Written evidence from Cardano (PPF0061)

1. Executive Summary

The problems of British Home Stores Scheme (BHS) and British Steel Pension Scheme (BSPS) are wake-up calls to the looming pension crisis and highlights the fact that we are seriously lacking in solutions. These two schemes are clear cut case studies on how struggling businesses ends up not being able to honour their DB pensions. We believe there are a lot more schemes who will face similar situations - at worst another 1,000 pension funds could be forced to seek the help of the Pension Protection Fund (PPF), according to a recent report by the Pensions Institute and Cass Business School.

We believe the political discussion should be broadened to address the much larger problem, namely that there are many legacy DB schemes that are simply unaffordable to their sponsors and the current legislative environment gives little flexibility as to how to address this, short of forcing a ‘lose-lose’ outcome where members face severe cuts to their pensions and the sponsor goes bust.

This issue should be a top priority for the Government, as it has arisen, in our view, due to multiple agendas across several Governmental departments in combination with a political unwillingness to deal with this critical problem. It is important that the responsibility for solving the DB legacy problem is galvanised within the DWP and that industrial policy considerations are addressed by other Governmental departments.

The tacit recognition of this problem is hopefully the beginning of a process that sees UK pension law change to allow much greater flexibility in situations where the sponsor cannot afford to stand behind the pension promises that were once made.

We think reforms are required in two areas:

- **Better prevention** (through clearer regulation and better risk management), and

  Better prevention of future scheme crises requires a combination of focussing on the true economic valuation of benefits (as opposed to Technical Provisions) to make sure risks are better measured and managed. The Pensions Regulator should also have a much clearer mandate in terms of enforcing prudent risk management, with an explicit view to minimising the chance that schemes ends up underfunded versus PPF equivalent benefits.

- **More flexibility** in dealing with situations where the DB pension promise is simply unaffordable

  For sponsors with little possibility of meeting their commitments, we believe it is essential to provide trustees with more flexibility to adjust the accrued benefits, as part of an integrated approach to seeking the best collective solution for members and sponsors alike. This needs to be an option in advance of a bankruptcy to salvage value for their members. Greater flexibility would create the possibility for ‘win-win’ situations to be negotiated.

2. The DB Legacy Problem – A Tale of Collective Failure

Technical Provisions gives a false sense of security

The regulations prescribe the use of Technical Provisions as a measure of the amount of assets that need to be held to meet the liabilities. Technical Provisions represent a prudent estimate of the amount of assets required to meet the liabilities, based on assumptions about future investment returns. Almost all pension funds *assume they will earn returns above the risk free rate* – that of gilts.
This is despite the fact that for the last 20 years, almost all pension funds have actually earned returns below the risk free rate. A stricter, and arguably more realistic, measure of the health of the pension scheme would be to use the risk free rate to value the liabilities. This is commonly known as an 'economic basis', and is, in practice, quite close to the buy-out value. Technical Provisions allow for future returns that may well not be achieved. The Technical Provisions approach has, in fact, proved overly optimistic, masking the true cost of the liabilities and creating a false sense of security. Details on the importance of better risk management under fair market valuation of the liabilities can be found in Kocken (2006).

Although DB trustees are now required to calculate the buy-out value of their liabilities during the triennial actuarial valuation, very few trustees use this as a key decision making input. Very few trustees measure risk versus the buy-out (or economic) basis and consciously manage their scheme to control the buy-out deficit. The focus has been overwhelmingly on Technical Provisions, which by their nature involve subjective assumptions about future investment returns, and this has contributed to many trustee boards having insufficient risk management policies and practices in place.

This reliance on assumed returns and relative neglect of the economic basis has contributed to pension deficits growing to alarmingly high levels. The information provided by DWP in their public consultation paper on the BSPS is very clear. Based on December 2015 figures, the underfunding measured on Technical Provision (£700m) is less than 10% of the deficit under a buy-out basis (£7.5bn) and the scheme was £1.5bn short to buy-out PPF equivalent pension benefits. Real rates have fallen since then, leading to significant increases of these deficits.

