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Dear Chancellor and Secretary of State,

The review of institutional investment which I am leading was established to determine whether there were factors distorting institutional investment decisions: for example, encouraging institutional investors to focus their investment on quoted equities and gilts at the expense of investment in alternative assets, particularly investment in smaller, high-growth companies.

I issued a consultation document in May 2000 in which I set out in more detail the issues which I would be investigating. I expressed a hope that a broad spectrum of organisations and individuals would respond, and that there would be a constructive process of consultation and dialogue.

I am glad to report that the financial community has responded very positively to my request. I received over 200 responses, many of them clearly the product of considerable time and effort. Responses came from a very wide range of organisations:

fund managers, pension scheme trustees, life insurance companies, investment consultants, law firms, companies, other professional bodies, and a number of interested individuals. My team have also had a number of very helpful informal discussions with industry participants in a variety of fora, both bilateral and group discussions. The responses and other discussions identified the following areas as being particularly worthy of further investigation:

- Structural changes in the industries concerned including importantly the shift from defined benefit to defined contribution pension provision.
- The time and expertise which pension fund trustees bring to investment decision-making, and the nature and scope of the advice given by investment consultants to pension funds.
- The specific characteristics of private equity as an investment by institutions.
- The impact of benchmarking and performance measurement on institutional decision-making, whether by reference to a peer group or an index.
- The impact of life assurance solvency regulations, the Pensions Act and other pensions regulation on investment decision-making.

Work to date has also identified some key principles which will inform the rest of the work of the review – that investment decision-making is most effective when it is:

- skilled;
- transparent;
- well-informed and
- properly debated.

I will continue to investigate these and the other issues raised by my consultation document and plan to report, as requested, in time for the 2001 Budget.

There are two issues on which I would like to make recommendations before next year, however, in order to meet the timetable of two Government consultation exercises. The two issues are the Minimum Funding Requirement (MFR) and a legal question concerning the impact of financial services legislation on investment in limited partnerships.

Providing security for members of defined benefit pension schemes is an essential objective for any responsibly run pensions system. While I am sure that the

overwhelming majority of pension funds are run both properly and effectively, it is essential to have effective safeguards to ensure that members of defined benefit pension schemes can have confidence in the system. I do not believe that the MFR is such a safeguard. An effective alternative is needed. It is also a source of distortions in investment decision-making. I propose instead that it should be replaced by an enhanced compensation scheme for fraud, mandatory arrangements for safe custody of pension fund assets, and transparency and independent review of pension funds' finances and plans. The paper attached sets out my thinking on the MFR in more detail, together with my separate proposal for change relating to the law on investment in limited partnerships.

Yours sincerely,

Paul Myners

A. THE MINIMUM FUNDING REQUIREMENT

Background

1. The DSS and the Treasury issued a consultation document in September on this issue, with the consultation period lasting until the end of January. Since I am not due to present my final report until the 2001 Budget, the consultation document explained that I would be giving my views on the MFR at the time of the Pre-Budget Report. This timing enables me to make comments in time for them to be considered as part of that consultation exercise. It also enables other respondents to the DSS/Treasury consultation exercise to comment on my proposals if they wish to do so.
2. It is clearly an important issue for my review. Almost half the respondents to my own consultation process commented on it, and over half of these viewed it as significantly affecting asset allocation decisions. It also has considerable wider significance. As I say in my covering letter, providing security for members of defined benefit pension schemes is an essential objective for any responsibly run pensions system. While I am sure that the overwhelming majority of pension funds are run both properly and effectively, it is essential to have effective safeguards to ensure that members of defined benefit pension schemes can have confidence in the system.
3. In considering the issue I therefore had in mind twin objectives:
 - A specific objective to ensure proper protection for members of defined benefit pension schemes.
 - The remit of my review as a whole, to examine and seek to ameliorate distortions in investment decision-making.
4. I have sought to set out my proposals in sufficient detail to demonstrate that they are practicable. At the same time, I have identified a number of issues of detail which it would be neither practical nor sensible for me to seek to resolve at this stage.

Should the MFR be retained?

