Written evidence from Andrew Rear (PPF0085)

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Andrew is an actuary, formerly a member of the Council of the Institute and Faculty of Actuaries, and a member of the profession’s regulation board.

Introduction

This submission is written in a personal capacity but it is informed by my reaction to recent events around the BHS pension scheme and a comparison between that and the actions I took as the employer for a pension scheme with a significant deficit. Though I am an actuary, I do not claim to have particular expertise in pensions legislation.

My comments are focused on two areas. First, what is the nature of pension promise. Second, what is the cause of the so-called pension crisis.

My conclusions are that there is a crisis in pensions but it is not new. Nor is it caused by QE: it is caused by ineffective regulation failing to prevent (perhaps even encouraging) inequitable creditor bargains struck by pension scheme trustees on behalf of their members. The Work and Pensions Committee should recommend to Parliament that it acts to:

- Strengthen the regulator’s powers and find mechanisms to ensure it uses those powers to make sure that pension scheme creditor agreements are in the best interests of creditors
- Ensure that pension scheme liabilities stay connected to the company from which they originate, and that the creditor agreement takes only this company into consideration
- Outlaw the use of valuation bases, for any purpose whatsoever that has an impact on the members, which take into account the assets when valuing the liabilities; that is, base all valuations on accepted principles of financial economics.
- After a transition period, make the presumption that all schemes be invested in low-risk matching assets except where the Trustees explicitly, and with independent advice given to only the member-nominated Trustees, justify to the Regulator the use of non-matching assets. Professional trustees making such decisions should be held to a certain degree personally liable for the outcome of those decisions.
- After a transition period, make the presumption of rapid correction of pension scheme deficit in any situation where the company continues to pay a dividend, with exceptions from this rule having to be justified to the Regulator by the Trustees, with independent advice given to only the member-nominated Trustees.
What is the nature of the pension promise?

Whatever the legal position, and I accept that it can be complex, the pension promise seems to me to be a contractual one equivalent in status to a debt. Funding statements and valuations are simply accounting exercises to help the company and its creditors (the pension scheme members) assess the debt.

In ordinary circumstances Parliament could argue that this is private enterprise in which it does not need to be involved. But successive Parliaments have not done this: instead they have made many Acts over the years which set out ways of managing pension fund deficits with the ambition to ensure the debt is paid.

Why has Parliament seen fit to legislate? I believe, because it has accepted that the Trustee system suffers from drawbacks. Trustees are not experts, though they receive training. They are not independent, though they may try to act so: in fact they are employees or ex-employees of the company in many cases. The employer-nominated trustees are their managers. In my own experience and observation, member-nominated Trustees struggle to find the time, expertise and independence to make a determined employer act in the most beneficial way.

In this unbalanced situation, it is right that Parliament should seek to regulate. But this legislation, or the bodies that it enacts, do not work. Actually the legislation itself already tries to avoid imposing any strong requirement on the employer, aiming for agreement on each scheme’s “specific funding standard”. Agreement in an unbalanced game is not balanced agreement.

The result is that the pension promise is diluted. Companies can pay dividends, often large and even life-sucking, whilst relying on the ‘agreement’ not to contribute anything to the pension scheme.

The result, in numerous cases (e.g. well-publicised Trinity Mirror, Trafalgar House) is employers putting other creditors or shareholders ahead of pension scheme creditors, often with the apparent blessing of the regulator. If even the regulator supports inequitable bargains, the member-nominated trustees have no practical hope of reaching a fair agreement.

