Effect of Regulatory Change on UK Pension Funds

Liability Driven Investment Conference

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Outline

- Current situation
- Regulatory changes
- Trustee issues
- Investment response
- Conclusions

History

- UK pension model – rely on funded private pensions
- Surpluses and holidays
- Over-reliance on equities – peer group, index
- Maxwell and 1995 Pensions Act
- Continual added cost burdens
- Member security, MFR, Myners

Where are we now?

- Equities down, interest rates down, longevity up
- Deficits and mature schemes
- Relaxation of MFR to discourage more gilts (2000!)
- FRS17
- Finance directors recognising true costs and funding
- Corporate UK took too much risk for maturing liabilities

Effect on Members

- Reduction in security
- Assets inadequate to meet liabilities
- Law failed to provide promised protection
- High profile failures
- Loss of confidence
- Regulatory failure

Government Response

- Impose tighter regulation – new requirements
- Replace MFR
- Full buyout on wind-up
- Pensions Bill
- Pension Protection Fund and new Regulator
- Increase trustee responsibility

Impact on Trustees

- Focus on paying pensions
- Higher level of competence/investment expertise
- Increased emphasis on funding decisions
- Understand risks of mis-match
- Consider alternative investments
- Negotiate higher contributions

Scheme Specific Funding

- Statement of funding principles
- Regulator to oversee funding – still no guidelines
- Problems of relying too heavily on equities
- Focus on liabilities
- Explain to members

Investment Aims

- NOT to ‘maximise returns’
- NOT to outperform peer group or index
- YES to be able to pay pensions
- Match liabilities
- If in deficit, *outperform* liabilities

Regulatory Requirements

- Increased funding scrutiny
- Increased emphasis on trustee investment decisions
- Statement of Funding Principles
- How plan to deliver the benefits to members
- Pension Protection Fund
- Risk based levy

Effects of Regulatory Changes

- Increased costs
- Increased uncertainty
- Difficulty of long term planning
- Compliance issues
- Difference between actuarial and accounting valuation

Emphasis on Risk and Liabilities

- Trustee education
- More focus on investment decisions
- Explicit risk/return objectives set relative to liabilities
- Look for more diversified sources of return
- Increased ongoing monitoring
- Can we pay the pensions?

New Approach

- Focus on liabilities
- Don’t just rely on equity risk premium
- No perfect match for liabilities
  - Inflation
  - Duration
  - Longevity
- Alternative ways to add value
- Depends on scheme profile

Asset Allocation in Future

- Solutions tailored to scheme liabilities
- Corporate techniques new to pension funds
- Cash flow matching – swaps, derivatives
- Hedge funds? Portable alpha?
- New balanced? End of long-only active mandates?
- Target return? Absolute return?

Barriers to Liability Driven Investing

- Lack of matching assets
- Capacity issues for alternatives
- Government needs to issue appropriate gilts
  - Longer dated
  - Inflation linked
  - Mortality bonds

Impact of Regulatory Changes

- PPF risk-based levy
- How will they assess risk?
- New Regulator – corporate activity
- European accounting changes
- Further increases in costs
- End of final salary schemes?

Conclusion

- Regulatory changes have continued to raise costs of delivering pensions
- Trustees and employers face increased burdens
- Costs of delivering pensions to rise
- Crucial to focus on liabilities, rather than assets
- Risk of not being able to pay pensions
- Use of new investment approaches essential

Thank you for listening

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