arguing the system is "far from broken", even if it may need some "tightening".
Whether or not significant reforms are approved by congress before presidential elections next year remains to be seen. The current proposals could add around $1.5bn, or 0.5 per cent of GDP, to the fiscal burden of a government that is already suffering from the end of the commodity boom.

Ms Bachelet's political capital is also at historic lows — her approval ratings have sunk to just 15 per cent — making negotiations in her divided coalition complex.
Although political analysts say it is unlikely that Chile will cave in to the demands of street protesters and follow in the footsteps of countries like Argentina, which

nationalised private pension fund managers in 2008, Mr Bravo fears "populist" solutions.

"The big risk is that pensions become a campaign issue as presidential elections approach, and the discussion becomes polarised and reduced to slogans," said Mr Bravo. "That's dangerous."

Bonus culture in asset management 'out of control', by Madison Marriage and Attracta Mooney, FTfm, September 4, 2016

Chief executives of the world's largest fund houses receive bonuses 15 times larger than salaries

Asset management CEOs received bonuses on average 15 times larger than their salaries

The chief executives of the world's largest asset management companies received bonuses that were on average 15 times larger than their salaries last year, raising concerns about inappropriate pay structures in the fund market.

According to FTfm analysis of executive pay at the 20 largest listed fund companies in Europe and the US, Larry Fink, the chief executive of BlackRock, and T Rowe Price's James Kennedy had the highest level of variable pay compared with their salaries last year.

Mr Fink's variable pay — which is mostly made up of bonuses and share awards — was almost 30 times his salary, while Mr Kennedy's was 24 times his basic pay.

The ratios are far higher in asset management than in investment banking, where the chief executives of the five largest US lenders received variable pay that was on average 10 times larger than their salaries last year.

Camilla de Ste Croix, senior policy officer at ShareAction, a charity that campaigns for responsible investment, said the figures demonstrated bonus culture in asset management was “out of control”.

She added: “Following the financial crisis, a lot of new EU legislation and reforms were directed at the banking sector. The asset management sector has not faced the same level of scrutiny. Measures to curb excessive pay and risk taking should be comparable across investment banking and asset management.”

In Europe, banks have been forced to limit the size of bonuses for senior staff to twice a bankers’ basic salary since 2014. European MEPs narrowly voted against introducing similar measures, which were intended to reduce excessive risk taking, for fund managers in 2013.

The FTfm data additionally show the chief executives who received the biggest salaries also received much higher variable pay: every $1m dollar increase in fixed pay led to a $2m increase in bonus payments.

This undermines the argument put forward by some companies that they need to pay big bonuses to make up for low salaries, according to David Blake, professor of pension economics at London’s Cass Business School.

“The advantage of low fixed pay and high bonuses is, in bad times, [asset management companies] can reduce bonuses without firing staff. We don’t get that here. There is a high correlation between high fixed pay and high bonuses. [The correct] incentive structures are not there in this industry,” he said.

The findings come as questions are raised about the appropriateness of paying bonuses to investment staff. Last month it emerged that Neil Woodford, Britain’s best-known fund manager, has eliminated bonuses for staff at his company, arguing such payments are “largely ineffective” in influencing the right behaviour.

A spokesperson for Woodford Investment Management said of the new data: “There is a need for greater corporate governance on the issue of CEO remuneration. This is about the alignment of CEO rewards with shareholder returns. We are all for CEOs being rewarded, but at present the system can fail shareholders and damage corporate growth.”

Bumper bonuses for asset management CEOs

Fund company (European)	CEO	Total pay, 2015 (£)	Variable pay as a % of fixed, 2015
Ashmore	Mark Coombs	1,937,247	1837
Investec AM	Hendrik du Toit	8,130,189	1744
Schroders	Michael Dobson	8,905,000	1583
Henderson	Andrew Formica	6,469,000	1440
Jupiter	Maarten Slendebroek	2,739,000	996
Aberdeen AM	Martin Gilbert	4,340,000	743
Standard Life Investments	Keith Skeoch	3,642,000	534
Man Group*	Manny Roman	5,367,210	437
Amundi**	Yves Perrier	2,665,213	281
GAM***	Alexander Friedman	5,004,579	150

* US dollars ** Euros *** Swiss francs

Fund company (US)	CEO	Total pay, 2015 ($)	Variable pay as a % of fixed, 2015
BlackRock	Larry Fink	25,792,630	2766
T Rowe Price	James Kennedy	8,748,249	2399
Artisan Partners	Eric Colson	5,918,041	2267
Affiliated Managers Group	Sean Healey	17,506,689	2234
Legg Mason	Joe Sullivan	10,571,443	2014
Invesco	Martin Flanagan	15,875,975	1910
Eaton Vance	Thomas Faust	10,248,276	1871
Franklin Templeton	Greg Johnson	15,097,340	1827
Janus Capital	Dick Weil	8,553,112	1387
Waddell & Reed	Henry Herrmann	6,261,023	526

Source: Annual reports and regulatory findings

FT

Daniel Godfrey, former chief executive of the UK's Investment Association, the trade body, similarly plans to scrap bonuses at the investment company he is establishing. He urged fund houses to increase the level of fixed pay and to lower variable payments for executives.

"Boards should stand up for the right salary level, even if that is higher than it is now. It may be a multi-generation journey, but I would like to see performance pay being a proportion of salary, not a multiple," he said.

Azimut, the Italian-listed asset manager, is the only other known example of a fund company that does not pay any form of variable remuneration to senior staff. A quarter of the shares staff hold in the company can only be sold at retirement. "This prevents top management from being short-term focused [and] encourages [them] to create shareholder value in the long term," said a spokesperson for the company.

Many senior executives in the fund market, however, said high variable pay helps to motivate top executives and to maintain a flexible workforce.

Lee Kranefuss, founder of BGI, which eventually became BlackRock's exchange traded fund business, and executive chairman of Source, the passive investment specialist, said: "Personally I am a big fan of payment for performance. I think more variable pay is generally good. When I was at Barclays, [the bank] believed in a very high variable to fixed pay ratio and I think it encouraged performance at BGI. It did not encourage extraordinary risk taking."

Lee Higgins, chief executive of the Buy-Side Club, an asset management recruitment firm, added: "If bonuses are high, then it is likely to reflect the fact that there is a very small pool of high-calibre chief executives who can take on the pressure of running an investment firm successfully. Due to the nature of the role they are taking on large amounts of risk and are seen as stewards for billions in clients' money, which should be reflected in their rewards.

"Bonus caps were introduced in reaction to a public outcry and the perception of excessive risk taking in investment banking. That culture does not exist in asset management and therefore a cap would be counterproductive."

'Cartel-like' pricing of funds in UK, say experts, By Anna Devine, Ignites Europe, 4 August 2016

Asset managers have been accused of offering "cartel-like" prices to investors as the UK regulator prepares to deliver its assessment of the competitive forces at play in the country's fund management industry.

Campaigners believe that asset managers could come under increased pressure to lower management fees as the Financial Conduct Authority unveils in September the draft findings of its long-awaited asset management market study.

According to Morningstar data published by the FCA last year, 40 per cent of annual management charges on equity funds in the UK sit at around 1.5 per cent.

The UK regulator has said that as part of its market study it would "look to understand further" the clustering of AMCs for active equity funds.

Experts admit there is no evidence that asset managers are controlling fund prices but say the data show that competition is not working as well as it could for investors.

David Blake, a professor at Cass Business School, says: "[Cartel] is a dangerous word to use because you can't prove it. I would call it cartel-like.

"The only reason you have competing companies offering the same price is because they've all got the same cost and therefore are pricing at a minimum cost or they are holding the pricing up and implicitly running a cartel."

Mike Barrett, consultancy director at financial services consultancy The Lang Cat, says the fact that the AMC is the same for four in 10 equity funds will have likely rung alarm bells at the FCA.

“This feels to us to be pretty significant in some of the work they will be conducting. We would expect this to be a focus [of the market study],” says Mr Barrett.

“How are so many charging that particular level [of AMC]? It has to raise questions around the clustering there.”

Gina Miller, founder of investment management group SCM Private, says: “The usual suspects – Schroders, M&G and the traditional active managers – have always charged around the same fee.

“Most people will follow the lead of the big brands. Most people just copycat and do the same."

M&G, Schroders and the Investment Association, which represents the UK's £5.5 trillion (€6.5 trillion) investment management industry, declined to comment.

According to Mr Blake, the clustering of AMCs is linked to a “monopolistic competition environment in which you’ve got a relatively small number of fund management houses”.

There are 1,783 asset management firms in the UK, according to the FCA.

“With 1,700 fund managers it’s hard to call it a cartel, but the cost structures are such and the nature of competition is such that it still acts like a cartel,” he says.

Mr Barrett believes “regulatory change” could eventually lead to management fee cuts but adds that fund firms will be resistant to making changes.

“Unless big market forces in terms of investor behaviour and increasing adoption of passives, or until [there is more] regulatory pressure, I can’t imagine why they would give up margin,” he says.

Hugues Gillibert, chief executive officer of fee data provider Fitz Partners, says it is “remarkable how consistent between asset managers their management fees are”.

However, he adds: “This could be as far down as they are prepared to go for the time being.

“The recent drop in fund flows will certainly not encourage them to reduce their management fees and cut further into their revenues.”

One fund manager, speaking on condition of anonymity, says the “price war” in passive funds has “not exactly transferred to active management because unlike passive, active is not homogenous or commoditised in the same way”.

Data from Fitz show that the average ongoing charges figure for all UK equity funds has stagnated at 0.91 per cent between 2013 and 2015.

Meanwhile the average OCFs for retail share classes for UK All Companies funds was around 1.61 per cent in 2013 and has stayed around that level since then.

A number of active asset managers, including Franklin Templeton, Aberdeen Asset Management and Kames Capital, have cut fees on UK equity funds in the past few months.

Franklin reduced the AMC on three funds in July, saying it was in response to growing demand for lower-cost actively managed products.

Aberdeen also cut the AMC on three of its UK funds in April, including the £933m UK Enhanced Equity B share class, slashing it from 1 per cent to 0.2 per cent.

David McCann, director at Numis Securities, expects "further" management fee compression.

Mr McCann flags the asset management market review as being a potential reason, among other drivers such as low nominal returns, higher transparency, inconsistent active performance by a number of managers, increasing competition, and greater use and awareness of passives.

Paul McGinnis, analyst at Shore Capital, says listed asset managers tend to guide analysts to assume management fee rates deflate by 2 per cent to 3 per cent a year.

"As an active manager, to address the grinding deflation in annual management fees, you need to better align your fee structure with the experience of the investor," he says.

He expects active asset managers to move from fixed to variable fee models in the medium term as a result.

The 15 ways companies can legally avoid pension deficits, Kristian Brunt-Seymour, Professional Pensions, 4 August 2016

Damning research by the Pensions Institute has uncovered a number of ways by which sponsoring employers can shed or avoid their defined benefit (DB) deficits.

The *Milking and Dumping: The Devices Businesses Use to Exploit Surpluses and Shed Deficits in Their Pension Schemes* report looked at various ways employers have been able to take advantage of schemes and avoid their duties.

The Pensions Institute, which is part of Cass Business School, noted how parent companies can use techniques to exploit the scheme or sponsoring employer.

15 ways employers can shed or avoid DB scheme deficits:

1. Large, excessive dividends
2. Interest-free loans granted to non-scheme affiliates

3. High interest-bearing loans received
4. Commissions
5. Management fees
6. Supplier rebates diverted
7. Tax surrenders
8. Transfer pricing prejudice
9. Creation of central purchasing or sales unit to cream off margin
10. Retrospective imposition
11. Assumption of intellectual property centrally
12. Customer business/links diverted
13. Incremental/new business or products diverted
14. Maintaining token employee or token ongoing accrual
15. Introducing or increasing the employee numbers

Action urged to tackle sponsors 'milking and dumping' DB schemes, Kristian Brunt-Seymour, Professional Pensions, 4 August 2016

The government should give the regulator more powers to prevent companies from avoiding defined benefit (DB) deficits, according to a Pensions Institute report.

The *Milking and Dumping: The Devices Businesses Use to Exploit Surpluses and Shed Deficits in Their Pension Schemes* study looked at various ways employers have been able to take advantage of schemes and avoid their duties.

It cites various examples of surplus exploitation and fund extraction from the 1980s and 1990s.

Despite more protections in the past few years, the report says there are 15 ways employers can shed or avoid scheme deficits. This can involve paying large excessive dividends, loans and management fees to the parent companies. In some cases one scheme can be used to fund the administration costs, obligations and members' benefits of others.

While some of the activities highlighted in the report were unlawful, others were and are still legal.

The Pensions Institute, which is part of Cass Business School, noted how parent companies can use techniques to exploit the scheme or sponsoring employer, such as extracting pension assets to fund other projects. In some previous cases one scheme or sponsor was used to fund the administration costs, obligations and members' benefits of other schemes.

Companies could also engineer the transfer of value from scheme-participating employers to other companies within the group whose assets are free from the exposure by not being scheme-participating employers.

This would not affect the scheme deficit but would weaken the sponsoring company and its capacity to fund members' benefits.

The report said in these situations, trustees are "fairly helpless". They could notify TPR but do not have the authority to pursue the parent company themselves. While the regulator has anti-avoidance powers, the report suggested it has been reluctant to use them to prevent these value transfers.

The paper's author and Association of Corporate Trustees president Keith Wallace said in light of recent concerns around British Home Stores (BHS), British Steel and Halcrow, the current situation is unsatisfactory.

He called for stronger punishments on sponsors, and questioned whether regulatory authorities have sufficient resources to pursue companies drawing funds from the sponsor or scheme.

The UK should consider introducing extra powers like those implemented by the Pension Benefit Guaranty Corporation (PBGC), the American equivalent of the Pension Protection Fund (PPF), he said. The PBGC has powers to claim up to 30% of a business's net worth.

The Pension Regulator (TPR) could also have an early warning programme which would allow beleaguered schemes and their sponsors to be identified and supported earlier.

Wallace is also concerned government interference with pension schemes through mandatory indexation had prevented them from operating effectively. He believes this has made it costly and difficult for schemes to invest in assets matching their liabilities. This had not been helped by scheme rules being too rigid to switch annual pension increases from the retail prices index to the consumer price index, which could reduce liabilities.

"Good policemen without laws are useless and good laws without policemen are useless," said Wallace. "However, we have neither good policemen nor laws.

"TPR, the PPF and trustees seem to have neither the power nor inclination to pursue these actions being committed, which is not particularly clever."

"Some of these things have been going on for forty years. It is naïve to think that they have now stopped, especially given the current enormous size of pension deficits. The PPF faces a huge moral hazard as a result of the practices employed by some companies in this country," he added.

A spokesperson for TPR said in response: "We already operate a system of early proactive engagement with weaker and more high-risk schemes undergoing their valuations, similar to that proposed by the Pensions Institute. We will investigate potential avoidance activity and have strong powers that we will use. Any additional powers would be a matter for government and would require us to consider the resource implications of their use.

"It is important that employers treat their pension scheme fairly and we expect trustees to question employers' dividend policies where deficit recovery contributions are constrained. Our DB code and covenant guidance can help both parties have constructive discussions in these circumstances."

A spokesperson for the PPF said the report raises "a number of issues" and it looked forward to discussing them with the author.

"Where we believe an employer is deliberately attempting to avoid their pension obligations, leaving the PPF to pick up their pension liabilities, we work closely with TPR.

"The issue of moral hazard is no different now than when we and the regulator were established; the regulator has a statutory duty to protect the PPF and a range of powers which enable them to do so. Alongside this we will also act as required; in the BHS case we were instrumental in securing the appointment of FRP as co-administrators to conduct investigations on behalf of the creditors."

Pensions Institute: 15 ways employers milk and dump their pension scheme, Pensions World, 3 August 2016

Do not underestimate the ingenuity of businesses and advisers to milk and dump their pension schemes. This is the stark warning from a new research paper published today by the Pensions Institute at Cass Business School, City University London.

The paper, Milking and Dumping: The Devices Businesses Use to Exploit Surpluses and Shed Deficits in Their Pension Schemes, was written by Keith Wallace, president of the Association of Corporate Trustees and chair of the Legal Advice Panel of the Pensions Advisory Service.