Funding bases always create debate, and I do not consider myself to have sufficient expertise to be definite as to the right technical basis on which liabilities should be measured. However, two things are clear. First, when a scheme is in deficit – that is, when the employer owes the scheme money - it is reasonable for the creditors to determine how and when they should be repaid, and to take into account the company circumstances. For example they may, rationally, decide to accept a slower repayment to avoid the employer’s bankruptcy (just as any creditor can do). It is unlikely to be rational that they would accept continued dividends, still less a special or excess dividend. The regulator must be able to, and must, enforce a professional review of such an ‘agreement’ to ensure it is in the creditor’s best interests.
Second, the valuation of liabilities is independent of the assets backing those liabilities. This is no more an opinion than it is an opinion that the tides are caused by the Moon not the Sun. But it must therefore follow that any scheme which is using an assumption of higher-than-risk free (or, say, AA credit spread) returns to lower the value of its liabilities is being allowed to mis-state them. These valuations are not merely wrong, they are dangerous: they allow the employer and his advisers to push the creditors into inequitable bargains. A competent regulator would have, and would use, the power to ban all such valuations, for whatever purpose.

What is the cause of the pension crisis?

Suddenly it seems pensions are in crisis. Measures are being suggested, such as to allow reduced pension increases. “Easing corporate pension promises” would allegedly “save” £350m a year (FT, September 11 2016). Promises cannot be eased, they can only be kept or broken. Liabilities cannot be saved, they can either be met or not met.

Creditors can agree to alter the nature of their agreement so as to increase the probability they will be paid (what other reason could they have?), for example rescheduling to avoid the company’s bankruptcy. As I have argued above, the current system fails only in that the agreements struck are often inequitable and the regulator does not, or can not, regulate to ensure fairness.

Is there a pensions crisis? I believe there is. There has been a pensions crisis for 20 years or more. The crisis arose because trustees accepted the nonsensical position that the debt owed to the members was less if the scheme invested in risky assets. This absurdity led to deeply inequitable arrangements between pension scheme creditors and shareholders.

The way out of a funding crisis is either to inject money into the scheme, or to pretend there is no crisis. In my company, we injected money into the scheme. We then protected the members by investing their money in matching assets. Once this was done, the employer could resume paying dividends to shareholders, knowing that a fair bargain has been struck. Of course there are no perfect matching assets – though we got very close – but the amount of funding volatility is now small compared to the size of the employer. We considered the employer at a legal entity level, because this is in line with company law. I think BHS shows the folly of allowing a scheme’s liabilities to become detached from the legal entity in which they arise.

Those same employers who pretended there was no crisis, or their advisers, are now blaming QE for the crisis. This is economically illiterate. QE is simply part of an overall plan to manage the economy. One result of that overall plan is a level of interest rates, in this case lower than these commentators would like. These interest rates are not ‘artificial’ in any sense: on the contrary, they are the implied by observed market transactions. Amongst other things, they reduce company borrowing costs, and therefore increase the value of companies for whom current borrowing costs are a concern.
Some companies have made large financial bets on equity markets and high interest rates. Two ways to bet on equity markets are (1) issue a fixed-rate corporate bond and use the proceeds to buy equities, or (2) invest an in-deficit pension scheme in equities. These two are equivalent in terms of the impact on the corporate balance sheet. In both cases, QE, coupled with weak equity markets, make a fool of the person trying that bet. But that does not mean QE caused the loss: it was the bet that caused the loss. The only difference between the two situations is that employers in situation 2, and some of the advisers who helped them make the bet, are now trying to make the pension scheme creditors pay. This cannot be allowed to happen.

The solution to the crisis is as clear now as it has been for years:

- Strengthen the regulator’s powers and find mechanisms to ensure it uses those powers to make sure that pension scheme creditor agreements are in the best interests of creditors
- Ensure that pension scheme liabilities stay connected to the company from which they originate, and that the creditor agreement takes only this company into consideration
- Outlaw the use of valuation bases, for any purpose whatsoever that has an impact on the members, which take into account the assets when valuing the liabilities; that is, base all valuations on accepted principles of financial economics.
- After a transition period, make the presumption that all schemes be invested in low-risk matching assets except where the Trustees explicitly, and with independent advice given to only the member-nominated Trustees, justify to the Regulator the use of non-matching assets. Professional trustees making such decisions should be held to a certain degree personally liable for the outcome of those decisions.
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