5. There are several serious criticisms that can be made of the MFR. A number of them apply to other funding and solvency standards as well. They are not original, but I think bear repetition here.
6. The MFR distorts investment decision-making by its use of a set of reference assets to calculate discount rates for liabilities: namely, UK quoted equities and gilts. Pension funds are not required to invest in these assets, but to do so is the best way of minimising volatility against the funding standard. It is inherently

difficult to quantify the extent of the distortion that a particular regulation has on investment decision-making, particularly since the first MFR valuations are only now taking place. But in discussions with the investment community, I have been struck by how frequently funds and their advisers speak of “matching the MFR portfolio”. This distortion is a cost. By preventing investment being allocated in an optimal way, the MFR increases the cost of defined benefit pensions provision.

- A number of respondents also felt strongly that the MFR was distorting the gilts market, with adverse consequences for capital allocation and economic efficiency, as well as an impact on annuity prices.

7. One might argue that the distortions and costs caused by the MFR were justifiable if it delivered an important and necessary protection for members of pension funds. In reality, I do not believe that it does, for a number of reasons:

- The MFR, as with any other fixed standard, simply records the state of the fund at one point in time. Yet financial markets and economic conditions change constantly. It is not particularly helpful to know whether or not an annual target has been hit or missed. Indeed, it can create a false sense of security.

- The MFR was not designed to protect against fraud, one of the original concerns behind the establishment of the Goode Committee and the subsequent pensions legislation. I consider how this particular issue can best be addressed later in this letter.

- By distorting pension fund investment and so imposing direct costs on defined benefit pension funds, the MFR creates additional incentives for employers to close such schemes.

8. This latter point has wider ramifications. The MFR only applies to defined benefit pension schemes, not defined contribution schemes, because members of defined contribution and defined benefit schemes are subject to very different kinds of risk. Defined contribution members bear the investment risk of the contributions. Defined benefit members bear no risk at all unless the employer becomes insolvent; if this does occur, then they bear a mixture of investment risk and an additional “trustee risk” – that the trustees could have incompetently or dishonestly managed the fund and left it underfunded.

9. There are already a series of provisions in pensions legislation and trust law to protect against trustee risk: the requirement for trustees to be independent, to take advice and so on. A number of these were introduced following the Maxwell

scandal. It is not clear to me how significant is the trustee risk remaining, given these provisions. This means, in my view, that any measure to provide further protection for defined benefit members must consider carefully the costs involved, both for schemes and for the economy as a whole.

10. This is particularly important because of the specific impact that creating additional regulations like the MFR can have. Employers are not compelled to offer defined benefit schemes. If because of regulation the cost of such schemes becomes too high, they close the scheme to new members. The scheme may even be wound up. The practical result of attempting to increase protection is therefore that future employees are deprived of access to defined benefit provision and have to join defined contribution schemes instead, effectively exchanging employer insolvency risk for investment risk. It is not clear to me that they are better off for this exchange.
11. Most fundamentally, it seems to me that a funding standard such as the MFR, by its nature, does not address properly the question of protecting defined benefit scheme members. The MFR is concerned to prevent a situation where a defined benefit pension fund is underfunded and then because of employer insolvency is unable to meet its obligations. The question is: what is underfunding? Underfunding is a matter of judgement, linked intimately to one's views of future investment return. Whether or not a functioning fund is underfunded depends on one's view of future investment returns.
 - It might be argued that there is a clear and objective measure of underfunding: the extent to which the fund has sufficient funds to secure benefits by purchasing annuities for pensioners and deferred annuities for non-pensioners. I do not agree. This measure also makes an assumption about the future strategy of trustees: one which will be incorrect in many cases. If a fund were wound up, it is far from certain that trustees would seek to secure benefits by buying annuities. Deferred annuities in particular are expensive and in many cases, it might make more sense either to run the fund on as a going concern or to seek a transfer value for non-pensioners into a personal pension scheme. In either case future investment returns would affect the actual pension paid.
12. In my view, there is no escaping the question of whether the assumed investment return of the fund is reasonable. Therefore a true system of protection for beneficiaries should focus on the issue of the reasonableness of that assumed return.

13. This the MFR fails to do. On the contrary, its assumptions on investment return and on the assets and liabilities in general are:

- The same for all funds, albeit with adjustment factors for maturity;
- Fixed by legislation;
- Treated as a technical question for resolution by the actuarial profession.