The research discovered 15 ways of shedding or sidestepping a deficit. These include: large, excessive dividends; interest-free loans granted to non-scheme affiliates; high interest bearing loans received likewise; “management fees” payable likewise; transfer pricing prejudice intra-group; creation of “central” purchasing or sales to cream off margin likewise.

The study is particularly pertinent, given what has been happening at companies like BHS, Halcrow and Tata Steel – with allegations of excessive dividends paid to proprietors, bludgeoning pensioners into accepting lower benefits, proprietors distancing themselves from legal liability and incoming proprietors seeking to avoid liability altogether.

Commenting on the report, Professor David Blake, director of the Pensions Institute, said: “A pension scheme is like a coach and horses carrying gold on a long journey through hostile territory in a Wild West movie. Despite the determination of the trustees to navigate a safe journey over the rocky terrain and the bravery of the Pensions Regulator as outrider, the coach with its valuable bullion is a sitting duck for corporate ingenuity”.

Keith Wallace added: “Some of these things have been going on for 40 years. It is naïve to think that they have now stopped, especially given the current enormous size of pension deficits. The Pension Protection Fund faces a huge moral hazard as a result of the practices employed by some companies in this country”.

The report concludes: “Government intrusion into occupational pension provision has not been universally commendable. Being “generous with other people’s money” – obliging already generous defined benefit schemes to further increase their generosity by conferring indexation – has proved a disaster, not only in cost terms but in the sheer functional impossibility to schemes of investing to match this imposed and volatile liability.”

It recommends: “Legislation according a pension scheme’s deficit priority in insolvency would dramatically alleviate the problem of underfunded schemes. The pressure from other (thus demoted) creditors and stakeholders would quickly produce tangible amelioration.

“PPF benefits – by their very availability – provide a powerful bludgeon with which to coerce members – “if you don’t consent to your benefits being diminished, we’ll put you into the PPF” – is the unspoken subtext behind negotiations and member circulars.”

The Pensions Institute is calling on the government to establish an effective Early Warning Programme (similar to that operating in the Pension Benefit Guaranty Corporation, the US equivalent of the Pension Protection Fund) in which The Pensions Regulator actively seeks out and starts negotiations directly with weak employers. This would enable the regulator to pick up early signs of the kind of practices identified in this report. An extra incentive would be to adopt the PBGC’s ability to claim up to 30% of a business’s net worth in the most extreme cases of abuse. This would give greater assurance to beneficiaries that energetic and robust actions are taken on their behalf by the regulator.

The research also identified 20 ways in which scheme surpluses have been exploited. These include:

- Employer now has the scheme bear administration costs, etc
- Employer “loads” administration cost recovery against the scheme
- The scheme receives inward bulk transfer from other underfunded scheme/s of the employer
- The scheme assumes hitherto unfunded pension obligations
- The scheme assumes health, death-in-service, accident, redundancy benefits hitherto met from payroll
- “Augmented” benefits replace bonus and golden hellos

- A promise of generous bulk transfer increases saleability and sale price of divested subsidiary
- Scheme makes “investment” loan to (external) buyer of asset from employer
- Scheme makes “investment” in securities of business sold-off by employer
- Scheme enters into sale and leaseback of property in favour of business sold-off by employer.

Companies ‘milking and dumping’ DB schemes, By Ruth Gillbe, FTAdviser, Aug 03, 2016

All defined benefit pension scheme members should be alert to the danger of businesses exploiting their retirement savings then dumping their liabilities, according to a Cass Business School report.

The study is published against a backdrop of problems in defined benefit pension schemes, from BHS and Halcrow to Tata Steel.

In April, BHS went into administration after 88 years of business, putting 11,000 jobs and 20,000 people’s pensions at risk with a £571m deficit to the workplace scheme.

Then in June this year, the trustee of the British Steel Pension Scheme - at 130,000 members, one of Britain’s biggest - urged members to support cuts to their benefit to prevent the scheme falling into the Pension Protection Fund (PPF), in a move that is likely to have ramifications for the entire sector.

And in July this year, it became clear the Pensions Regulator is to face a legal challenge against its decision to allow a major restructure of the chronically underfunded Halcrow pension scheme.

Investigating some of the reasons schemes like BHS, British Steel and others have run into problems, the Cass paper identifies 20 ways in which scheme surpluses have been exploited.

This included employers now having the schemes bear administration costs and employers ‘loading’ administration cost recovery against the scheme.

Written by Keith Wallace, president of the Association of Corporate Trustees and chair of the Legal Advice Panel of the Pensions Advisory Service, the report listed other ways scheme surpluses have been exploited, including:

• The scheme receives inward bulk transfer from other underfunded scheme(s) of the employer

• The scheme assumes hitherto unfunded pension obligations

• The scheme assumes health, death-in-service, accident, redundancy benefits hitherto met from payroll

• ‘Augmented’ benefits replace bonus and golden hellos

• A promise of generous bulk transfer increases saleability and sale price of divested subsidiary

• Scheme makes 'investment' loan to (external) buyer of asset from employer

• Scheme makes 'investment' in securities of business sold-off by employer

• Scheme enters into sale and leaseback of property in favour of business sold-off by employer.

The research also discovered fifteen ways of shedding or sidestepping a deficit. These include:

• Large, excessive dividends

• Interest-free loans granted to non-scheme affiliates

• High interest bearing loans received likewise

• 'Management fees' payable likewise

• Transfer pricing prejudice intra-group

• Creation of 'central' purchasing or sales to cream off margin likewise.

Professor David Blake, director of the Pensions Institute, said: "A pension scheme is like a coach and horses carrying gold on a long journey through hostile territory in a Wild West movie. Despite the determination of the trustees to navigate a safe journey over the rocky terrain and the bravery of the Pensions Regulator as outrider, the coach with its valuable bullion is a sitting duck for corporate ingenuity".

Mr Wallace said: "Some of these things have been going on for forty years. It is naïve to think that they have now stopped, especially given the current enormous size of pension deficits. The Pension Protection Fund faces a huge moral hazard as a result of the practices employed by some companies in this country".

Are employers milking and dumping their pension schemes?
by Martin Hunter on 03/08/2016 13:50

http://www.pstransactions.co.uk/pensionswire/Lists/Posts/Post.aspx?ID=374

This morning the Pensions Institute published a report called *"Milking and Dumping - The Devices Businesses use to Exploit Surpluses and Shed Deficits in Their Pension Schemes"*.

www.pensions-institute.org/reports/MilkingAndDumping.pdf

The report includes a list of 15 techniques which it claims can currently be used to shed or sidestep a pension scheme deficit. It is stated that *"the motivations behind* *shedding pension liabilities are endemic in a capitalist model, where proprietor profit is supported by the ingenuity of advisers"*. I am clearly not a sufficiently ingenious corporate pensions adviser, as the list of apparent avoidance measures came as news to me!

Many of the techniques set out in the report involve transferring value away from the pension scheme's sponsoring employer. The first option mentioned is the payment of large and excessive dividends. Unfortunately (from the perspective of unscrupulous employers seeking to avoid pension liabilities) there are already safeguards in place to protect pension schemes from this. A dividend payment of this nature would likely be a "Type A" event, putting the recipients of the dividends (companies or even individuals) at risk of the Pensions Regulator's moral hazard powers. Many of the other actions listed are also corporate events which would probably expose employers to the risk of the Pensions Regulator using these potentially very strong powers to pierce the corporate veil.

The report notes that the Pensions Regulator does have anti-avoidance powers, but *"considerable reluctance has been encountered from that party to implementing the provisions available to it"*, stating that only six contribution notices and financial support directions have been issued to date.

It is unfair to suggest that the Pensions Regulator's relatively sparing use of its formal powers means that it has been going soft on employers. It seems the Pensions Regulator has deliberately limited the formal use of its powers, instead preferring to use the threat of the powers to influence behaviour. In our experience this approach has been relatively successful. Employers should therefore be well aware that payment of a "large and excessive" dividend would have implications for the pension scheme and put them at risk of regulatory action.

Given that the report references BHS as a demonstration of the need for change, it is worth noting that BHS paid its dividends between 2002 and 2004, at a time when its pension schemes were in a far healthier position than they are now.

The report also puts forward some possible changes which it claims would improve the position. The first suggestion is that the pensions debt should have priority over all other creditors, including secured debt, on insolvency. Such a drastic change could make it extremely difficult for companies with DB schemes to access the debt markets, thereby putting the financial position of the company and in turn the security of their pension scheme at risk. The other suggestions all relate to allowing retrospective changes to benefits, perhaps by altering pension increases or retirement ages. Various bodies have been suggesting changes of this type for several years, but to date the Government has not given any indication that it intends to make the necessary changes to legislation which would allow this.

One issue which the report does help to highlight is that many forms of corporate activity will have a material impact on the employer covenant of the pension scheme. This in turn can influence funding and investment decisions. Employers should therefore always be aware of the impact of corporate activity on its pension scheme, and discuss any material developments with their pension scheme trustees. Meanwhile trustees should monitor their employer covenant on a regular basis, to ensure they are aware of any corporate changes which affect the pension scheme.

Crackdown urged on pension scheme 'tricks', Josephine Cumbo, Pensions Correspondent, Financial Times, August 3, 2016

About 5,000 of the 6,000 "defined benefit" schemes being operated by private sector employers in the UK are in deficit. At the end of June this year, the combined deficit was £383bn, up from £209bn a year ago, according to Pension Protection Fund estimates, putting more pressure on employers to fund their pension promises.

Although pension funding protections have tightened in recent years, the report by the Pensions Institute, which is part of London's Cass Business School, suggested there were still opportunities for employers to avoid their pension duties.

The paper identified 15 ways that businesses could shed, or shift, a pension deficit including by paying "excessive" dividends to shareholders.

Other practices identified include interest-free loans being granted to non-pension scheme affiliates, and corporate parents saddling subsidiaries, which have pension liabilities, with central management charges.

"These practices hit the profits of the subsidiary which in turn impacts funding for the pension scheme," said Keith Wallace, president of the Association of Corporate Trustees and author of the report for the institute.

"They are tricks to seep value out of the scheme."

The study identified 20 ways in which pension surpluses had been "exploited", including employers having the scheme bear administration costs.

"Some of these things have been going on for 40 years and it is naive to think they have now stopped, especially given the current enormous size of pension deficits," added Mr Wallace.

The study came a week after a parliamentary report documented the "systematic plunder" of BHS, the collapsed high street retail chain, at the cost of 11,000 jobs and with 20,000 people's pensions now at risk.

The Pensions Regulator is investigating whether to use its powers against Sir Philip Green, former owner of BHS, to settle the former retail chain's pension debt.

But the institute says schemes remain at risk and the government should establish an "early warning" programme, which would allow the regulator to "actively seek out" and start negotiations directly with weak employers.

"This would enable the regulator to pick up early signs of the kind of practices identified in the report," said Professor David Blake, director of the institute, which is part of London's City University.

The regulator said: “We already operate a system of early proactive engagement with weaker and more high-risk schemes undergoing their valuations, similar to that proposed by the institute.

“We will investigate potential avoidance activity and have strong powers that we will use. Any additional powers would be a matter for government.”

The CBI, the employers’ trade body, said effective stewardship of defined benefit pension schemes was “a particular challenge”, given the long timescales involved.

“Each group of trustees needs to work with their employer to make the right decisions to ensure the scheme is well-funded and the employer is strong enough to support the scheme,” said the CBI.

The £30k cut to your pension lifeline: Former employees of companies that have gone bust face financial blow if they retire early, by Ruth Lythe, Daily Mail, 21 June 2016

- *Tapping pensions early will lead to reduced payouts from October*
- *Revelation is a blow to 100k-plus ex-employees of collapsed companies*
- *Up to 1k firms are on the brink of needing a bailout, say experts*

Hundreds of thousands of former employees of companies that have gone bust face a £29,000 pension blow if they retire early.

New regulations have been quietly introduced by Britain’s pension lifeboat scheme that will leave workers who plan to retire in a few months’ time with vastly lower payouts than those who are to take their nest eggs today.

The revelation is a major blow to more than 100,000 ex-employees of collapsed companies, whose pensions will now be paid by the rescue scheme known as the Pension Protection Fund.

Many will have planned to take their pensions early because they have been unable to find a decent job after being made redundant.

And hundreds of thousands more people could also be affected because up to 1,000 companies are on the brink of needing a bailout from the PPF, according to several pensions experts.

Those turning to the rescue scheme include 20,000 workers of High Street chain BHS, which went into administration in April. Next, could be the enormous British Steel Pension Fund, which has 130,000 members and a £700 million hole.

The PPF says the cuts to payouts for future pensioners, which are scheduled for October, were first discussed before BHS went under.

But experts say the lifeboat fund knows it will struggle to cover its soaring costs — and desperately needs to slash its bills.

David Blake, professor of pensions economics at Cass Business School, London, and an expert in the lifeboat fund, says: ‘The PPF could be in serious trouble if more pension schemes need to be bailed out than expected.

‘It is going to be desperately looking at every way possible to reduce its obligations to savers in the scheme.

‘I’m not surprised cutbacks like this are taking place and expect more to occur even more regularly in future, given the pressures that are on it.’

The PPF was created as a safety net for workers if their employer goes bust. It protects up to 90 pc of an employee’s expected annual pension, up to a maximum of £37,420 a year.

Those bailed out by the scheme are workers with final salary pensions, where their employer must guarantee a worker’s payout at retirement.

Without the fund’s existence, they would be left with nothing or just a fraction of their retirement income if their employer went out of business. There are more than 220,000 savers with final salary pensions which are protected by the PPF at present.

Some 120,000 are already taking their pensions and another 105,000 are waiting to retire — many are close to retirement with an average age of 51.

Another 60,000 members are forecast by the PPF to join the scheme in the coming years. Most will have a retirement age of 65.

But many workers in their 50s and 60s are expected to tap into their pensions early.

Doing this means you get a slightly reduced payout. This is because your pension is expected to be paid out for longer.

Special accountants, known as actuaries, calculate how much to deduct from a saver’s pension by analysing how long they are likely to live and how far they are off normal retirement before taking their pension.

Now the PPF, which is funded by a levy charged to all companies with final salary schemes, has decided to use a less generous calculation for future pensioners.

Under current rules, a worker with a final salary pension in the scheme who was entitled to a payout worth £21,000 at age 65 would receive £19,551 a year if they took their pension at 60.

This October, the rules will change. From then on, if another worker due the same payout retired at age 60 they would receive £18,396 a year. That’s £1,155 a year less.

It means that over 25 years of retirement the worker who took their pension in October would receive £28,875 less than the one who retired now. Those who have already retired will be spared these cuts. Francis Fernandes, the senior expert at adviser Lincoln Pensions, says: ‘These rules will have an enormous impact on savers.

‘If you plan to retire early, you should consider taking your pension now under the current rules as you will receive far more.’

Many companies with final salary schemes are buckling under the huge weight of the guarantees that they have made to workers.

According to figures compiled by consultancy Lane Clark & Peacock, just 24 out of FTSE-100 firms with final salary pension schemes have more than enough money in their schemes to meet their payout promises.

By comparison, ten companies had eye-watering deficits totalling nearly £40 billion.

These huge liabilities mean many firms may be pushed towards bankruptcy and their pension books shunted into the PPF.

A spokesman for the PPF says: ‘We are not reducing the basic levels of compensation. The new actuarial factors relate to options members can take, such as early retirement.

‘We update our actuarial factors regularly to ensure that the PPF is financially no better or worse off if people choose to take these options.

‘For example we will allow for external factors such as movements in financial markets or changes to life expectancy.’

UK plc sleepwalking into BHS-style black hole, pensions experts warn, by Joanna Bourke, *Evening Standard*, 16 June 2016

Pension experts told corporate Britain today to get their business in order, in the wake of the commotion surrounding collapsed BHS’s £571 million pension fund black hole.

Richard Butcher, managing director at trustee company PTL, told the Standard that British companies should learn from BHS: “Make sure your business adapts and survives. Don’t ignore your pension scheme.