Path dependency of a closed scheme – the sinking giant effect

The fact that most DB pension schemes are materially underfunded is well understood, but underfunded pension schemes are still forced by law to continue paying full pensions and hope that future investment returns, together with future sponsor contributions, will make up for the underfunding. In a closed underfunded scheme, this creates huge wealth redistribution from younger member to retired members with potentially dire economic consequences for the younger members of the scheme. This is known as the sinking giant effect, see Kocken and Potters (2010), Kocken (2011) and Kocken (2012) for details. A technical solution to the sinking giant effect would be to force sponsors to supplement, pro-rata, each pension payment so that the funding level of the scheme is not negatively affected by outflows.

The deficit is a call on the sponsor, but this sponsor option is only crystallised in a merger, acquisition or windup situation, and therefore management can be tempted to view the deficit as an interest free loan and a poison pill against a hostile takeover. This reduces the incentive for sponsors to voluntary close the funding gap. Further, many underfunded DB schemes have corporate sponsors that are unlikely to have the financial strength to honour the sponsor option when required. In theory, the Pension Protection fund (PPF) is designed to protect the member in case the sponsor defaults. But in practice, the PPF will not be able to withstand a series of business failures as we would likely experience in a recession. As a consequence, the sinking giant effect could become the harsh reality for members in closed and underfunded schemes.

Moral hazard

The recovery plans, approved by The Pensions Regulator (TPR), have also been sliding. As schemes have become more severely underfunded, longer recovery periods and higher future return expectations have been accepted. So a fuzzy measure of the health of the pension fund (Technical Provisions) contributed to poor risk management on behalf of trustees, which led to deteriorating funding positions, and that has been met, broadly, by TPR simply relaxing the parameters, and tacitly accepting the new status quo.
In our view, the main roles of TPR are to protect the scheme members’ interests and avoid losses to the PPF. The spirit of the current legislation implies that TPR should put sponsors into bankruptcy as soon as the assets of the pension scheme fall below the buy-out value of PPF equivalent benefits. This would ensure that schemes experience an ordered transition into the PPF without financially damaging the PPF levy payers (other DB schemes). Allowing scheme to fall below this minimum funding level means implies that the PPF enters into the credit insurance market. The Pensions Act 2013 added as an objective to TPR that it should “support scheme funding arrangements that are compatible with sustainable growth for a sponsoring employer”. This objective is, however, at odds with the primary objectives set out earlier, and contributes to a lack of clarity in terms of TPR’s mandate.

The statutory PPF route is frequently portrayed as the back stop in the system, but that misses the point. The PPF is merely an industry insurance, financed via a levy on remaining pension schemes. The PPF currently has a surplus of several billion pounds which is there to cover risks related to their existing members, such as changes in life expectancy and adverse investment returns, and to provide some capacity to absorb new underfunded entrants to the PPF. However, the aggregate deficit (PPF 7800 index, August 2016) of pension funds eligible for the PPF is nearly £460bn! The PPF can absorb a very small number of bankruptcies, but it will not be able to withstand a series of business failures as we would likely experience in a recession. In a recession, the strain of supporting a massive influx of funds into the PPF would be borne by the surviving funds through higher levies, just at a time when their funding levels and corporate sponsors will probably be struggling financially.

In the trade-off between ‘saving jobs’ and ‘saving pensions’ the government also faces a moral hazard. Industrial policy considerations have been added to in the TPR mandate, but the government has no funding obligations towards the PPF.

A cautionary tale from the past

When the effects of overly optimistic accounting practice, path dependence, and moral hazard are compounded, the result can be very painful to scheme members. This is illustrated by the cautionary tale of the mutual insurer Equitable Life and the impact its insolvency in 2000 had on the life of ordinary people who thought they had a guaranteed product. The origin of the problem was that Equitable Life had been guaranteeing returns without hedging their liabilities with respect to adverse market changes. The Parliamentary and Health Service Ombudsman report in 2008 accused the regulators of "comprehensive failure" and called for compensation of policy holders. In 2010, the Government agreed to pay some compensation.