14. All of these assumptions are wrong. The assumptions underlying the calculations of assets and liabilities should not necessarily be the same for each fund. They should differ with the maturity of the scheme, the strength of its sponsor, and the views of the trustees on a suitable investment strategy. They should be free to change with changing circumstances. They are not an obscure technical question, but the very heart of the question of whether the fund is adequately funded or not.

15. It follows that the MFR does not provide the protection that many assume it does, as the standard assumptions it makes may prove to be wrong. Indeed, its effects could well be counterproductive to the extent that it gives trustees a spurious sense of certainty about funding levels and weakens the fiduciary responsibility that should be at the heart of protection for members of defined benefit schemes.

16. Taken together, all these flaws lead me to conclude that the MFR is seriously inadequate as a form of protection, that it is unnecessarily adding to the pressures moving companies away from defined benefit provision, and that it should be replaced.

Criteria for an MFR alternative

17. Any alternative needs criteria for its effectiveness. I have had in mind the following considerations.

18. The MFR replacement must provide effective protection for members of defined benefit pension schemes by seeking to protect against clearly inappropriate investment strategies, but not against all possible economic scenarios. The latter would be so costly as to make continuing provision of defined benefit pensions impossible. Equally, while my wider review is concerned to remove unnecessary distortions to investment decision-making, if a funding standard has no effect at all on investment decision-making, then it is either ineffective or not needed. A criterion must therefore be that an MFR replacement only affects the investment of funds which are pursuing an investment and funding strategy which is inappropriately risky given the nature of the fund's assets and liabilities and the attitude and strength of its sponsor company.

19. An MFR replacement must also take account of the important differences between small and large schemes.

- Larger pension funds control the bulk of pension fund money. Precise figures are not available, but my understanding is that more than 80% of pension fund money is controlled by the top 400 or so schemes. They also contain the majority of defined benefit pension scheme members: schemes with more than 4,000 members account for approximately 70% of the total community of private sector defined benefit scheme members. They typically have greater levels of management resources to devote to managing the schemes, and third party interest in their activities would generally be greater.

- Conversely, small schemes have fewer management resources than large schemes, so solutions which would work well for large schemes might prove burdensome or unrealistic for them.

20. I have therefore assessed the options against the following criteria:

- That any alternative should seek to provide effective protection for members of defined benefit schemes by preventing funds taking an inappropriately risky attitude to investment given the circumstances of the fund and its sponsor.

- That the differences between small and large funds should be taken into account.

21. More generally, though I do not consider these factors to be absolute criteria, I believe that an MFR replacement will be most effective where it encourages pension fund decision-making which is in accordance with my wider principles that investment decision-making should be:

- skilled
- transparent
- well-informed and
- properly debated.

22. I note that a number of these themes, particularly transparency, have been picked up in the recently issued proposal for a European Directive on the regulation of institutions for retirement provision.

Preliminary proposals: improved protection against fraud

23. An important impetus behind the creation of the MFR was the Maxwell scandal. Yet that was a case of fraud. The MFR was not in fact designed to tackle fraud. In

that sense the issue is unresolved. Pension fund fraud has been rare. But its impact on individuals in these rare cases can be significant, and I have two initial proposals to make which I believe will help protect members of defined benefit pension schemes against the risks and consequences of fraud. Neither involves imposing unnecessary or excessive costs.

24. Where a fraud has taken place, the Pension Compensation Scheme (under revised proposals contained in the Welfare Reform and Pensions Act 1999 and due to come into effect early next year) is limited to restoring a fund to either:

- 100% of its pensioner liabilities (and those within 10 years of retirement) and 90% of its MFR liabilities for other members, or;
- the amount of the loss, whichever is the lesser (since otherwise underfunded schemes which were subject to fraud would benefit relative to equally underfunded schemes which were not).

This is funded by an industry levy scheme supervised by the Pensions Compensation Board

25. I propose that the level of this compensation for non-pensioner members be increased to cover not simply the MFR liabilities as at present, but something closer to the cost of securing members' accrued rights (or the amount of the loss, whichever is the lesser). The precise formula for calculating the accrued rights would be for further discussion.

- On a separate but related issue, some adjustment would need to be made to the regime governing transfer values, where the MFR currently serves as a statutory minimum. This is a matter on which the actuarial profession is best placed to advise.