“Select committees, the pensions regulator and trustees are under pressure. None of this points to the next round of valuations being more relaxed,” added Butcher, who sits on the independent governance committee of Standard Life.

The comments come a day after BHS’s former owner Sir Philip Green gave six hours of evidence to a parliamentary committee investigating the collapse of the retailer in April. Green, who sold the 163-store chain to Retail Acquisitions in March 2015, pledged to resolve the pensions “mess” affecting some 20,000 members.

The Topshop tycoon admitted there were “very very very few” conversations with any of the trustees. But Professor David Blake, director of the **Pensions Institute** at Cass Business School warned of more such cases from other firms.

Business select committee chair Iain Wright said the inquiry is considering calling his wife, Lady Green, but it was “unlikely”.

How to use tracker funds for cheap, easy investing, by Naomi Rovnick, *Financial Times*, June 2, 2016

Investing with professional stockpickers can be expensive and far from worth it. Academic research shows that the fund managers who steward our cash do not always beat stock markets over the long term. And some do not even try to outperform, as suggested by recent revelations over “closet tracking”, which involves high-charging fund managers doing little more than closely following a stock market index.

Some active fund managers do outperform, but this tends to last just two to three years, according to **David Blake**, a professor at Cass Business School. It also takes a lot of research and luck to know when to switch in and out of actively managed funds to capture this best-in-class performance. Otherwise, fund managers can be like annual flowers, which will bloom briefly and spectacularly in summer, before dying in the frost.

“If you have a manager that outperforms massively one year and underperforms massively the next, as a client, you never know if you are coming in at the right times,” said Alan Miller, a former manager of the Jupiter Investment Trust who now purely invests in trackers on behalf of his clients at SCM Direct.

Tracker funds, however, can be bought fairly cheaply, then left alone. They follow the movement of a chosen index without investors having to pay professionals to oversee them, and providing the market they track is broad-based enough, they can simply be left to grow.

Tracking the FTSE 100 over the past two decades has delivered such a result. Between February 1996 and February 2016, anyone who put their money in the FTSE 100 for 10 years would have made a 70 per cent total return before fund charges, according to Axa Self Investor.

The FTSE rises and falls, of course. But according to Axa, you would have lost money over a 10-year period (excluding charges) only if you had bought during the dotcom boom (January 31 to June 30 1999), and subsequently sold in the corresponding month 10 years later when markets were still reeling from the financial crisis (January 31 to June 30 2009).

Trackers also cost very little to own, compared with actively managed mutual funds. An investigation of more than 46,000 funds by Citigroup executive Ajay Khorana found the average cost of UK investment funds was 2.2 per cent a year. Someone investing £12,000 a year for 10 years would pay fees of up to £22,158 if the funds grew by an average of 5 per cent a year.

A tracker fund may charge 0.2 per cent, however. So achieving that same 5 per cent return over a decade would cost the investor total fees of £2,158.

Invest over 20 years and the effects of compounding really kick in. Over two decades, a £12,000 annual investment with the active fund manager would cost £91,914 more than the tracker, assuming both investments achieved 5 per cent annual growth before fees. We used the FT's interactive fund costs calculator to come up with these numbers, and you can play around with it here.

There are two main types of trackers. One is an index tracking mutual fund that is sold by big-name fund management houses, such as BlackRock. These can be purchased from the fund manager or from fund supermarkets, such as Hargreaves Lansdown. The other type is an exchange traded fund, which is bought and sold on the London Stock Exchange, just like a share, and can be accessed through stockbrokers. ETFs can track anything from global shares to soybeans.

To escape the risk of losing your money, the best tracker funds to own are those that buy shares in the index they follow. The shares should be held in safekeeping by an institution that is separate from the tracker fund's manager — usually a trustee or depository. So if the investment firm that manages your tracker fails, the assets are protected.

The alternative to a physically backed tracker is what is known as a "synthetic" instrument. This does not hold any assets, but instead mimics the performance of underlying stock indices by using derivatives. Many ETFs are synthetic. And people who invest in them rely on an array of financial institutions to supply them with the performance of the index they track. If one of these so-called "counterparties" goes under, the ETF could lose its value. Institutions from the International Monetary Fund to the Bank for International Settlements have warned about this feature of synthetic ETFs in recent years.

Providers of synthetic ETFs argue their products are viable because they hold collateral that is at least as valuable as their funds' net asset values.

"Still, I would tend towards physically backed ETFs in asset classes where this is possible," said Ben Smaje, chief executive of Kennedy Wealth Management, which mainly recommends tracker funds to clients.

Mr Smaje also cautions against buying ETFs that track esoteric commodities, arguing that this is a form of speculation and not the same as using trackers to acquire a broad-based exposure to global stock markets.

Tata Bailout threat to UK Pensions - Rescue Fund could be drained dry by steel deal, by James Burton, Scottish Daily Mail, 1 June 2016

Hundreds of teetering pension programmes could be put at risk if a rescue fund is forced to bail out a troubled scheme for staff at Tata Steel.

The Government is scrambling for a solution to keep the British Steel scheme which is now backed by struggling Tata out of the pension Protection fund.

It comes as the Work and Pensions Committee of MPs prepares to launch an inquiry into occupational pensions.

Chairman, frank Field has been leading an investigation into the scheme at collapsed retailer BHS. He is hoping to look at the wider system claiming it is 'creaking from rising life expectancy and record low returns'.

Loss-making Tata has been put up for sale by its Indian owners but the pension fund's £700m black hole is seen as a major obstacle to a rescue.

This gaping deficit will be handled by the PPF if Tata becomes insolvent and another solution is not found.

Pension expert John Ralfe said it would cost around £1.5bn for the lifeboat fund to turn things around – dwarfing its previous record bailout of £300m.

The PPF is paid for by a levy on company pension schemes, with £574m paid in last year. If it has to take on the Tata deficit, the fund will be pushed closer to the point where it has to either increase levies or slash the benefits for retirees who rely on rescued schemes.

Professor David Blake, Director of the **Pensions Institute** at Cass Business School at City University in London, said a rise in levies would put extra pressure on schemes close to collapse. And it could push more secure businesses away from offering final salary pensions at all. He said: 'You will get more and more bad schemes going in and the good companies saying they've had enough of it, 'It's a Ponzi scheme and you can't do anything about it'

The Institute believes 600 pension funds are certain to collapse in the next decade, with another 400 also at risk. These funds have deficits of around £45bn, a far greater number than the PPF can afford.

A 33,000 – member scheme backed by bankrupt Canadian telecoms giant Nortel Communications could also end up in the PPF.

Courts are set to rule on how much of Nortel's £5bn assets will be given to the UK scheme as soon as this week. But if enough cash is not secured, it could pass into the life boat. In the past, fund have also sought loopholes to avoid paying their full levy. It emerged last night that BHS exploited a legal accounting trick to cut the size of its payment in to the lifeboat fund.

The firm claimed a discount in 2011-12 – almost halving its contribution to £196,000, according to the Financial Times.

Fearful of encouraging a wider collapse, ministers are scratching around for an alternative to a bailout for Tata. One possibility is spinning the pension fund off into a new company and linking it to a lower measure of inflation, which could save billions in the long run.

But Blake said that this controversial tactic would mean the state provided a backstop to guarantee the new owner wouldn't fail. He warned it could lead to a clamour for copycat solutions from similarly precarious schemes. “The Government is saying this is a unique case. I don’t believe that”, he said.

Labour MP Field’s inquiry comes as no surprise to observers. He told the Mail a fortnight ago that he hoped to launch a wider probe into how British pensions would fare over the next three decades.

Tom McPhail, head of retirement policy at Hargreaves Landsdown, said: ‘It is no longer possible to turn a blind eye to the yawning reality gap that has opened up’.

The companies with pension fund time bombs: After BHS, how big is the threat and should investors steer clear? By Tanya Jefferies for Thisismoney.co.uk (Daily Mail), 5 May 2016

- BHS's demise throws spotlight on other final salary pension schemes
- These place big obligations on firms - and on investors if they are listed on the stock market
- One in six schemes in private sector are at serious risk, finds a study

The collapse of BHS is a sobering affair. Staff in its final salary pension scheme are being rescued by the Pension Protection Fund, but those who aren't yet retired will still end up with less income than they expected in old age.

The retailer's £571million black hole in its pension fund was far from the only cause of its woes, but its vast size and the controversy surrounding the firm's demise has thrown the spotlight on other final salary pension schemes.

These offer guaranteed and typically generous payouts for workers, but place big obligations on businesses - and on their investors if they are listed on the stock market.

Angry politicians are now looking to get former BHS owner Sir Phillip Green to cough up extra for its pensioners, and they might also tighten the rules on sales of firms with heavy pension responsibilities in future. Potential buyers of Tata Steel are likely to come under heavy scrutiny as a result.

BHS was not listed on the stock market, so no share investors are directly affected by it going bust. But there are many other huge, well-known companies - popular with individual investors and widely held in index tracker and pension funds - which carry liabilities to see current and former staff through their old age, and could also get caught up in political fallout from the BHS crash.

They include Shell, BT, Next, Royal Mail, Sainsbury's and the Pru, to name just a few. Some of those above and plenty of others are well funded and in surplus. Others were in deficit at last count, although it must be stressed that this doesn't necessarily mean they are in any danger.

Nevertheless, a recent study estimates that one in six final salary schemes in the private sector are at serious risk of falling into the hands of the PPF rescue vehicle, as BHS did last week.

Out of 6,000 schemes in total, some 600 are expected to become insolvent in the next five to 10 years, and a further 400 will struggle to survive unless they manage to offload their pension obligations, according to last December's report from the **Pensions Institute**, which is part of Cass Business School.

So how serious a threat do pension fund deficits pose to companies, and should it affect whether you invest in them or not?

WHAT ARE FINAL SALARY PENSIONS?

Final salary pensions, also known as 'defined benefit' schemes, provide workers with a guaranteed income in retirement, and often carry on paying a reduced sum to spouses after they die.

Employers rather than workers bear all the investment risk, and the costs of people living longer.

Outside the public sector, employers have mostly closed or phased out these safe and generous schemes for new staff. But companies still have legacy obligations to retired or longstanding workers that could stretch another 50 or 60 years into the future.

If you have a traditional final salary pension and your employer goes bust, the ***Pension Protection Fund*** *should come to your aid.*

It is funded by other healthy final salary schemes and is in surplus, so should easily be able to meet obligations to members of the BHS scheme.

Under ***the current rules,*** *if you have already retired, your payouts should be fully protected. If you are coming up to retirement, you should get 90 per cent up to a cap of £30,000-plus a year.*

Nowadays, most private sector workers are in 'defined contribution' pension schemes which they and their employers pay into to build up a pot of money for retirement. Company payments into these are stingier and savers bear the investment risk.

How big are final salary pension deficits - and how serious is the problem?

The overall deficit of the near 6,000 schemes covered by the PPF was £302.1billion at the end of March, according to its latest figures.

That's a bit smaller than the £322.8billion recorded at the end of February, but significantly worse than the previous year when the deficit was £244.2billion.

The chart below shows how the position has changed since the start of 2008, as the financial crisis got under way. The overall deficit has widened and recovered several times since then, but has ballooned again over the past couple of years.

The PPF says the main drivers of pension funding levels are gilt yields - the interest rates paid by the UK Government on its bonds - and stock market performance. Favourable movements in these during March led to the recent narrowing of the deficit.

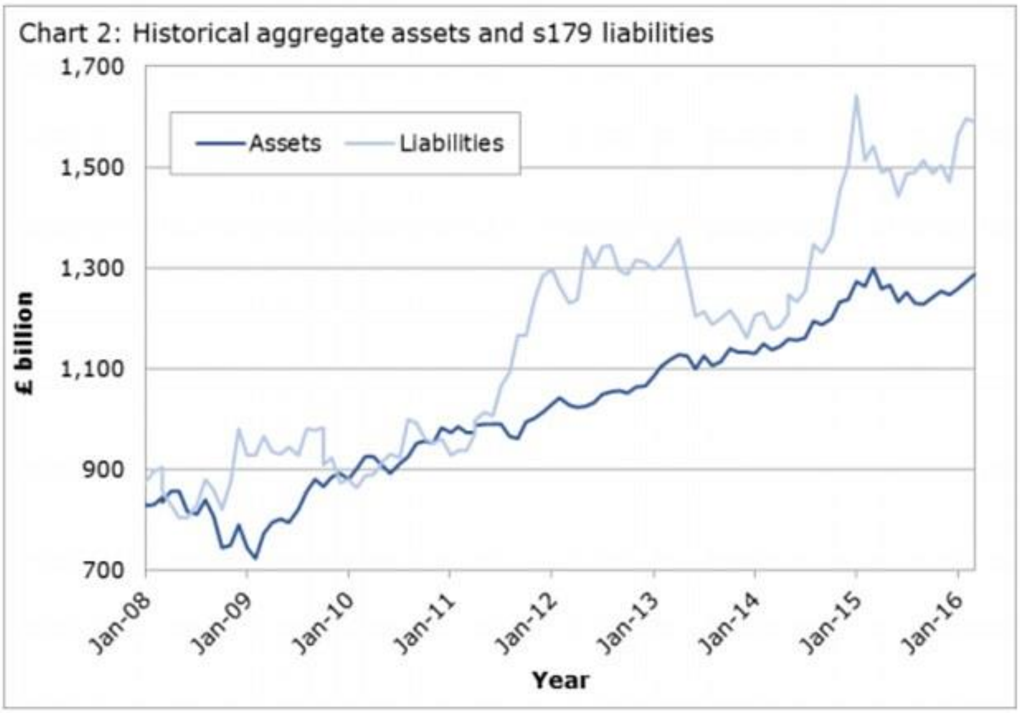
Interest rates and therefore gilt yields have been at rock bottom since the financial crisis, although shares have seen a strong recovery.

But going further back in history, former Labour Chancellor and Prime Minister Gordon Brown is often accused of blowing a hole in pension funds by scrapping the dividend tax credit during the 1990s. And looking even further back, the Tories are blamed for allowing firms to take 'holidays' from making contributions into pension schemes.

Meanwhile, pension consultancy Hymans Robertson warns the size of the 'real' deficit in final salary schemes actually stands at a record £800billion.

That's because the PPF bases its estimate on the lower payouts it would pay to pensioners whose employers entered its rescue scheme (see box above). But Hymans includes the full potential loss in lifetime savings to pensioners if their schemes failed, which it says works out at £45,000 on average per pensioner.

In a survey carried out early this year, Hymans found one in seven finance directors believed their final salary pension scheme was a major risk to their business. And it estimates that up to a million people are at risk of seeing reductions to their pension benefits due to their schemes becoming unaffordable to the businesses providing them.



Assets vs liabilities: Overall deficit has widened and recovered several times since the financial crisis in 2008, but has ballooned again over the past couple of years. S179 is a measure of pension liabilities which the PPF uses to illustrate the impact of changes in financial markets (Source: PPF)

Calum Cooper of Hymans said: 'To pay workers their pensions in full, these schemes will either need to see unexpected growth in the business sponsoring them or a reversal of the capital market headwinds that have blighted defined benefit schemes for the past 16 years.

'Putting this in context, since the start of the millennium the value of the UK companies has stayed constant while pension deficits have tripled. The aggregate UK defined benefit deficit is at an all-time high of £800billion and UK companies now have defined benefit pension liabilities of £2.1trillion, outstripping the entire GDP of the UK.'

The **Pensions Institute**, which highlighted the 'worst case scenario' of 1,000 out of 6,000 schemes turning to the PPF in coming years, says those it identified are highly vulnerable to the risk of underfunding and an employer's insolvency.

'Quantitative easing [money printing by the Bank of England], low interest rates, and low gilt yields are all considered to add significantly to the problem, especially as gilt yields are a key factor in the assumptions used for valuations,' it says.

So which top listed companies have the biggest pension deficits?

Pension consultant Lane Clark Peacock carries out an annual study of how FTSE 100 companies manage their final salary pension risks. The most recent was published last summer, and based on information given by firms in their annual reports for 2014.

It covers 87 firms, with 12 excluded because they don't have a big enough final salary scheme, and Dixons Carphone left out because its merger meant no 2014 figures were available.