We are aware that there the members of BHS and BSPS are in a better situation with the existence of the PPF, but the underlying drivers leading to the problems are the same in the Equitable Life case. If there is a financial recession, then the PPF will not be able to act as a hard back stop. Who, if any, will compensate scheme members in such dire situations? In the following section, we propose some changes to the current system that we consider helpful to deal with the problems in a constructive way for both scheme members and sponsors.

3. The situation requires political leadership

BHS and BSPS are just the tip of the iceberg, 5 out of 6 DB schemes are underfunded and the aggregate deficits that could end up in the PPF is almost £460bn. This is a structural problem that needs to be dealt with in a systematic and orderly fashion. A natural political reaction is to save jobs in a struggling industries and given that, it is clear that the current DB legislation needs a thorough revision to avoid a ‘kicking the can down the road’ type of behaviour.

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1 We are critical to the design of the statutory PPF route since it is not robust and it provides DB scheme members with a false sense of security. We are positive to how the PPF manage their current liabilities.
We believe that the focus should be on **better prevention** of future situations like BHS and BSPS and **more flexibility** in dealing with these situations when they do arise.

**Better prevention** of the problem starts, in our view by bringing clarity to the measurement of deficits and clarity around how TPR regulates risk management by trustees. Our recommendation for better prevention are:

- Require trustees to monitor and manage the schemes against an economic valuation of the benefits
- Exclude any industrial policy objective from the TPR’s mandate
- Set the buy-out value of PPF equivalent benefits as the floor for underfunding
- Require trustees to demonstrate how they are managing risk versus the above
- Avoid moral hazard by committing government to partly finance the PPF levy

Inevitably, many businesses will not be able to meet their pensions obligations. Therefore we need **more flexibility** to deal with these situations. Current law only provides one option to a business that cannot afford its pension promises – go bankrupt and pass the pension fund to the PPF. This is clearly a ‘lose-lose’ as the members take a heavy haircut to their pensions and shareholders suffer a complete loss of equity. It is not currently possible for trustees to renegotiate the pension contract **before** a bankruptcy in order to salvage value on behalf of their members. This must change. If permitted by law, ‘pension fund restructuring’ could provide members with a better pension outcome than the statutory PPF route and give additional breathing space for the company to find a solution that potentially could save thousands of jobs.

For an underfunded scheme with a weak sponsor, it’s a question of when, rather than if, a haircut will be applied. The members shouldn’t have to wait and watch the pension fund enter the PPF – resulting in reduced benefits and having their pension assets parked in a conservative portfolio.

Like in almost every other aspect of commercial life, the trustees should have the power to negotiate with the sponsor and consider other options. These should include the power to cut accrued benefits, thereby alleviating the financial burden the sponsor cannot afford. We think that trustees should have the power to cut accrued benefits **below the PPF level** if that is done in conjunction with the introduction of a risk-sharing component, such that in aggregate members will probably do better than going in into the PPF.

This would allow trustees to convert an insolvent DB scheme that represents a fatal noose around the neck of its sponsor into a hybrid scheme that offers DB benefits at a substantially reduced and affordable level with some contingent upside if investment performance is good. This would allow a ‘win-win’ outcome - members continue to save for their future instead of locking into the reduced benefits the PPF offers, and the sponsor is released from an unaffordable burden.
4. About Cardano

Cardano was founded in 2000 to help pension plans achieve their financial objectives in a steady, predictable way by applying robust investment and risk management techniques.

We are a purpose-built pension investment manager with an advisory mind-set. We offer Fiduciary Management and Advisory services with a dynamic and opportunistic approach to risk management, asset allocation, manager selection and implementation.

We aim to help clients achieve a steady, predictable improvement in funding ratio without significant loss, in all market conditions. We believe steady, predictable progress toward securing members’ benefits is a better outcome for members and the sponsoring company.

Additionally we also specialise in the area of swaps and derivatives overlay research, advice, design, execution and implementation activities for institutional clients. We have implemented over €400 billion of strategic hedges over the last decade through our Dutch office.

We currently employ 140 people based in London and Rotterdam with clients whose assets total in excess of £140bn. We have a team of over 90 in London and we work with 22 UK pension schemes whose assets total over £50bn.

September 2016

5. References


