Spotlight on Pensions
PRESENTS
Le Grand View

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Pension schemes and balancing risk

In the film Wall Street, Gordon Gecko maintained that "greed is good". Although in a capitalist society there may be some truth in that, the film went on to show what can happen if left unregulated.

Likewise, risk is an essential part of a successful economy – but again needs to be appropriately supervised. The Department for Business, Energy and Industrial Strategy (DfBEIS) has published a response to consultations on insolvency and corporate governance which incorporates the fundamental issue of how to balance risk equitably between competing financial stakeholders.

Risk is central to a capitalist economy. Without an acceptance of the principle that a financial venture might not be as successful as anticipated – or may even fail altogether - commerce would never have developed beyond a simple bartering system. Bright ideas would be stifled and projects that require time to develop would simply not be possible.

Such projects also require a social system that enables collectivism, bringing together different skillsets to achieve success. In a capitalist economy this is achieved through allowing individual freedoms and incentivising individual stakeholders to engage; in a centralised economy the state organises and controls these functions. But common to both is the inescapable existence of risk.

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Sharing

The issue then is how economic risk should be shared between multiple stakeholders. This has always presented difficulties. Parties with differing bargaining strengths compete to gain personal advantage. The most extreme approach is to allow the survival of the fittest, but most Western civilisations take the sensible view that some protection for weaker parties is appropriate. There are considerable differences between where lines are drawn in individual countries, despite the growth of international commerce and globalisation.

Moreover, the position is fluid. As the apparent balance of power fluctuates between stakeholders, as a natural function of commercial activity and economic reality, so the parties whose influence diminishes try to regain their previous status. This leads to questions of whether further state intervention is required to effect a rebalancing.

Pension schemes in the mix

Where do workplace pension schemes fit? They impact companies in many different ways. Members are employees and sometimes shareholders of employers; schemes are creditors of sponsoring employers through receiving promised funding contributions; schemes invest their funds in other companies, looking for both dividend income and capital growth. Defined benefit schemes also have an interest in the financial position of companies that have defined benefit pension schemes of their own, through the Pension Protection Fund (PPF) levy, effectively underwriting some others' benefits in the event of sponsor insolvency.

In short therefore, a workplace pension scheme could be said to be a microcosm of all the interests jostling for position for a share of the company "cake" and provides in one place a view of competing interests to be shared equitably.

The consultations address a broad range of related issues, but recent high profile corporate failures with attaching pension schemes have ensured that schemes' interests have received prominence.

Key items addressed include:

- Transparency of information
- Shareholder stewardship
- Dividend policy
- Decision-making in respect of distressed companies, particularly around whether they should be helped to continue or be allowed to fail
- Balancing competing interests on insolvency.

Some of these are also the subject of previous and ongoing reviews, but such is their complexity and breadth that they continue to attract attention. A central theme is the balancing of the competing interests of parties, including schemes, in the financial cake.

Stewardship standards and transparency of information are of course fundamental and should always be of the highest standard. It is not difficult therefore to support strong regulations in these areas provided they do not disproportionately impede the efficient operation of the company. However valuing stakeholders' respective interests and dividing the company cake between them, whether the company is ongoing or insolvent, are harder to resolve. This is where the risk issues come to the fore.

In it together

Some recent comment on the direct consequences of corporate insolvency and the reductions to defined benefits if an attaching scheme is not fully funded has started from the position that benefits should be protected in full whatever the circumstances. This arises from the fallacy – which unfortunately the pensions industry has consistently failed to correct - that stated DB benefits are guaranteed. In fact they are subject to sufficient funds being available – in other words, scheme members are carriers of risk, as are other stakeholders in the corporate entity. However, their risk is already rightly mitigated by strong – but balanced – regulation aimed at securing funding to a level appropriate to circumstances.

A pillar of the UK's company-sponsored DB pension system is the avoidance of the need for the sponsoring company to fully-fund the scheme at all times with cash, allowing the company to retain more assets to use in the business, hopefully for wider benefit. The company covenants to provide the balance of cost from future profits. In this way companies have been able to afford to provide the defined benefits coveted by members. Members' risk of not receiving benefits in full (mitigated by PPF compensation) is consistent with the principle of sharing risk between all stakeholders. Allowing any single party's interests to dominate undermines the principle of equitably shared risk underpinning economic success. The consultation may be driven predominantly by concerns that some commercial parties may currently enjoy an unfairly strong position, but the answer is not to swap one party's dominance for another's.

Trust trustees

Although tempting from a scheme's perspective to take a narrow view that retirement benefits should have a preeminent position, schemes exist in the real world and a wider perspective is required. As new rules are developed, maintaining that wider perspective will be important. Risk will always exist, and on a day-to-day basis it is the responsibility of effective trustees to work within the system to provide an appropriate level of protection for their members. That is as it should be. Member benefit risk should be balanced, not eliminated.

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