Tables revealing the biggest pensions liabilities and deficits, and the companies with the highest funding levels, appear immediately below. Other tables covering largest contributions, including versus dividends paid out, are shown further below.

Largest liabilities		
Company	2014 Liabilities £m	2013 Liabilities £m
Royal Dutch Shell	62,153	53,914
BT Group	47,135	47,422
Lloyds Banking Group	37,243	33,355
RBS	36,643	31,484
BP	33,648	29,569
BAE Systems[1]	30,506	25,943
Barclays	30,203	27,407
HSBC Holdings	27,004	24,483
National Grid	22,914	23,676
International Airlines Group	21,157	19,112

Source: LCP

Largest deficits		
Company	2014 Deficit £m	2013 Deficit £m
BT Group	7,022	5,856
Royal Dutch Shell	6,739	2,183
BP	5,507	3,486
BAE Systems[2]	5,387	3,540
Tesco	3,193	2,378
Unilever	2,309	1,206
RBS	2,284	2,996
AstraZeneca	1,870	1,347
GKN	1,711	1,271
GlaxoSmithKline	1,689	613

Source: LCP

Highest funding level				
Company	Assets £m	Liabilities £m	2014 Assets/ Liabilities %	2013 Assets/ Liabilities %
Royal Mail	3,833	2,097	183	133
Standard Life	4,266	3,237	132	121
3i	899	702	128	123
Old Mutual	621	514	121	117
Aviva	15,474	13,170	117	102
Next	668	597	112	112
Schroders	988	884	112	108
Prudential[3]	8,067	7,312	110	110
Rolls-Royce Holdings	12,934	11,956	108	101
Ashtead Group	84	78	108	101

In the black: FTSE 100 firms with the highest funding levels (Source: LCP)

LCP says the UK's biggest employers continued to reduce their pension contributions in 2014. Total contributions to final salary schemes were £12.5billion, compared with £14.8billion in 2013 and £16.8billion in 2012.

What should investors consider?

Investors need to take a detailed look at a company's accounts when assessing the importance of a pension deficit, according to Hargreaves Lansdown senior analyst Laith Khalaf.

'The deficit is the balance sheet item defined by the assets of the scheme and the liabilities of the scheme, and both of those figures can move around depending on market movements,' he says.

'More relevant is probably the payments that the company is making into the scheme to cover service costs and make good the deficit. Service costs are the benefits promised to employees.'

But Khalaf notes that some firms have divested their pension liabilities by paying insurers to take them over, which removes them from the balance sheet.

'There are big numbers going around which sound quite scary but you need to put them into context. A lot of companies have these liabilities,' he says.

'What you need to drill down into is how they are going to affect the business going forwards - the annual costs, contributions and service costs. See what they are taking out of the business on an annual basis. It gives you an idea of the kind of drain on resources a given scheme is going to exercise.'

Largest employer contributions		
Company	2014 Contributions £m	2013 Contributions £m
Royal Dutch Shell	1,113	1,649
RBS	1,065	821
BP	760	814
BAE Systems[5]	640	646
BT Group	553	542
Tesco	535	666
Lloyds Banking Group	531	804
International Airlines Group	483	479
Unilever	433	504
HSBC Holdings	410	601

Top-ups: FTSE 100 firms making the biggest contributions to final salary pension funds (Source: LCP)

Patrick Connolly, investing expert at Chase de Vere, says most people don't have the time, knowledge or expertise to research individual companies and their pension liabilities in great depth, and are better off investing in funds. These can spread your risk across many shares and other assets, and are run by professional managers who will assess risks like pension liabilities for you.

Connolly says that even if you look at the documents a firm publishes like its annual report, this will only given you a piece of the puzzle on pensions. To find out how a company intends to fund a pension deficit, you would need to ask its finance director - something a fund manager like Neil Woodford can do, but Mr Bloggs can't, he points out.

On the investing risks, Connolly says: 'If you avoided all companies with a pension deficit you would cut out a large part of the universe. Just because a company has a pension deficit it isn't necessarity a warning sign, because some of these deficits aren't excessive and they are manageable.'

But he adds this word of caution: 'Pension deficits are likely to become an even bigger problem in the future. People are continuing to live longer. Liabilities will continue to grow. We are in a period of low growth which is also reflected in terms of lower investment returns.'

Highest employer contributions compared to dividends paid[6]				
Company	Contributions £m	Dividends £m	2014 Contributions /Dividends %	2013 Contributions /Dividends %
RSA Insurance Group	114	6	1,900	75
RBS	1,065	383	278	204
Lloyds Banking Group	531	314	169	3,216
Whitbread	62	62	100	48
BAE Systems[5]	640	656	98	100
Babcock International Group	97	101	96	90
Meggitt	42	51	82	55
TUI Travel	117	153	76	47
BT Group	553	778	71	79
GKN	85	135	63	44

IAG, BAE and Sports Direct did not pay a dividend during their 2013 or 2014 accounting years, but did make contributions to their pension schemes (Source: LCP)

Largest liabilities compared to market capitalisation				
Company	Liabilities £m	Market cap £m	2014 Liabilities/ Market cap %	2013 Liabilities/ Market cap %
International Airlines Group	21,157	9,897	214	234
BAE Systems[1]	30,506	14,929	204	184
RSA Insurance Group	7,598	4,372	174	200
BT Group	47,135	29,881	158	217
RBS	36,643	25,026	146	151
Sainsbury (J)	6,868	5,966	115	91
Aviva	13,170	14,269	92	92
Marks & Spencer Group	6,529	7,360	89	107
Smiths Group	4,023	4,998	80	72
GKN	4,338	5,603	77	63

(Source: LCP)

Largest deficit compared to market capitalisation				
Company	Deficit £m	Market cap £m	2014 Deficit/ Market cap %	2013 Deficit/ Market cap %
BAE Systems[2]	5,387	14,929	36	25
GKN	1,711	5,603	31	21
BT Group	7,022	29,881	23	27
TUI Travel	699	4,351	16	16
Sainsbury (J)	737	5,966	12	9
Tesco	3,193	26,450	12	8
RBS	2,284	25,026	9	14
Severn Trent	348	4,340	8	9
G4S	319	4,312	7	12
BP	5,507	74,955	7	4

(Source: LCP)

Could BHS be the tip of the iceberg for the pensions lifeboat?, By Sara Benwell, Engaged Investor, 26 April 2016

The failure of BHS raises big questions about what happens to those schemes that are guaranteed to fail

That BHS has finally gone into administration is hardly surprising. Nor is it a shock that its pension scheme will have to be absorbed by the Pensions Protection Fund.

Back in March a Company Voluntary Arrangement (CVA) proposed by the firm was accepted by its creditors. This would have seen landlords and other creditors voluntarily taking a hit to keep BHS out of administration.

But the £571m shortfall in its pension fund also needed to be addressed, and the firm held talks with the PPF to explore options for offloading the scheme onto the lifeboat fund. The CVA was ultimately scuppered however, as the department store chain failed to secure the financing it needed to restructure.

Malcolm Weir, head of restructuring and insolvency at the Pension Protection Fund said: “Following the BHS CVA last month we had been in discussions to find a solution that was in the best interests of the pension schemes and the company. However following the BHS announcement that it has filed for administration the PPF will now work with the Pensions Regulator and other parties to secure the best outcome for the pension schemes.”

At first, as with Tata Steel, this looks like a simple case of an ailing industry failing to manage its pension schemes. And in many ways it is. But actually the facts are more complicated.

There are questions over whether the current and former BHS owners diverted money that should have been used to plug the pension deficit, and the Pensions Regulator is currently investigating to see whether it can use its anti-avoidance powers. These powers allow it to act when it believes that an employer is attempting to avoid its pension obligations, leaving the PPF to pick up the pension liabilities.

A spokesperson for the regulator said: "We can confirm that we are undertaking an investigation into the BHS pensions scheme to determine whether it would be appropriate to use our anti-avoidance powers."

Such investigations can take a long time, and we may not know for months or years whether the company is found to have acted inappropriately. What is noteworthy is that the regulator has commented at all, as it is usually tight-lipped when it comes to its investigations.

While it is not yet clear whether the investigation will centre on the current owner - a consortium led by Dominic Chappell – or its prior owner, Sir Philip Green who sold the chain for a pound last year, a source close to the situation has indicated that the regulator will be taking a keen interest in any money that has been taken from the company in the years before its eventual fall into administration.

Professor David Blake, director of the Pensions Institute argues that both the regulator and the PPF should be "very concerned" about this. His argument is not just that BHS could have been "gaming the PPF" but also that there are a thousand of other 'zombie' pensions schemes out there, that could find themselves in the same boat.

He said: "When Philip Green took over the scheme had a surplus of £6m according to the news reports and now it's got a £350-500m deficit depending on whether you value it on an ongoing basis or the buyout basis.

"Your scheme actuary tells you every three years [how your scheme is doing]. So he must have had five times where the scheme actuary told him that things aren't going well and rather than put money into the scheme he was taking money out, in £400m worth of dividends.

"We're predicting that there are up to 1000 companies in this position. With the small ones it doesn't really matter, but this is an example of a big one."

In a research report published in December 2015, the Pensions Institute estimated that there were 1,000 DB pension schemes at serious risk of falling into the PPF. In aggregate these 1,000 schemes represent liabilities estimated at £225bn with deficits estimated at £45bn.

Of the 1,000 distressed schemes, which include about 25 of the largest schemes in the UK, each with £1bn or more in liabilities, the institute predicts that 600 sponsoring employers will never pay full pensions, with many of becoming insolvent in the next five to 10 years – just as has happened with BHS.

This is deeply concerning. On a fairly obvious level, there are worries about the members of these schemes whose pension payments will be reduced.

But there are deeper questions about what this means for the PPF as an organisation. The BHS failure alone has prompted a work and pensions committee enquiry into how the receipt of the pension liabilities from BHS, which has a £571 million deficit in its pension scheme, will affect the fund and its users.

There will clearly be an impact on other pension schemes if the PPF has to swallow many more schemes with deficits this large, particularly in terms of a possible levy increase as a result.

The chair of the Work and Pensions Committee Frank Field MP said: “We need as a committee to look at the Pension Protection Fund and how the receipt of pension liabilities of BHS will impact on the increases in the levy that will now be placed on all other eligible employers to finance the scheme.”

Blake said: “Basically, you’re going to get bad driving out good here because this scheme will no longer pay the levy and it’s a bad scheme. That means the levy will have to go up for the remaining schemes that are good…. The good schemes are paying the price of the bad schemes.”

However, it is important to note that the PPF is geared up to absorb schemes of this size – that’s why it is currently running a surplus of £3.6bn. And the BHS isn’t even in the organisation’s top five claims, although it is one of the larger ones in recent years.

But if you believe the Pensions Institute’s estimate of £45bn in stressed scheme deficits, the picture is more bleak.

Blake said: “It’s not good because this is a huge deficit. [The PPF] get their money from the levy and from the assets that they take over and from their investment performance.

“The investment performance of the Pension Protection Fund has been very good. They’ve been very good at hedging their risks and they’ve had very successful performance. So you have to rate them as among the best pension fund managers that we’ve got. But not even with all that are they going to overcome the size of this deficit, because it’s huge.”

The PPF’s own figures are less alarming, with the organisation’s modelling framework suggesting that the lifeboat fund should be on track to cope with any schemes that need its help over the next ten years.

What is clear, however, is that not all schemes will make it. Indeed, when *Engaged Investor* spoke with Alan Rubenstein, chief executive of the PPF, back in March he said: “Even with a rise in interest rates there are a rump of schemes that are so poorly funded that they are never going to make it. To my mind it would make sense for us to accept that fact and figure out what the solution is.”

Some of those schemes may have sponsors that are unable to meet the funding pressures on their scheme, while other firms may be simply shirking their obligations.

The latter should fall foul of the Pensions Regulator’s anti-avoidance powers. After all, TPR has a statutory duty to reduce claims on the PPF. And those questioning whether its powers are strong enough to prevent employers trying to game the system will be reassured to hear that the Work and Pensions Committee will be examining just that.

Field concluded: “We will then need to judge whether the law is strong enough to protect future pensioners’ contracts in occupational schemes.”

POINTS OF LAW: Worth the risk?, 25 April 2016 Pensions World

Robin Ellison, Pinsent Masons, on the importance of achieving a sensible balance when managing risk

In a nutshell:

- risk management has become a major issue for pension trustees in relation to investments and liabilities
- trusteeship almost by definition involves taking risks, and trustees need to be comfortable in assuming risk for the benefit of members
- diversification may be an adequate or at least major way of managing investment and liability risk.

Risk in recent years has become a big issue in pension scheme management and trusteeship. There are risk budgets, risk appetites, risk journeys and risk advisers. There is liability driven investment (LDI), integrated risk management (IRM) and deficit reduction contributions. The Pensions Regulator’s note, some months back, on IRM quite properly comes in for a bit of stick in trustee meetings, because it rather wordily states what we do anyway, perhaps with professional support, although maybe not with formal recording of the choreography.

Scheme members have become exposed to much higher risks of benefit failure because of the perfect storm that schemes find themselves battling: lower discount rates, longer mortality experiences, unhelpful accounting rules – and regulatory obligations.

Risk is not a thing that is unique to pension scheme trusteeship. In flying, the Civil Aviation Authority manages rather successfully to make travelling by plane a low risk experience. And a recent book by neurosurgeon Henry Marsh (*Do No Harm*) brilliantly explores the risks that surgeons take on behalf of their patients (who actually carry the risk).

The trouble is that the same word can be used to describe rather different kinds of risks. On an aeroplane, the passenger takes the risk – and it is important to them, the pilot and the community at large that the plane does not crash. Risk controls are critical. But even here, the governing authority faces dilemmas which can be insuperable: should it design a cockpit door that is impregnable from the outside to terrorist passengers, but which then is also impregnable to co-pilots trying to get in to subdue mentally unstable pilots?

Managing risk does not mean that nothing should ever go wrong. The issue is always how wrong and whether potential failure can be mitigated at a sensible cost. Understanding risk is as important as managing it, as was explained by Professor David Speigelhalter at the PLSA Investment Conference in Edinburgh in March 2016. He was looking at the public understanding of risk. What he cautiously avoided was looking at the scheme trustees' (and the Regulator's) understanding of risk. His talk followed that of the popular economist Tim Hartford, who tackled rather similar issues at an NAPF conference some years ago.

Following the professor's talk, we now understand that the *Daily Mail* can misrepresent the true risk involved in eating a couple of pieces of bacon a day. But are trustees better equipped to understand the risks they are running? And should they do anything about those risks? Back to the professor, who pointed out that trying to manage risk in some cases can be pointless and very expensive. It is not certain, for example, that scanning for breast or prostate cancer is entirely beneficial.

His talk provoked some reflection on just what risks it is sensible for trustees to take into account – and who decides whether a risk is a smaller or greater one. Finally, and rather importantly, who puts a price on the cost of managing risk?

The Regulator might perhaps usefully change the IRM note for its next edition, assume that we all know what the usual risks are (longevity, investments, sponsor failure) and instead talk us through some of the trustee issues on risk not otherwise explored. Six of these issues are set out below, but readers no doubt have others they might like to add:

1. Is the risk one which is not worth worrying about, because to be blunt there is not much one can do about it (eg corporate weakness)?
2. Is the cost of dealing with it disproportionate – and how can we quantify the cost of LDI, swaps, etc?
3. By removing or reducing one risk, are we introducing a fresh risk and one which is more difficult to assess?
4. Is the risk one which the scheme was invented to carry, rather than laid off elsewhere?
5. Can political or regulatory risks be covered by joining, for example, a trade body that can do whatever it takes to prevent absurd initiatives (eg pension freedoms, super low interest rates, or unhelpful and counterproductive tax legislation)? So far, our trade bodies have been permanently on the back foot.

6. Should trustees worry about risks that are not theirs, eg those that properly belong to regulators or the Pension Protection Fund (PPF)?

