B.A.J. **10**, V, 909-913 (2004)

GUEST EDITORIAL

BY T. D. KINGSTON

INTRODUCTION

I spent the first fifteen years of my career as an actuary moving back and forth between roles in group pensions and investment. The vast majority of my time was spent working on, and thinking about, defined benefit pension arrangements.

In the period between 1980 and 2000, I was largely involved in general management roles; I retained my interest in investment and pensions, but it was very much a secondary interest, and I really lost touch with the broad thrust of what was going on.

For the last five years, I have found myself with an increasing involvement in the philosophy of pension arrangements through various roles — as a non executive director of a number of insurance and investment companies, as a pension scheme trustee, as an executive director of a strategic investment management consultancy, and as an active member of the actuarial profession.

As I look back on my two pension careers, split by a 20-year gap, I am constantly struck by the changes which have taken place in the philosophy underlying pension planning, particularly that of defined benefit schemes. Yet, in one sense, very little has changed. The average defined benefit scheme has much the same benefits as 25 years ago. It probably has the same retirement age, the same accrual rate, the same management structure, similar advisory structures, and so on.

When, however, we look at the philosophy, everything has changed. What was thought of as a good system is now severely criticised. A high proportion of plan sponsors want out of that role; the majority have closed their schemes to new entrants. There is a constant barrage of information about systemic under funding. The traditional method of investment is under attack. Having a defined benefit scheme is regarded as a liability. Government is trying to reduce its role. There have been a series of wise men — the latest being Myners and Turner — giving advice on how to ameliorate the situation. The Morris review has had the change in defined pensions as a background to much of its thought. What seems to me fascinating is that an industry could have continued for so long in a state of very little apparent change and should then suddenly appear to be in a position where everything it stood for is questioned. Did those of us who were involved in the industry miss something along the way? If we did, are there any lessons to be learned? I stress, at this point, that this editorial is not intended as a criticism of anyone involved in the management of pension schemes. It is aimed at changing a system which, to my mind, no longer serves its original purpose.

Structure and Management of Pension Schemes

I want to start by looking at the structure and management of the pensions industry, concentrating particularly on defined benefit pension schemes. The fundamental structure is that the schemes are set up under trust. Employer — and often employee — pay money into a trust. The trustees of that trust are then responsible for managing the funds and for seeing that the benefits are paid, insofar as is possible, from the available monies. If there is not enough money, they must ask the contributors for more; if there are insufficient funds, benefits must be adjusted accordingly.

This system has some merit when trustees really are the managers of the monies and are ultimately responsible for matching income and outgo; but, somewhere along the line, this all changed. The benefits have, effectively, now become guaranteed, and it is not the trustees who are the guarantors.

In a sense, this was always a flaw in the system. Whether the guarantees of the benefit were absolute or conditional, the 'bank' to the scheme was normally the sponsoring company. It seems strange, therefore, that the company did not have the major responsibility for managing the funds which had accumulated and for ensuring that the finances were sound.

In this context, it is interesting to look at the recommendations of the Myners reports. Many of their recommendations are targeted at getting the trustees to learn more, manage better, etc., but it seems to me that this is trying to mend a flawed system. In most cases, the trustees are amateurs who do not have the ultimate responsibility for funding the pension scheme. Perhaps they have a role akin to the German supervisory board, with a major interest in compliance, but it does seem misplaced to try to give them an executive management role.

It is my contention that the trustee structure has been a key contributor to what has gone wrong with pension schemes in the United Kingdom and Ireland. The form of management determined by trustees has often not been management at all. In a normal company structure, we find a board which is responsible for the running of the company, and which delegates responsibility to full-time professional managers, who are the acknowledged experts in the business. In the case of a pension scheme, the trustees have some sort of confused role, where they are supposed to be both non executive and yet expert managers. Moreover, they are rarely in a position where they can delegate responsibility to a full time professional management.

So, how do pension schemes get run? In practise, most of them have been

https://doi.org/10.1017/S1357321700002890 Published online by Cambridge University Press

run by trustees, who are essentially amateurs, who rely for advice on outside experts who would deny any management role in the process. It is not surprising that there is a 'gap' which pervades the management of both assets and liabilities. This would not matter in a stable situation, but, in a period of underlying change, it is highly unsatisfactory.

