

THE FATE OF PENSIONS POLICY

Pension Deficits – how real are they?
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Baroness Ros Altmann

Twitter: @rosaltmann

Blog: pensionsandsavings.com

Website: www.rosaltmann.com



PENSION POLICY CHALLENGES

- Pension problems magnified by ultra low interest rates
- Pensions devalued and more complex
- Rising annuity costs hit both DB and DC
- Desperate hunt for better yield, long-term returns and risk management
- Low rates causing pension pain in US and other countries, not just UK



QE EXPERIMENT DAMAGES PENSIONS



- Typical pension fund sensitivity to interest rates:
 - 1% point fall in long rates => 20% rise in liabilities
 - 1% point fall in long rates => 6-10% rise in assets
- Deficits increased despite sponsors putting in billions – vicious spiral
- QE distorts investment and interest rate risk
- Pension risk increased as liabilities, deficits and volatility rise
- UK has particular problems with inflation-linked liabilities

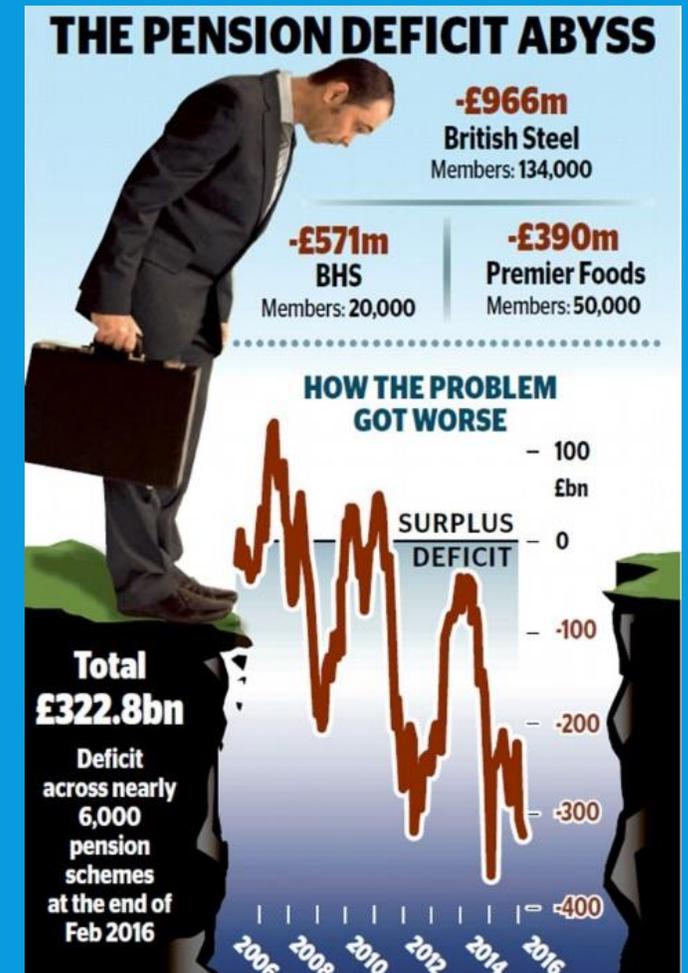
BOE UNCONCERNED ABOUT PENSION IMPACTS

- Private employers struggling with rising pension costs but BoE immune
- BofE staff/management insulated
- Turning corporate UK into annuity providers?
- BofE scheme holds only top quality bonds but still had deficit
- Employer contributions increased from 25% to >50% salary
- If this is true cost of final salary promises what are the implications?



CORPORATE STRESS

- Mark to market measures – overinflated or realistic
- Short-term vs. long-term funding pressures
- Threat to sponsor covenant?
- How to reduce or remove balance sheet risk?
- Dividends vs. pension deficits
- Either full benefits or PPF



DILEMMA FOR TRUSTEES



MANAGING RISK AND RETURNS



- How risky is the supposedly 'risk-free' asset now? Nobody knows!
- So what is 'de-risking'?
- Reducing risk reduces expected long-term return
- Just 'matching' liabilities not enough – and bonds aren't a proper match
- Fixing deficits requires outperforming liabilities, not just matching
- Outperforming liabilities requires risk-taking

SEARCH FOR SOLUTIONS



- Search for inflation-linked income above gilts, with upside too
- Need upside as well as protecting downside by hedging
- But many schemes too small to manage sophisticated diversified fund
- Pooling improves economies of scale, diversification, governance
- LGPS may set future trend – reduce to 6-8 pools, target £25bn per fund
- 10% infrastructure - National Infrastructure Investment Vehicle or Clearing House for projects?

USE PENSION ASSETS TO BOOST GROWTH, NOT QE

- Just creating money to buy more bonds is indirect route to growth
- Could use pension assets as direct way to boost economy
- Inflation-linked returns plus upside potential – better than gilts
- Infrastructure/housing projects (perhaps with Government underpin)
- Illiquidity and other risk premia



DIFFICULT CASES



- Current system can help distressed employers – clearance, RAA
- Does tPR need more powers for restructuring?
- Most employers are not just trying to avoid pension liabilities
- BHS is not the norm but has damaged perceptions
- Don't just help one employer – political panic is bad policymaking
- Tata consultation – much more than rpi-cpi change
 - Member consent? Who stands behind the new arrangement?

'WINTER' DB GREEN PAPER – COMPLACENCY?



- Many employers truly can't afford their DB deficits as measured – SME, charities
- Central discontinuance fund? Wind-down regime?
 - Pooling, economies of scale, smoothing
- Standardise benefits
- Relax annuity burden – new measure of self-sufficiency?
- Issue pension bonds e.g. Ipi, cpi...
- tPR powers?

SHOULD GOVERNMENT INTERVENE MORE?

- DB unsustainable for many employers without reform – PPF risk
- Assess future of DB strategically – review whole system
- Need ongoing good business if possible
- Consider liability management exercises – CETVs attractive
 - Small deferreds, short-service, AVCs
- DB -> DC transfers can reduce liabilities, enhance scheme security
- Member consent



FUTURE PENSIONS WILL BE DC



- Future is DC – explain new freedoms
- Improve contributions, make pensions more engaging for savers
- Auto-escalation
- Devise good new products and services
- Investment approaches for DC can learn from DB diversification
- Pensions are precious – the last money you should spend

THANK YOU FOR LISTENING



Any Questions?

- Blog: pensionsandsavings.com
- Website: www.rosaltnann.com
- Twitter: [@rosaltnann](https://twitter.com/rosaltnann)