Negligence

In law, judges have been looking at risk issues in relation to negligence for several hundred years. For example, in *Harris v Perry* ("the Bouncy Castle case") the question was whether the defendant should have to pay £2m for severe injury caused to a child of 11 who was playing on a bouncy castle and bungee run, which the defendant had hired for a birthday party for her ten-year-old triplets. The claimant was injured when a bigger boy (aged 15) was allowed to use the bouncy castle at the same time. The instructions on the hire form were clear: watch what goes on at all times – and do not mix the ages of the children. In the Court of Appeal, the judges concluded that, even though the defendant had not followed the instructions, there are risks in everything we do and we sometimes just have to live with them.

Pension trustees are encouraged in some ways to lay off risk, at least for themselves. They have spent large sums of money and time on laying off risks through swaps, options and LDI policies, sometimes for spurious reasons, spending what are risk budgets without thinking whether it is worth the trouble.

Trustees themselves have risks which they manage by using insurance, relying on terms in the documentation or taking advice. But these are simple risks with simple solutions. In relation to member risks, we need to ask ourselves whether many of the risks we are being encouraged to take off the table through derivatives or LDI are risks which we should actually continue to carry. It is possible that the conventional nostrums about risk management are today inappropriate, as David Spiegelhalter pointed out. If the Regulator feels in the mood to commission David Spiegelhalter to carry out research on the pensions understanding of risk, it would be a good use of public money. The question may be not so much whether trustees understand the nature of the risks involved in running a scheme, but rather whether we have overdone risk management in recent years by raising costs and introducing new risks.

In Brief

What are pensions for?

In Australia, the government issued a discussion paper, preparatory to introducing legislation to enshrine the objective of its superannuation system. The paper is only eight pages long and is a model of how these things should be done. Coincidentally, the Australian government also published a rather longer paper on superannuation efficiency and competitiveness, which we could also do with. When it reaches its conclusions, maybe it will examine the anti-competitiveness of regulatory frameworks. It is not certain that reducing the number of providers to half a dozen, however well run, is a recipe for consumer benefit. A paper by Professor David Blake, commissioned by the Labour Party, on what a proper UK pension system might look like, is a massive work of scholarship and could be used as a basis for a similar UK review.

HMRC

HM Revenue & Customs (HMRC) has published its Pension Schemes Newsletter 77 (which says something about the stability of the system). It is only available on the government website in HTML, but if you try and print it out, it is about 15 pages long (small print, close spacing). The PLSA should have coffee with the director of the HMRC department responsible, open a laptop, log on to wifi and ask them to find their own newsletters on the system. Those that are not easily and readily available should be considered not applicable.

DWP

Similarly, the Department for Work & Pensions (DWP) has issued guidance on alternative quality requirements for defined benefit (DB) schemes for auto-enrolment purposes. For an HR manager, it will be impenetrable. Fortunately, there are now relatively few DB schemes, so not many will be affected. In the meantime, Lord Turner, who has been taking credit for the success of auto-enrolment, should be asked to reflect on the auto-enrolment regulations, which have been updated so many times that you can only just detect the original text beneath the forest of amendments.

Company law

As a director of a trustee company, from 30 June you can get a criminal record, plus up to two years in prison and/or a fine if you do not file with Companies House a register of people with significant control, which sets out a list of individuals who directly or indirectly own more than 25% of the shares or voting rights, including a sponsor company that owns the shares of the trustee company. Hopefully, the enforcement authorities will take a pragmatic view of breaches.

The question is what mischief is expected from a pension scheme in such circumstances. The legislation is clearly overkill – and runs counter to the deregulatory agenda of the current administration.

Sources

Australian Government, *Objective of Superannuation*, Discussion Paper, 9 March 2016

Australian Government, *Productivity Commission, Superannuation Efficiency and Competitiveness*, Issues Paper, March 2016

Australian Institute of Superannuation Trustees, *Fee and performance analysis*, December 2015

David Blake, *We need a national narrative: building a consensus around retirement income*, Independent Review of Retirement Income, March 2016

Debbie Harrison and David Blake, *The greatest good for the greatest number*, Cass Business School/Pensions Institute, December 2015

Department for Work & Pensions, *Automatic enrolment: guidance on the alternative quality requirements for defined benefits pension schemes and the defined benefits element of hybrid pension schemes*, DWP, April 2016

Djuna Thurley, *Pensions: automatic enrolment 2010 onwards*, House of Commons, Library, Briefing paper SN06417, 14 March 2016

Djuna Thurley, *State pension age increases for women born in the 1950s*, House of Commons, Library, Briefing Paper CBP 07405, 24 March 2016

Financial Reporting Council, *Joint forum on actuarial regulation, review of transfers from defined benefit to defined contribution schemes following pension freedoms*, March 2016

Harris v Perry and Perry (CA) [2008] EWCA Civ 907, 31.07.08 (Bouncy Castle case)

Henry Marsh, *Do No Harm*, Weidenfeld & Nicolson, 2014

HMRC, *Pension schemes newsletter 77*, 29 March 2016

House of Commons, Work and Pensions Committee, *Communication of the new state pension*, HC 926, 23 March 2016

Mia Molsio and Camilla de Ste Croix, *Reclaiming ownership: a survey of governance and responsible* investment at UK automatic-enrolment pension providers, ShareAction, undated

Professor David Speigelhalter, www.youtube.com/watch?v=a1PtQ67urG4

Rebecca Moore, *Moody's predicts PBGC premiums will become unaffordable*, Plan Sponsor, 25 November 2015

Small Business, Enterprise and Employment Act 2015

The Occupational and Personal Pension Schemes (Automatic Enrolment) regulations 2010 SI 2010 No 0772, especially regulation 32L (!)

This generation game must stop, By David Blake, FTAdviser, Apr 13, 2016

It is increasingly clear that the five-year political business cycle is not suited to dealing with long-term issues such as pensions, long-term care and long-term savings.

Political parties, whether in power or in opposition, are totally focused on winning the next election and appear unable to think beyond that. It is therefore very hard to get any political party to adopt sensible long-term solutions to the problems of pensions, long-term care and long-term savings, especially if this involves sacrifices today, because they fear it would benefit their opponents who could well be in power when the benefits began to show.

This has fundamental consequences for intergenerational equity, since every generation passes the consequences of its own failures down to the next. While this can be a small problem when a population is growing, it becomes very severe when a population is rapidly ageing.

To illustrate, a key reason why we would want each generation to hedge its own exposure to longevity risk is that, if it fails to do so, it is expecting the next generation to provide that hedge for free. The main objection to buying annuities – the classic longevity hedge – by the baby boom generation currently retiring is that they are 'too expensive'. But they will be even more expensive for the next generation if significant numbers of baby boomers run out of money and demand that the next generation provides them with an income for life (also known as an annuity) to keep them out of 'poverty'. For how much longer can the baby boom generation keep asking for a free lunch from the next?

One way of achieving a national narrative as well as dealing with the myopia of the political business cycle is to have a permanent Pensions, Care and Savings Commission (PCSC). This would be an independent body that would have cross-party support and would make recommendations on issues relating to pensions, long-term care and long-term savings. The PCSC would require an evidence basis for any policy recommendations, together with an impact and risk assessment. A particularly important role for the PCSC would be to ensure inter-generational equity. Since no generation during its working life can store for its retirement the goods and services it will consume in retirement, each generation depends on the next to provide those goods and services in a way that is not widely recognised. The PCSC would report directly to Parliament.

There is widespread support for such a commission, including the Work and Pensions Select Committee, the Association of Consulting Actuaries, the National Association of Pension Funds, the Association of British Insurers, the Trades Union Congress, the International Longevity Centre – UK, Tisa's Savings and Investments Policy Project, Age UK, and Pensions Age's Unchaining Pensions from Politics campaign.

Politicians are less keen on having a PCSC. While recognising the problems that the commission would be trying to address, politicians have said it is the responsibility of government to deal with these. David Willetts, the former MP, believes politicians would be reluctant to surrender control of certain aspects of pension policy, but were more supportive of the idea of a pensions commission having some role. He said in digital magazine Pensions Insight last year: "I remember the original Turner commission on pensions and I thought that part of [Lord Adair Turner's] effectiveness came from the way it assembled a large amount of data that hadn't been properly brought together before. I think there is a case for a long-term commission to provide material evidence so that you've got a solid, analytical base, especially as it is shared across at least two government departments [HM Treasury and Department for Work and Pensions]."

The Independent Review of Retirement Income also supports the idea of having a standing PCSC. It could be justified on any number of grounds, as discussed above. But perhaps the simplest justification would be to help avoid in future the kind of problems that have emerged from the introduction of 'freedom and choice' without any consultation with industry, as raised in our interview panels:

• "The Pension Commission had an evidence basis for its policy recommendation – auto-enrolment – namely, the success of auto-enrolment as a nudge in the US to increase defined contribution savings. There was no evidence basis for 'freedom and choice'".

• "Even supporters of these proposals could not deny that they failed the test of having an impact and risk assessment. Further, they are a clear example of short-term political populism at the expense of long-term stability."

• "Failure by Government to put in place both success criteria – in particular, a definition of 'what good outcomes are' – and methods of measuring and monitoring outcomes in response to the new flexibilities, resulting in a complete data vacuum."

• "Coupling of flexibility and choice which disregards any understanding about how real people choose."

• "Lack of member engagement – a disconnect between auto-enrolment at the front end and 'freedom and choice' at the back end. Engagement is not necessary for auto-enrolment – it is critical for 'freedom and choice' to work."

• "Whoever does it, it is crucial to have information and discussions with employees in the workplace to engage them. A workplace visit is the holy grail but is not commercially viable in small companies. But smart electronic communications can replace face-to-face meetings. Communication, information, education, simplified advice are all needed for engagement. Pension Wise does not deliver this."

• “Adequate financial education not in place for Flexiday; for example, most people are incapable of converting a lump sum into an income equivalent, believing that £50,000 is a ‘large’ lump sum, when it is only one third of the value of the new single-tier state pension of £8,000 a year.”

• “Failure to put guided pathways with defaults in place for Flexiday.”

• “No clarity on charge structures, unlike auto-enrolment.”

• “Insufficient protection in place for consumers who are at risk of mis-selling or ‘rip off’ charges.”

• “Failure to understand that safeguards only work if people are engaged and understand the risks.”

In short, there is no longer a coherent national narrative about what pensions are for, just a lot of noise around a series of short-term policy initiatives. A new type of commission is needed to reduce the risk of anything like this happening again.

Professor David Blake is a director of the Pensions Institute, Cass Business School and chair, Independent Review of Retirement Income

Key Points
Political parties are totally focused on winning the next election and appear unable to think beyond that. One way of achieving a national narrative as well as dealing with the myopia of the political business cycle is to have a permanent Pensions, Care and Savings Commission (PCSC). Politicians are less keen on having a PCSC.

Pension schemes face buyout roadblocks ahead, By Peter Davy, Financial News, 24 March 2016

The road to UK pension derisking could be facing a new challenge. With strict new regulations biting on insurers, as the pension liabilities of UK corporates continue to increase, there are fears that the pensions buyout market is heading for a capacity crunch.

Total pension liabilities of FTSE 250 companies increased to £81 billion in mid-2015, up from £75 billion the year before, according to a report by JLT Employee Benefits in January 2016. Such is the extent of the pensions burden on UK corporates that JLT expects there to be few, if any, remaining open defined benefit schemes run by FTSE 250 firms by the end of the year.

But as schemes close and contributions stop being paid in, companies still face the task of paying out pensions to increasingly older scheme members.

Charlie Finch, a partner at LCP, said: “It’s just a question of when and how they are going to hedge longevity risk. You then have two questions – is it offering value now, and can I afford it?”

This is the key driver behind the growing popularity of bulk annuities: both buyouts, in which the pension scheme and company pay a lump sum to an insurer to take over responsibility for running the scheme and paying pensions; and buy-ins, which cover a portion of the pension scheme members as an interim step.

In 2015, bulk annuity deals reached £11 billion, the second highest annual total on record after 2014, according to consultant LCP. It predicts such deals could reach £15 billion in 2016, while consultant PwC is even more bullish, expecting volumes of £20 billion.

But some pension experts believe that such demand from pension funds will be difficult to meet. Even at the top end, the predicted number of buyout deals pales next to total outstanding private pension liabilities, estimated at £2 trillion by consultants Hymans Robertson in 2015.

Tiziana Perrella, head of buyout at JLT, said: “The liabilities being transferred, compared with those that are not, are ridiculously small. There is going to be a big capacity crunch.”

Price strain

Much of the worry in the short term has focused on the impact of Solvency II regulations, which came into force in January 2016 and oblige insurers to hold more capital against the pension liabilities they insure. PwC warned last year that buyout deals could be up to 10% more expensive for some pensions.

Most consultants agree this has largely failed to materialise for schemes with high numbers of pensioners and older members, where there is less longevity risk. However, schemes with younger members are being hit by higher prices, according to Jerome Melcer, pensions director at PwC.

He said: “Based on what we’ve seen, pricing for those sorts of schemes has, indeed, moved up quite sharply since Q2 last year, perhaps by 5% to 7%.”

In January 2016, insurer Prudential told shareholders that it would be paring back on its UK bulk annuities business because of Solvency II. Chief financial officer Nic Nicandrou told investors on January 19: "We did £1.8 billion of bulk annuities business last [financial] year [2014]; £1.5 billion as of the third quarter of this year [2015]. I don't see us sustaining those levels as we move forward."

He explained: "If the market pricing was to move substantially, if we went after higher-yielding assets, or if we did extensive longevity reinsurance, then it's possible to kind of make the thing work. But it's a lot of financial engineering to deliver this consistently.

"Candidly, when it's contributing less than 1.5% of our profit, it's a lot of work, when we could deploy this capital more usefully elsewhere in Asia or in the US and deliver higher returns."

On March 17, Prudential's rival, Legal & General, said it was currently competing for bulk-annuity business worth £10 billion, after an unusually busy start to the year. According to a person familiar with the company, this was at least partially due to certain insurers, particularly at the smaller end, deciding to cut their exposure to pensions business and sell those books on the secondary market.

It is not all one way. Recent new entrants into the market include Scottish Widows and Canada Life. Another, LV=, is expected to launch later this year, bringing the number of bulk annuity insurance providers to nine. Increased interest in bulk annuities from some providers stems partly from the pensions freedoms that came into force in April 2015, removing the requirement of individuals to buy an annuity.

Emma Watkins, director of bulk annuities at Scottish Widows, said: “Capital being released as a result of the shrinking retail annuity market definitely means there is more for insurers to deploy on bulk annuities.”

Moreover, according to a report by consultant Deloitte, published in January 2016, bulk annuities will be a key business for insurers as they face growing competition from banks, asset managers and other institutions. It predicts that the buyout market will generate annual profits of £1.7 billion by 2025.

However, the market has also seen some consolidation, with Partnership Assurance Group merging with Just Retirement.

In any case, the bulk annuity market doesn’t feel overcrowded to Simon Bradley, former chief investment officer of the Philips Pension Fund, which completed a £2.4 billion buyout with insurer Pension Insurance Corporation in November 2015.

He said: “For the size of transaction we were looking to do there were probably only four players out there. I didn’t feel there were a huge number of insurers capable of undertaking larger transactions.” It may be even more difficult for smaller schemes, however.

Talent pool

One key challenge for insurers is not capital but labour. David Blake, director of the Pensions Institute, said: “There aren’t enough people out there who have the right experience and expertise. The capacity constraint is going to be a human one before it is financial.” As a result, insurers are likely to concentrate their resources on the bigger deals.

Added to this, pension schemes looking to offload their liabilities are not just competing with one another for insurers’ capital, they also have other insurers trying to sell off their historic annuities businesses. Ian Aley, head of pensions transactions at consultants Willis Towers Watson, said: “If we see significant transfers of annuity back books taking up insurer capacity, we may find that the latter part of this year isn't as active as forecasts suggest."

There are two things pensions can do to help when considering derisking, however, according to trustees and advisers.

The first is to make the deal as attractive as possible to insurers. Scheme data should be accurate and complete, and the company, trustees and consultants should have thought through and discussed their requirements, said Jacqueline Woods, a director of independent trustees Capital Cranfield.

Woods, who was chair of Trustees for the Visiocorp UK Limited Pension Scheme, which completed a £20 million full buyout in late 2014, said: "You have got to be a prospect the insurers think is worthwhile, both in terms of the data and in terms of the people that they are dealing with."