In a period of change, pension funds have needed capable management with full-time attention on the issues involved. The trustee structure has been of little help, both because it no longer reflects reality and because it puts the 'gifted amateur' in charge. The sooner this structure is changed and the total financial responsibility is placed with those who are being held accountable, the better.

What has Changed?

I want to give a brief overview of some things which have changed in pension arrangements over the last 20 years.

There are essentially two types of change. The first derives from legislation and regulation; the second from underlying social and economic change.

The legislative changes have been fundamental. In the U.K., we have moved from a situation where, in law, pension promises were not underwritten by the plan sponsor. There were no promises of what early leavers might receive. The taxation treatment was favourable, and not under any threat of compromise.

In effect, legislative changes have made a voluntary system into a compulsory one, and sponsoring companies find themselves running insurance companies — sometimes bigger than themselves, and often insolvent. Regulation has brought with it solvency tests, both from regular actuarial valuations and from FRS 17 accounting reporting, which are forcing schemes to report on their solvency at least annually, and to act if it is not in order. This is a world away from the dreams when schemes were created 40 and 50 years ago.

The second type of change has been around the economic cost of pensions. In the first instance, a *sine qua non* of defined benefit pension schemes has been a fixed retirement age. In truth, this probably never made sense in a period of improving longevity. However, the recent recognition that longevity has been improving by considerably more than pensions actuaries were allowing has caused a step change in cost. It has also forced pension scheme sponsors to recognise that they are carrying a serious risk of which they were unaware — and of which they probably had not been advised. The idea of a fixed retirement age being promised to people 40 years hence is now fundamentally too great a risk for anyone to carry — even with a government guarantee.

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At the same time, there has been a secular drop in real long-term interest rates. This has been even worse in the euro zone and in the United States of America than in the U.K., but even this comfort is disappearing. It may well be that this drop is temporary, but it has forced up the cost of the pensions promise. At the same time, there has been recognition that the legislative changes outlined in previous paragraphs have caused a huge constriction on the investment policy of pension funds.

The Role of the Actuarial Profession

It is salutary to look at the role of the actuarial profession in what has happened. In fairness to pensions actuaries, they were amongst the first to recognise that the world had changed and that the economics of defined benefit pension schemes were fundamentally altered.

Why, then, did it take so long for anything to happen? Much of the above change actually started ten or 15 years ago, and it is only in the last five years that serious action has taken place. Defined benefit pension schemes are still facing huge financial challenges. It is my contention that the structure of pension funds, where it was unclear where the responsibility for strategic management lay, has caused a good deal of the problem. If the actuarial profession is to be criticised, it is for being too comfortable with the management status quo; the profession was often the only expert which understood what was happening, and its connections were often not with the senior financial executives who should have been able to understand the underlying risks.

Perhaps this also points to the conflicts involved in advising both trustees and sponsoring company. For most of the history of defined benefit pension funds, there was little conflict involved in advising both parties. However, as the fundamentals changed, this was no longer the case. As a profession, we should have been encouraging change in the management structure of pension schemes, recognising differing interests and trying to encourage a more rational set up. In my view, we have failed to point out the deficiencies of the form of management of pension funds and the need to change, to ensure that there is serious professional management (as opposed to advice) available to those responsible for sponsoring and running pension schemes.

There is a role for trustees and management in pension schemes, but these roles need to be redefined to reflect reality and to ensure that there is real executive management by people who understand the underlying changes which are taking place. Nowhere is this clearer than in the investment of pension funds. The current situation, where trustees — who are rarely experts, and who have little or no capacity to manage — are advised by investment consultants — who are not managers either — is unstable, and is not likely to lead to happy results. The investment responsibility needs to be placed with the plan sponsor, with the trustees having no more than custodian, governance and oversight roles.

Summary

My broad concern is that the management of pension schemes is confused, with the roles of trustees and sponsors not being aligned to their real responsibilities. Partly as a result, there is too much advice and too little management of pension funds. I sometimes yearn for the time when there was one investment manager, effectively giving exclusive investment advice to the sponsor, with the trustees being little involved in financial decisions concerning the fund assets.

We need a root and branch change in the way in which pension schemes are controlled and managed. It would be good if the Actuarial Profession could lead in advocating such changes.

Please note that this editorial is written from the point of view of the U.K. and Ireland, although similar trends are evident in most of the English speaking world.

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