Francis Fernandes, a senior adviser at pension and employer advisory firm Lincoln Pensions, also suggests schemes draw up a shortlist of bulk annuity providers. He said: "If there are seven or eight insurers quoting, they will be asking whether, with a one in seven chance of winning, they really want to pull out all the stops."

Second, while the price of deals still remains dependent on interest rates and financial market returns, schemes should make themselves familiar with the greater choice of deals available.

Phill Beach, head of bulk annuities at Legal & General, said: "In the past, we had an off-the-shelf product that worked for some and didn't work for others, but that isn't the market we are in any more."

As well as an increase in medical underwriting and options such as top slicing, there has been a growing market for longevity swaps – to hedge only pensioners living longer than expected – and deferred premiums, which spread the cost of buy-in over a number of years.

Beach said: "The key innovation in the market in recent years has been the acceptance that it is no longer an all-or-nothing deal."

Boxout: A healthy addition

An increasing part of the growth in capacity for bulk annuities is coming from insurers using medical data on pension scheme members to more accurately price the longevity risk.

A report by the **Pensions Institute** in January showed that, from the first transaction in December 2012 by Partnership Assurance to mid-2015, more than £1 billion of pension scheme liabilities had been written via medically underwritten bulk annuities.

In the first half of 2015, they accounted for 15% of bulk annuity transactions below £100 million in value. Its influence on the market is likely to continue to grow, according to David Blake, co-author of the report. On the one hand, he says, there has been consolidation, with specialists Partnership Assurance Group and Just Retirement, announcing in August 2015 their plans to merge.

On the other, large, traditional players are becoming increasingly involved. In December 2015, Legal & General completed a £230 million medically underwritten pensioner buy-in – the largest to date – with an undisclosed pension scheme.

Over time, the divide between traditional buyout providers and medical underwriting will fade, predicts Blake. He said: "There will be a convergence between the two, and you will have increasing numbers of standard insurers buying the medical data and beginning to price on that basis."

Medical underwriters have not just brought additional capacity but innovation to the market, according to Costas Yiasoumi, director of defined benefit solutions at Partnership. It takes credit for pioneering "top slicing", in which only a proportion of pensioners – those representing the highest value of pensions – are insured.

He said: "Schemes tend to have a high concentration of risk in relatively few members, and by obtaining medical and lifestyle data, you can get a competitively priced bulk annuity to deal with them.

"Then, in two or three years, once you can afford it again, you do the next tranche."

Active managers defend their performance record, by Madison Marriage, FTfm, 24 March 2016

The idea that investors are potentially better off putting their money in cheap passive funds rather than expensive alternatives run by stockpicking managers is not new.

Finance professors and consumer groups have long argued that active managers charge too much and deliver too little for their clients.

"You could pile many rooms up to the ceiling with papers that would confirm [that theory] from an academic point of view," says Andrew Clare, professor of asset management at London's Cass Business School.

Even Warren Buffett, the legendary stockpicking investor, has advocated passive funds sold by the likes of Vanguard to avoid the high fees and lacklustre performance that critics believe are inherent in active management.

Prof Clare, who is also a trustee of the £2bn Magnox Electric pension scheme, believes the abundance of research papers that question the value of active management leads to one inevitable conclusion: investors should pick passive funds.

"Ninety-nine per cent of the academic papers in this area say exactly the same thing. You have to find the Usain Bolt or the Lionel Messi of the fund management world to make active management work for you.

“I do invest in funds, but I tend to go passive. I just don’t have the time or energy to do anything else.”

Research published in last week’s FTfm by S&P Dow Jones Indices supports the academic’s stance. The index provider found that, in Europe, four out of five active equity funds failed to beat their benchmark over the past five years, rising to 86 per cent over the past decade.

86% of active equity funds underperform

Large study raises more questions about the value stockpicking managers add

S&P also found that 100 per cent of actively managed equity funds sold in the Netherlands, 95 per cent of those on offer in Switzerland and 88 per cent of those in Denmark failed to beat their benchmark over the past five years.

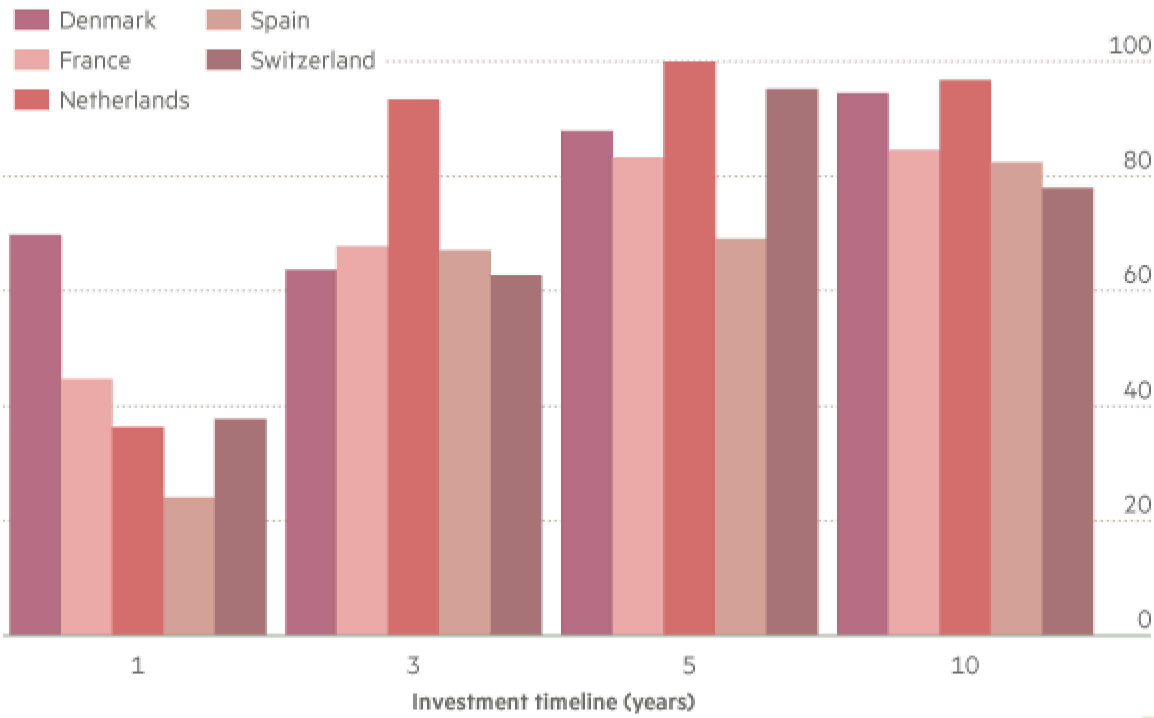
The figures, which took into account the performance after fees of 25,000 active funds across Europe, have reignited the debate over whether the fees charged by active managers are justified.

Actively managed equity funds in Europe charge a 1.5 per cent annual management fee on average, whereas passive funds charge 0.6 per cent, according to Deloitte, the consultancy.

One FT reader, writing under the pseudonym Goldghost, said of S&P’s findings: “Is there still a debate about what a rip-off active managers are? They automatically underperform because of the fees they charge.

Percentage of active equity funds that failed to beat their benchmark

2015 (%)



Source: SPIVA

FT

"They have to beat the index year in and year out by more than the extortionate fees they charge for providing precisely nothing to simply match an index fund."

Almost every actively managed equity fund in Europe investing in global, emerging and US markets, has failed to beat its benchmark over the past decade, according to S&P.

Active asset managers do not refute the findings, but they insist such statistics do not undermine the concept of active management. Many of them believe the onus is on investors to do more research to avoid poorly performing funds.

Andrew Dyson, head of distribution at AMG, the multi-boutique asset manager with $628bn of assets, says: "I have been in the industry for nearly 30 years and this has been a live subject for those 30 years. Unsurprisingly, I am a big believer in active management."

Mr Dyson, who says he "always has and always will" have personal investments in active funds, believes there are three red flags investors should watch out for: products that have grown too quickly; investment managers who have too little of their own money in the funds they run; and asset management companies that are heavily reliant on marketing.

Active fund managers find their voice

Pockets of outperformance occur, but beating the index remains rare

“People tend to veer towards brand rather than performance in retail. If you gravitate to brands because they have a nice name and advertise in newspapers or on TV, that will probably draw you towards managers with [funds that have become too big],” he says.

“You have to be willing not to be trigger happy. Take the time to find the right manager.”

Lars Dijkstra, chief investment officer at Kempen Capital Management, the Dutch asset manager, agrees active management is appropriate for retail and institutional investors provided they “do their homework very well”.

“If you are a private investor, go to your bank or adviser where they do very good research on manager selection. You still don’t have a guarantee you will outperform the indices, but the chances are much higher,” he says.

Turning to cheap passive funds in a bid to avoid overpriced, underperforming active managers carries its own risks, namely the difficulty of picking the best passive strategy in a given market environment, adds Harry Dickinson, a partner at Harrington Cooper, a fund consultancy.

“It is fine investing in passives, but that just transfers more risk on to the end investor. Finding individuals who can reliably predict the future, and allocate assets accordingly, is probably rarer than finding consistently outperforming active managers,” he says.

Despite the insistence that many active managers can add value and that capable managers are not impossible to spot so long as investors undertake careful research, there is widespread agreement that there is much room for improvement in the industry.

Investors pull more than $60bn from mutual funds in January

January saw worst outflows since height of financial crisis

Mr Dijkstra highlights the fact that there are around 40,000 mutual funds in Europe and only 4,000 in the US. The average size of a mutual fund in Europe is $200m, compared with $1.4bn in the US, and more than 50 per cent of European mutual funds have less than $50m of assets.

"One of the lessons for the European industry is that there are a lot of funds that do not add value," he says. "In certain areas of the market, [investors] are better off in passive products."

Kempen uses passive managers to gain exposure to large equity markets, and uses active managers in "less efficient" asset classes, such as high yield, property and some emerging markets.

When selecting active managers, the company prioritises funds with high active share — a measure of how much an equity fund's holdings differ from its benchmark — as well as low portfolio turnover and a high level of co-investment from portfolio managers.

Unlike the US, data on co-investment levels is not readily available in Europe. Mr Dijkstra believes this disclosure should become a regulatory requirement in the European industry as well.

Mr Dyson is critical of the "captive distribution" model in Europe, whereby banks and insurance companies sell their own investment products to retail clients, regardless of whether those funds have performed well. This keeps underperforming funds in business and exacerbates the statistics produced by the likes of S&P, according to the AMG executive.

"This is a structural problem that is truer of Europe than the US," he says.

But with these structural problems unlikely to subside any time soon, many industry experts remain adamant that sensible investors are better off bypassing active fund managers altogether.

This trend has already taken hold in the US, where, for the first time on record last year, active funds suffered net outflows of around $100bn, while passive funds attracted net inflows of $400bn, according to figures from Morningstar, the data provider.

In Europe, actively managed funds still accounted for the majority (around 70 per cent) of inflows to asset managers.

David Blake, director of the **Pensions Institute** at Cass Business School, says: "Individual retail customers should have a well-diversified passive investment portfolio [that avoids] faddish funds, [as well as] anything they do not understand, or anything that is too illiquid.

"[The fund managers] who beat the market only last two or three years; in four years' time, they won't be in the market.

"The industry sells itself on last year's good performance. That is mostly luck. Active fund managers do not want that lesson to be learned."

Pressure from new fee structures

Active fund managers in Europe tend to charge a fixed annual fee of 1.5 per cent of the money they run on behalf of clients. Some also take a performance fee of between 10 and 50 per cent of benchmark-beating returns.

These fee models have been widely criticised as a "win-win" for fund managers, allowing them to secure high fees irrespective of performance. But a number of investment companies are seeking to address those criticisms with innovative fee structures.

One of the most high-profile examples is the Patient Capital Trust set up one year ago by Neil Woodford, the renowned investor. His fund has no fixed management fee, but takes 15 per cent of any performance gains above 10 per cent.

Orbis Investment Management, which oversees £15bn of assets, last year launched a retail fund that goes one step further: it charges investors half of any gains above their benchmark, and refunds half of any losses below the benchmark.

Andrew Clare, professor at London's Cass Business School, describes these two models as "refreshing". "Ultimately they will put pressure on the incumbents. The fixed-fee model, under most scenarios, benefits the fund manager, not the investor. The investment industry needs to take a hard look at itself and ask whether it really offers the choice it should," he says.

86% of active equity funds underperform, by Madison Marriage, *FTfm*, March 20, 2016

Almost every actively managed equity fund in Europe investing in global, emerging and US markets has failed to beat its benchmark over the past decade, raising more questions about the value stockpicking managers add.

The findings pile further pressure on active fund managers, who have come under repeated attack from academics and consumer groups for charging high fees for poor performance.

An in-depth study by S&P Dow Jones Indices also found that 100 per cent of actively managed equity funds sold in the Netherlands have failed to beat their benchmark over the past five years.

Ninety-five per cent of funds sold in Switzerland and 88 per cent of those on offer in Denmark also underperformed.

Daniel Ung, director of research at S&P Dow Jones Indices, said: "The 100 per cent figure is very shocking. The other statistics are not much better. We are not saying active management is dead, but active managers need to justify what they are doing."

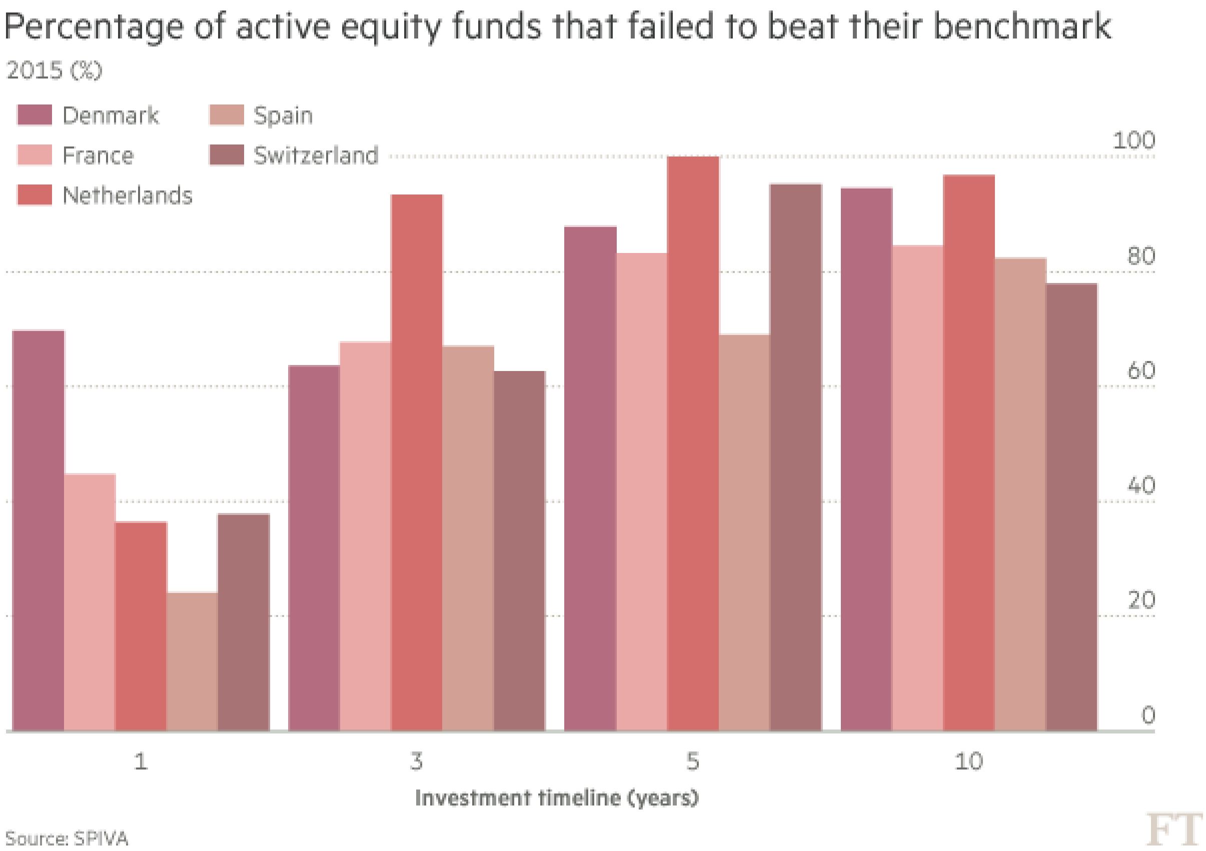
Overall in Europe, four out of five active equity funds failed to beat their benchmark over the past five years, rising to 86 per cent over the past decade, according to S&P's analysis of the performance after fees of 25,000 active funds.

Within that sample, 98.9 per cent of US equity funds underperformed over the past 10 years, 97 per cent of emerging market funds and 97.8 per cent of global equity funds.

“There are some good managers out there but they are not easy to find. At a regional level, at a global level, in emerging markets, you name it, they are not performing well. On a one-year basis it is still possible to outperform, but it is very difficult on a consistent basis over the long run,” Mr Ung said.

Asset management experts said the findings will exacerbate investor concerns about overpriced, underperforming active funds.

These fears have fuelled demand for cheap index-tracking funds, enabling the low-cost exchange traded fund market to grow more than sixfold over the past decade, to $2.9tn.



David Blake, director of the **Pensions Institute** at London’s Cass Business School, said: “The average equity fund manager is unable to deliver outperformance from stock selection or market timing. This means a typical investor would be almost 1.44 per cent better off per annum by switching to a UK equity tracker.

“A small group of star fund managers are able to generate superior performance, but they extract the whole of this outperformance for themselves via fees, leaving nothing for investors. All but the most sophisticated investors should invest in index funds.”

Andrew Clare, who holds the chair in asset management at Cass Business School, added: “Finding a good active manager of developed-economy equities is very difficult, which is why many institutional investors don’t bother looking.”

Equity funds domiciled in the UK — one of Europe’s largest asset management markets — performed relatively well, by contrast. The majority of UK large and mid-cap funds beat their benchmark over one, three and five years. Over 10 years, however, all UK fund categories underperformed.

A spokesperson for the Investment Association, which represents the interests of UK asset managers, said: “British actively managed funds are highly competitive and the average fund has beaten the UK, global emerging markets and European markets in the past five years.

“There are no guarantees with active management, but there is clear evidence that the UK investment industry offers a range of compelling active products that add value for investors.”

Net sales of European ETFs jumped 55 per cent last year, to €74bn, but sales of actively managed funds dropped 15 per cent to €274bn, according Lipper, the research company.

Jake Moeller, head of UK research at Lipper, said active managers needed to do more to combat intense competition from the passive industry.

He said: “Styles fall out of favour, fund managers make mistakes and markets are wholly unpredictable. Nobody denies that investing in active funds requires considerably more due diligence. But the rewards for selecting a good active fund remain considerable.

“If this [research] encourages some retail investors to question their financial advisers and fund groups, then that is a good thing. I would, however, like active fund groups to get on the front foot [and] sing out [their] benefits more loudly. The passive voice is getting louder and louder.”

Are regulators doing enough to tackle closet indexation?, by Stephanie Baxter, Professional Pensions, *15 March 2016*

As research finds up to a fifth of active equity funds could be index huggers, regulators are being urged do more to stamp out this cosy practice, writes Stephanie Baxter.

The spotlight on fees has never been greater as schemes seek to ensure they are paying fees that merit the skills and efforts of fund managers.

The practice of closet indexing, whereby equity funds marketed as actively managed in reality largely mimic a benchmark, has long been a concern. If investing in such funds, schemes will find they are paying high active fees for what is essentially a passive strategy, which has a negative impact on net returns.

Despite increased awareness in recent years, it continues to be a problem with several regulators across the globe recently undertaking investigations.

Regulatory investigations

Research published last month by the European Securities and Markets Association (ESMA) revealed a sixth of actively-managed equity funds across Europe could "potentially be closet indexers". The sample it analysed covered UCITS funds with management fees over 0.65%, based on the period from 2012 to 2014.

The regulator's head of investment management Richard Stobo says for the funds that were found to be closet indexers, the fee range went as high as 3%.

That is a shockingly high fee to pay for a fund with a very low active share. A fund's active share is essentially equal to the percentage of its portfolio that differs from the benchmark.

The picture is slightly worse according to separate analysis by Morningstar which looked at how active share has developed over 10 years from 2005 to 2015. It found around a fifth of 456 funds it evaluated were closet indexers - which it deems as having a three-year average active share below 60%.

Although, it notes the proportion of closet indexers has been shrinking in recent years. The peak clearly coincides with the aftermath of the financial crisis, with the proportion of closet indexers nearing 40% in 2008.

Among the least active funds, Morningstar found almost all closet indexers underperformed their benchmark. Such a fund is rarely a good choice if combined with high fees.

Senior manager research analyst Mathieu Caquineau says increasing scrutiny from regulators could lead to structural change and less closet indexing.

ESMA has now passed on the baton to national regulators to act as they see fit. Regulators in countries such as Sweden, Germany and the UK have started detailed investigations.

Stobo says: "Following our study at an EU-wide level, it is now up to national authorities to check on the basis of that initial overview whether there are causes for concern."

Create Research chief executive Amin Rajan who first came across the issue of closet indexing in 2003 says it is the prime factor behind the erosion of trust between pension funds and managers.

Interestingly, he argues it is a self-inflicted wound to an extent: "A ‘beat the markets' mentality on the part of pension funds has led managers to track the index carefully and take extra risk at the edge to eke out small excess returns. This has not always worked."

More action needed

But he does believe that regulators should be doing more: "This has been going on for so long and is yet another area where regulators have been caught asleep at the wheel. They can really do something about it. Investigations create the illusion of action and progress."

Fund managers are required to give investors information that is fair, clear and not misleading. So are the current regulations robust enough?

Rajan thinks they are, and argues enforcement is the issue: "The problem we have is not lack of regulation - it's the lack of intelligent application of regulation and lack of enforcement by regulatory bodies. Fund regimes across Europe have good checks and balances in place."

He believes the only way to introduce fairness in fees is by regulators ‘naming and shaming' the culprits. "Put through enforcement orders and things will start to change," he says.

When asked, the Financial Conduct Authority (FCA) does not say whether it would consider taking a name and shame approach.

A spokesperson says: "Descriptions must cover the essential features of the fund. This is something that we look at in our ongoing supervision of all funds, not just funds managed in relation to an index."

"The clarity of fund descriptions was also an aspect of the recent Meeting Investors' Expectations thematic review, the results of which we will be publishing. Where we identify poor fund descriptions, we require them to be clarified."

Although the increased regulatory focus is welcome, it is clear that much more needs to be done to nip the problem in the bud.

Identifying closet indexers

There are various ways to identify a closet indexer. One is to look at a fund's active share; and there have been calls to force managers to report on their active share on a regular basis. This should be looked at alongside fees. Morningstar's research found investors were more likely to overpay for a fund with a lower active share, on a fee per unit active share basis.

Schemes could look at historical performance to assess whether the fund has achieved its targets.

ESMA's Stobo says: "If a manger looks very passive there could be circumstances where that could be justified given the market situation at that particular time. But if it has happened over several years then it's a cause for concern."

Pensions Institute director David Blake believes it is not enough to merely look at active share and reported fees.

"Closet index trackers will generally underperform the index - they are not really trying to beat the market, but will still be incurring trading costs that the index will not incur," he says. "They will also be more volatile than the index, since, by deviating from the market, they are taking on some idiosyncratic risk on top of the market risk already in the index."

One way to capture these two factors is through the Sharpe Ratio - which describes how much excess return an investor receives for the extra volatility for holding a riskier asset.

Blake says: "The closet index tracker should have a lower Sharpe Ratio than the index. By contrast, a successful active manager, will certainly take on more risk than the index, but that will be more than compensated for by returns much higher than the index."

Therefore a successful active manager will have much higher Sharpe Ratio than the index.

As schemes face lower and more volatile returns, making sure they are paying managers fair fees has never been more important. Regulatory investigations must be followed through with appropriate actions to stamp out this cosy practice for good.

PLSA launches DB taskforce as deficits spiral, By Sandra Wolf, *Pensions Expert, March 14, 2016*

PLSA Investment Conference 2016: While the combined deficit in the PPF 7800 index has reached £322.8bn, the Pensions and Lifetime Savings Association said it has launched a taskforce to "tackle the problems faced by defined benefit pension schemes".

The taskforce, chaired by Ashok Gupta, a member of the Financial Reporting Council, wants to "help ensure DB pensions are sustainable for the long term", the PLSA said.

The taskforce is made up of pension professionals from different backgrounds including legal, consultancy, actuarial and trustee boards.

It plans to seek views from funds of all sizes as well as employers, regulators, government and intermediaries on what the solutions to the problems facing DB schemes should be, looking to make recommendations to the government, regulators and the wider industry about possible solutions.

Giving some focused attention to closed DB schemes in particular could bring some added value, as that tends to be a neglected area of public policy

Steve Webb, Royal London

Challenges ahead

Initial findings are planned for the summer and a final recommendation will be announced at the PLSA's annual conference in October.

Helen Forrest Hall, PLSA DB policy lead, said the taskforce aims to articulate some of the challenges facing DB, including their scale and consequences for the broader economy.

"It's quite easy to be too scared and not be specific enough about their impact," she said about the issues DB schemes are grappling with.

She cited substantial deficits, low gilt yields, fears about the global economy and improving longevity as the main challenges.

A paper from the Pensions Institute published in December entitled 'The greatest good for the greatest number' put a figure to the scale of the challenge. It found that around 600 private sector DB schemes might never be able to pay pensions in full.

Forrest Hall did not predict what solutions the taskforce might present, saying there is "no silver bullet".

"We're quite open-minded at the moment," she said.

Janet Brown, partner at law firm Sackers and PLSA DB Council member, said there will not be a single solution that will help every struggling DB scheme.

"It's going to be small things that will have an impact for some schemes," she said. "It's tinkering around the edges that can often give people breathing space."

She said possible changes could involve recovery periods, or benefit changes such as removing the requirement to have statutory pension increases.

Achievable goals

But Roger Mattingly, director at professional trustee company Pan Trustees, said while the idea of making DB more straightforward was attractive, it was about "working out if the objectives are achievable".

If they are, he said, "it's well worth doing; if they're aspirational, it could just be confined to yet another effort to simplify pensions".

Mattingly added that simplifying DB pensions was a project doomed to failure.

"If the expectation is to make it straightforward, I can't see that being achieved, it will always be complicated," he said, mentioning as an example the complexity of guaranteed minimum pension equalisation.

"It's not for the fainthearted, but doable at the moment, with all the restrictions, regulations and complications," he said.

"The challenge is making sure that you're on top of that ever-changing landscape."

Steve Webb, director of policy at insurer Royal London, said identifying problems or potential for government intervention on closed DB schemes could prove positive.

"Giving some focused attention to closed DB schemes in particular could bring some added value, as that tends to be a neglected area of public policy," he said.

Webb said government has tended to view the process of run-off as largely a matter for schemes and employers.

"But clearly the government can and does make decisions which have an impact on closed schemes as well."

Rekindling defined ambition

Jon Hatchett, partner and head of the corporate consulting practice at consultancy Hymans Robertson, said he is supportive of the idea of a DB task force.

"I think DB schemes are in a challenged place," he said, but added: "Whether it's successful will depend on how much the government is in listening mode."

He said one of the biggest challenges facing DB schemes is funding deficits, despite millions in contributions from scheme sponsors.

"It's cost more than anyone ever imagined," he said. "Private sector companies have largely had enough."

He said the taskforce can help the industry focus on how it tackles risk management and rekindle a debate on benefit provision.

The launch of this taskforce could also put more energy behind defined ambition schemes, according to Hatchett, to end what he termed a "dichotomy" of expensive legacy DB schemes and low-contribution defined contribution schemes.

How far can the medically underwritten bulk annuity market grow?, By: Kristian Brunt-Seymour, Professional Pensions, 25 January 2016

As medically underwritten bulk annuity deals reach record levels, Kristian Brunt-Seymour examines the anticipated growth of this practice and which schemes could benefit most

At a glance:

- Medically-underwritten deals have risen to £1.5bn and could hit £2bn this year
- There is still a small part of the bulk annuity market with room to grow
- MU bulk annuities particularly benefit smaller pension schemes

The medically underwritten (MU) bulk annuity market had a record-breaking year in 2015 with LCP figures revealing at least £894m of new deals, bringing total volumes to over £1.5bn.

The market has grown quickly in just three years since the very first buy-in was written using medical data. Legal & General completed the biggest ever MU bulk annuity for a defined benefit scheme at the end of December 2015 for £230m, highlighting the potential size of future transactions.

Market growth

The Pensions Institute predicts a boom in this market in its triennial report published in January as schemes turn to 'top-sliced' deals and traditional insurers enter the market.

The Good, the Bad and the Healthy: The medical underwriting revolution in the defined benefit de-risking market paper found that 15% of all sub-£100m deals in 2015 used MU to price the risk, up from 3% in 2013 and 5% in 2014.

The main benefit of using a medical underwriter is that a scheme can get a lower price for a bulk annuity if specific members might be in worse health than expected under a traditional underwriter.

Pricing should be driven even lower by increased competition among insurers to write new business, especially the merger of Just Retirement and Partnership.

The value of MU deals written this year is predicted to go beyond 2015 levels. Hymans Robertson partner and head of buy-out solutions James Mullins believes the total value of all MU deals could reach £2bn by the end of the year. "£2bn is quite a big number for a young market that's had good growth," he says. "I think that's very achievable because there have been a couple of FTSE 100 companies that have done medically underwritten buy-ins, which sends a message to all large pension schemes to follow suit."

Just Retirement director Stephen Lowe says while it is an exciting time for the market, he has heard of or seen little evidence from most consultants that total volumes could reach £2bn this year.

However, he says: "The evidence from the employee benefit consultants that we speak to is very bullish. They believe there is significant head room for growth."

The number of insurers which do buy-ins on an MU basis has risen and others are expected to follow suit including LV= which will enter the market this year.

Lowe says there have been higher levels of both post-deal underwriting and top slicing, both at the top of the value chain as well as the bottom.

"On its growth curve it's in the introductory phase," he says. "We're nowhere near reaching maturity so I think for consultancies to be talking about headroom for growth is significant."

It still represents a relatively small part of the wider bulk annuity market which over the last two years has ranged between £10bn and £15bn, and is likely to go beyond £11bn for 2015.

Pension Insurance Corporation head of business origination Jay Shah says the potential doubling or even quadrupling of the MU market is not implausible.

The benefits

Schemes with a small number of members are likely to benefit more from MU than very large schemes, for example those with up to 50 members.

This is because having smaller pools of employees to analyse will make it easier to identify trends and patterns in their health.

"If the scheme is so small that a factor specific to the members may not be picked up by the normal analysis that an insurer does, then it's worth doing," Shah says.

"The downside of it is that once schemes have that information, they cannot ignore it if members are healthier than expected and the cost of insuring increases," he adds.

A main consideration for trustees will be whether MU provides schemes with a cheaper solution than a non-medically underwritten bulk annuity.

"I think there's been quite a lot of froth around the price advantage of medical underwriting of bulk annuities which isn't supported by the actual process of medical underwriting," says Shah.

The future

As for the future, MorganAsh managing director Andrew Gething points out that while there were some very big deals in 2015, he in believes the increase in the size of deals may eventually plateau.

"We know that two deals have been done at over £200m but whether that is the natural point or top level in the market remains to be seen," he says. "There are a few deals I know of which are more like £300m so the average may turn out to be hundreds of millions."

Hymans Robertson's Mullins does not believe the market will see medically underwritten buy-ins of more than £500m. "I don't think that's where the market will ever go," he adds.

The Good, the Bad and the Healthy, Actuarial Post, January 2016

A new report from the Pensions Institute, part of Cass Business School, highlights the significant growth in medically underwritten bulk annuities* (MUBA). Looking to the future, it predicts that the bulk annuity market with its estimated £2trn of pension liabilities will see a convergence in pricing approaches.

• From a standing start in 2013, 60 transactions worth over £1billion have been transacted
• From 3% (2013), medically underwritten deals accounted for over 15% of transactions by mid-2015
• "Top-slicing" largest pensioner liabilities offers particularly cost-effective risk reduction
• Underwriting using some medical and lifestyle factors predicted to be adopted by most insurers in future
• Potential new entrants into the marketplace and the convergence between approaches will maintain competition in the marketplace

The report "The Good, the Bad and the Healthy: The medical underwriting revolution in the defined benefit de-risking market" suggests that as the sector develops those who currently operate in the MUBA space will begin to compete for more standard bulk annuities deals while "traditional" insurers will develop the ability to use some health and medical conditions to augment existing underwriting processes.

This convergence of approaches will be led by the appetite from employee benefit consultants and trustees who have reported MUBAs generating material savings of 5% – 10% of transaction price in some circumstances.

While the use of health and medical data in the retail space is long established, it is new in the bulk annuity market having first been used in any significant way in 2013. The report highlights the significant strides made since then with deal processes becoming more standardised, streamlined and responsive as parties become more experienced. This, in turn, has meant deals can be transacted quicker, enabling prepared schemes to take advantage of market opportunities.

Looking to the future, the report also suggests that the distinction between "traditional" underwriting and specialist medical underwriting may diminish as more insurers incorporate medical and lifestyle rating factors into their underwriting process and the specialist insurers compete in "vanilla" transactions.

The report highlights that top-slicing** transactions have the potential to remove a large amount of concentrated risk from a pension scheme, which medical underwriting can help achieve at a cost-effective price.

In addition, the report concludes that convergence in pricing approaches and the potential for new entrants into the bulk annuity marketplace means that pricing will remain affordable in future. This will fuel further growth in bulk annuity volumes.

Professor David Blake, Director of the Pensions Institute at Cass Business School, and one of the authors of the report, said: "Having originally looked at this market in 2013, "The Good, the Bad and the Healthy" allows us to revisit this fascinating sector to see just how far it has come. Growing from 3% of transactions under £100m to 15% by mid-2015 suggests that there is significant scope for further expansion, as we see a convergence between standard and medically underwritten approaches in the future. While this will not happen all at once, we accept that the clear distinction between sectors will not continue indefinitely and believe that medical underwriting is a process rather than a product. One that has enormous potential, provided additional financial and human capital is forthcoming."

"With new entrants bringing the potential for the development of new underwriting processes – using new risk factors and data sources – which will complement the market's existing experience, now is an exciting time to be involved in this field."

Costas Yiasoumi, Director of Defined Benefit Solutions at Partnership, said: "Having pioneered medical underwriting in bulk annuities, we are delighted to sponsor this second Pension Institute report which clearly shows the growth and significant potential. Indeed, we are pleased to see that it has moved from being an approach for early movers to one that is increasingly being viewed as a mainstream approach for providing better value outcomes to pension schemes.

"Looking to the future, we welcome the continuing evolution and increasing usage of medical underwriting in bulk annuity pricing. The volume of medically underwritten bulk annuities written since 2013 is now approaching £1.5bn. That is a lot of pension risk secured by UK pension schemes with insurers, much of which would otherwise have remained stuck on pension scheme balance sheets. Medical underwriting has been a welcome contributor to the de-risking journey most UK pension schemes are on."

Guest Viewpoint: Debbie Harrison & Dr David Blake - Cass Business School, Investments and Pensions Europe, January 2016

We predict that a revolution will take place in the UK life company sector over the next five years in terms of its involvement in private-sector pension provision. By 2020, between five and seven organisations, including life insurers, will be in the 'premier league' of auto-enrolment (AE) pension scheme providers. They will control 90% of total assets under management (AUM), which are expected to almost double from £280bn at present to £550bn in 2020. Several well-known life companies will no longer exist in their present form, or at all. Some will be bought by more competitive life companies; others will be sold-off piecemeal as a series of books of business.

Debbie Harrison (left)
Visiting professor at the Pensions Institute at Cass Business School
Dr David Blake
Professor of pensions economics at Cass Business School

Since the turn of the century, both the defined benefit (DB) and the defined contribution (DC) markets have changed beyond recognition. In DB, the change is due to the widespread closure of schemes (about 87% by number of schemes) and the trend towards the transfer of these liabilities from the employers' corporate balance sheets to the balance sheets of bulk purchase annuity (BPA) insurers. This market is relevant to life companies, in their capacity as providers of BPAs and also as third-party asset managers to DB schemes. However, the market in third-party asset management services to private-sector DB schemes has a finite future. As the demand for asset management services shrinks, it will not be compensated for by a corresponding increase in the demand for BPA buy-outs.

In DC, the change is due to the development of modern mass-market AE workplace schemes. With the exception of a small number of large single-employer trust-based schemes, mass-market workplace schemes began in the late 1980s and early 1990s. Today, the market is dominated by large-scale multi-trust, multi-employer schemes (known as master trusts).

Taken as a whole, the changes in the DC market call into question the fundamental purpose of the traditional UK life company. The largest and, arguably, the most visibly successful life companies are restructuring to compete with a diverse range of challenger-providers. Several of these challenger-providers have already demonstrated the merits of alternative business models in the master-trust auto-enrolment market and have gained a significant market share at the expense of traditional life companies. As these challenger-providers move into the decumulation market – in which the historic distinction between 'retail' and 'workplace' increasingly will be recognised as an anachronism – life companies will find themselves beset on all sides.

At this watershed in the history of UK life companies, clarity of understanding of market conditions, together with a vision of the future, are essential.

Massive consolidation in the auto-enrolment scheme provider market is inevitable and needs to be well-managed by the industry and the regulators to avoid market instability.

Policy and regulatory reforms have broken the near-monopoly of life companies in the DC market for accumulation and decumulation, facilitating the entrance and growth of powerful competitors in the master trust market.

Lack of clear and consistent data on the DC market undermines regulation and independent evaluation of areas of success and failure. It also creates the potential for regulatory arbitrage, for example, where certain contract-based schemes, which are regulated by the Financial Conduct Authority (FCA), in effect have been replicated as master-trusts, under the light-touch entry requirements and ongoing regulation of the Pensions Regulator (TPR).

We also predict a surge in sales of legacy back books, as life companies struggle with increasing capital requirements under Solvency II, which comes into force this month, and reducing member charges. Life companies with back books may face a second investigation – this time in relation to retail policies – where up to £50bn (€70.8bn) AUM may be held in policies with high charges and restrictive terms and conditions relative to modern products.

The definition of 'back-book' is out of date. It now includes private-sector closed DB schemes and bulk purchase annuities. The aggregate AUM of DB scheme 'back books' is almost three times the value of the legacy DC pension and long-term savings back-book market, at about £1.2trn versus £420bn, respectively.

Finally, the market suffers from a skill shortage. The heyday of the with-profits policy – from the mid-1970s to the mid-2000s – is long over, even though its legacy lingers on. The market holds little or no attraction for younger actuaries, resulting in a skill shortage for life companies that manage these back books.

The report calls for an open debate about the DC provider's business model of the future, which we believe will be based on specialist distributors that rely on a combination of joint ventures and outsourcing arrangements to deliver excellence across all the component parts of DC pension schemes and plans – for new business and back books alike. We propose that the debate centres around two sets of questions.

Questions the life company sector needs to address in relation to developing new business lines:

• In the light of the potential for significant consolidation in the life company market between 2016 and 2020, should the UK financial regulators (FCA and TPR) develop, agree and publish a clear regulatory position with the government on how this will be supervised?

• What are the alternative sustainable lines of business for mid-tier life companies that cannot make a profit out of auto-enrolment?

• What are the opportunities for life companies in the market for non-pension workplace-based savings schemes that give employers the control they need over the retirement management of key staff? What structure might these schemes adopt, for example, in relation to trust law and the use of a life company wrapper?

Questions the life company sector needs to address in relation to the management of existing and new types of back books:

• Should treating customers fairly (TCF) apply across the board in relation to charges, terms and conditions, that is, to retail policyholders and not just to members of workplace schemes?

• Should the government and regulators consider introducing a 'de minimis' for cash returns for small legacy policies? If so, should this include a metric for measuring 'TCF drift', and also a facility to return policy values to customers without requiring their permission, where they do not respond to an initial communication?

• What is the evidence that consolidators could achieve better economies of scale and better deployment of skills by managing both retail and institutional (BPA) back books?

• What is the best way for the actuarial profession, the FCA and PRA to address the with-profits skill shortage?

The paper, The Meaning of Life, is available at www.pensions-institute.org/reports/MeaningOfLife.pdf. The views expressed in this report are those of the authors and not the Pensions Institute, which takes no policy positions

Pensions Institute predicts medical underwriting boom in bulk annuity market, by Kristian Brunt-Seymour, Professional Pensions, 13 January 2016

The **Pensions Institu**te has predicted there will be rapid growth in medically underwritten bulk annuities as schemes turn to 'top-sliced' deals and traditional insurers get into the market.

The organisation's report The Good, the Bad and the Healthy: The medical underwriting revolution in the defined benefit de-risking market found 15% of all sub-£100m deals in 2015 used medical underwriting to price the risk.

This is up from 3% in 2013 and 5% in 2014 and was driven by the material savings of 5% to 10% achieved in some cases.

The report also predicted there would be convergence in the market as enhanced bulk annuity specialists competed for traditional buy-in and buyout business, and other insurers developed their underwriting capability.

Pensions Institute director Professor David Blake said: "Growing from 3% of transactions under £100m to 15% by mid-2015 suggests significant scope for further expansion, as we see a convergence between standard and medically underwritten approaches in the future.

"Medical underwriting is a process rather than a product. One that has enormous potential, provided additional financial and human capital is forthcoming."

Why medical underwriters offer lower prices that than traditional insurers:

- The medical underwriting itself, if specific individuals might be in worse health than would be anticipated using traditional underwriting factors and if greater certainty allows medical underwriters to offer lower prices.
- The business philosophy of the medical underwriters, who have entered the bulk annuity market from competing in the highly competitive market for retail annuities.
- The need to offer lower prices in order to motivate schemes to embark on a medically-underwritten approach, given the additional data collection costs this entails.
- The use of equity release policies, to support the bulk annuity policies with high-yielding, high-quality assets.
- Competition in the marketplace to write new business, especially between Just Retirement and Partnership.
- The appetite to write business created by the impact of the 2014 Budget and the collapse of the individual annuity market.

Interestingly, some market participants interviewed suggested almost all buy-ins for smaller schemes could be medically underwritten in the future, and most said medical underwriting would account for a substantial proportion of future deals.

Top-slicing transactions, where medical data is gathered on members who have accrued the largest pensions, had the potential to remove a large amount of concentrated risk from a pension scheme.

Finally, convergence in pricing approaches and the potential for new entrants into the bulk annuity marketplace meant pricing would remain affordable in future, leading to further growth in bulk annuity volumes.

Partnership director of defined benefit solutions Costas Yiasoumi said: "The volume of medically underwritten bulk annuities written since 2013 is now approaching £1.5bn. That is a lot of pension risk secured by UK pension schemes with insurers, much of which would otherwise have remained stuck on pension scheme balance sheets. Medical underwriting has been a welcome contributor to the de-risking journey most UK pension schemes are on."

Xafinity head of proposition development Paul Darlow said: "The elephant in the room is the potential impact on levels of competition of the merger between Just Retirement and Partnership.

"Legal and General's recent large medically underwritten transaction perhaps gives trustees some comfort that they will be able to choose between more than one insurance company, but it remains to be seen whether extremely keen pricing observed over the last couple of years will continue," he added.

The report comes after the bulk annuity market exceeded £10bn for the second year in a row.

It follows on from the Pension Institute's first report in 2013 A healthier way to de-risk: The introduction of medical underwriting to the defined benefit de-risking market.

Bulk annuity market prepares for jump in activity, by Oliver Ralph, Financial Times, 13 January 2016

The bulk annuity market is coming of age. Research from the UK **Pensions Institute** to be released on Wednesday shows that risk assessment for these deals is gradually becoming more sophisticated, amid predictions of a jump in market activity this year.

Traditionally, bulk annuity deals, in which insurers take on all or some of a company's pension obligations in return for a fee, have been priced based on postcodes and average assumptions for age and gender used by the whole industry.

But a growing number are now medically underwritten, a process that involves the insurers sending questionnaires to the employees and sometimes also asking doctors for information.

According to the Pensions Institute, medically underwritten deals accounted for 3 per cent of the bulk annuity market for schemes worth under £100m in 2013. By last year the proportion had grown to 15 per cent.

"There has been a big jump," said Professor David Blake of the Pensions Institute, one of the authors of the report. "There is a push and a pull. The consultants have started to spread the word to trustees, and the trustees can save 5 to 10 per cent on the price."

Last month, Legal & General announced the UK's largest medically underwritten bulk annuity deal, which covered £230m of liabilities. Aviva is also active in the market, along with specialists Partnership and Just Retirement (whose merger is due to complete in the first quarter of the year), who tend to focus on the smaller end of the market.

The issue of whether the deals are medically underwritten or not is important to the companies selling the liabilities and to the insurers buying them, but it should make little difference to the people whose pensions are covered. As members of defined benefit pension schemes, their pension payments are fixed.

The bulk annuity market as a whole is expected to grow as companies look to offload their pension obligations. "One way or another, over the next 20 years those liabilities are going to have to be taken off the books of British business because it is a millstone around their necks," said Professor Blake.

Willis Towers Watson expects the bulk annuity market to pick up sharply this year after a lull in 2015. "One of the main reasons for the dip was the preparations for Solvency II, which were time-consuming for the insurers," said Shelly Beard, senior consultant at Willis. The EU's Solvency II rules were introduced at the start of January. The company expects £12bn of liabilities to be transferred to insurers via bulk annuity deals in 2016, a fifth more than in 2015.

According to research from Barclays last year, UK companies have £1.7tn of defined benefit pension liabilities on their balance sheets. Of that, the bank thinks that about £180bn will be transferred to insurers via bulk annuity deals in the medium term. It sees the best opportunities coming at the larger end of the market where Legal & General, Prudential and specialists Rothesay Life and Pension Insurance Corporation dominate.

UK pensions two decades behind on liabilities, Attracta Mooney, Financial Times, January 3, 2016

UK pension funds face a two-decade wait before they have enough cash to meet their liabilities and the assets needed to pay the pension requirements of their members.

The funding level of so-called defined benefit pension schemes, where the employer promises to pay a pension typically based on a proportion of final salary, is worse now than in 2006, according to Redington, the pension consultant.

Dan Mikulskis, co-head of investment strategy at Redington, said the growth of liabilities at UK pension funds continues to outstrip the growth in assets, despite substantial contributions from the companies that back the schemes.

Many well-known companies, including BT Group, the telecoms company, and energy businesses Royal Dutch Shell and BP, have pension deficits that run into the billions, according to LCP, the pensions consultancy.

Redington estimates it will take until 2036 for the UK pension industry to collectively be fully funded. This figure is based on employers continuing to contribute £20bn per year and expected returns of 1.7 per cent.

Mr Mikulskis said pension funds are paying the price for cutting their equity holdings in the wake of the financial crisis, from 61 per cent to 33 per cent over the decade.

William Bourne, director at City Noble, an adviser to pension funds, said: "[The] research points to a longstanding truth that has been partly forgotten in the private sector over the past decade, that equities are the natural asset class for any open [defined benefit] scheme, because they provide a growing cash flow and some protection against inflation."

Amin Rajan, chief executive of Create Research, a consultancy, said the switch from equities to bonds worked well for plans with healthy surpluses. However, he added:

"It has proved lethal for those with large deficits and negative cash flows caused by ageing membership."

These pension funds have missed two strong equity rallies over the past decade, Mr Rajan said. Many also piled into fixed income when prices were at "sky-high levels", meaning they "paradoxically ended up using risky assets to de-risk their portfolios".

He said: "The switch from equities to bonds [by pension funds] was done with the best of intentions but it has ended up delivering the worst of outcomes."

According to the **Pensions Institute**, a research body, about 1,000 private-sector pension schemes are "highly unlikely" to pay their members' pensions in full because of huge levels of underfunding and financial stress.