26. This would provide additional protection in the event of fraud without burdening the industry with excessive costs. As I said, pensions fraud is rare – since the system came into force in 1997 there has been only one successful claim for fraud costing around £38,000.

27. I believe the issue of custodians of pension fund assets should be looked at again. Although I understand that the great majority of schemes use custodians independent of the employer, not all do. Protection for pension scheme members from the risk of fraud could be improved by making custody independent of the employer a mandatory requirement for pension funds. This would make it more difficult for improper use to be made of the pension fund's assets. One of the

objections in the past to this idea was that custodians are not regulated. They now are, and I recommend that there should be a mandatory requirement for their use.

Protection against underfunding

28. Fraud is one question; underfunding is another. As I said, the present MFR and all funding and solvency standards focus attention on the wrong question: whether, given certain investment assumptions and methods of calculating liabilities, defined benefit pension funds have adequate assets. It is obvious that the answer depends crucially on what these assumptions are. That may seem to be a technical actuarial matter. But in fact, it is simply the assumed rate of return on the assets, which is a question of future investment returns. That will depend on the investment strategy of the fund, which in turn depends on its maturity, the strength and risk appetite of the sponsoring employer and the views of the trustees. This is therefore:

- a) Fund-specific, and;
- b) A matter of subjective judgement.

29. In its calculations, the present MFR has the effect of assuming that a fund is backing pensioner liabilities with gilts and non-pensioner liabilities with UK equities, which is clearly a very specific assumption that will not necessarily apply to every fund.

30. The key issue for pensioner protection is the judgement of assumed investment returns. Any centrally set funding or solvency standard errs in standardising this judgement. A better approach would be to expose it and make it the key focus of discussion, as follows.

31. If the critical issue for fund solvency is the reasonableness and appropriateness of investment assumptions, then the best protection for pension scheme members is to ensure that these assumptions are as robust and well thought-through as possible. While existing pensions legislation has done much to raise standards of scheme management, the field of debate on investment assumptions is still generally a narrow one, restricted to trustees and their advisers. Indeed, it is not clear to me that even trustees are always as actively involved in setting investment assumptions as they could be.

32. I raised the possibility of broadening the field of debate on investment decisions in my consultation document. A number of respondents argued that this was inappropriate, as poor investment performance by a defined benefit fund only affected the sponsoring employer and not the beneficiaries, as their pensions were guaranteed. This is generally true – but not where one is seeking to provide protection from the consequences of employer insolvency, as we are here.

Subjecting investment assumptions to outside scrutiny and comment would make it more difficult for a fund to proceed on the basis of inappropriate assumptions. It would reinforce and clarify the trustees' fiduciary responsibility to have an appropriate and well thought-through investment strategy. The better the trustees fulfil this responsibility, the better the protection for defined benefit scheme members. One of the aims of my proposals is therefore to encourage active involvement by trustees in debating investment assumptions and setting asset allocations.

33. My proposal on investment decision-making is as follows. Each defined benefit pension fund would be required each year to set out in clear and straightforward language the following:

- The current value of its assets and in what asset classes they were invested;
- The assumptions used to determine its liabilities;
- Planned future contributions.
- Its planned asset allocation for the following year or years.
- The assumed returns and assumed volatilities of those returns for each asset class sufficient to meet the liabilities.
- A justification by the trustees of the reasonableness of both their asset allocation and the investment returns assumed in the light of the circumstances of the fund and of the sponsor.
- An explanation of the implications of the volatility of the investment values for possible underfunding, and a justification by trustees of why this level of volatility is judged to be acceptable.

34. This statement would be produced annually. It would be produced having taken advice from advisers with the appropriate skills and experience for forecasting long-term investment returns. A possible outline of the sorts of things which such a "transparency statement" might contain is attached in the annex. More detailed information on the state of the fund, including a statement of the solvency of the fund on immediate wind-up, would be available to beneficiaries on request.

35. I am aware that pension funds are already required to produce a report and accounts, and Statements of Investment Principles. An annual Statement of Investment Principles could be drafted in such a way as to answer the questions above. But my understanding is that the Statement does not need to do so, and most do not. A new document, along the lines above, is therefore required. I suggest that, once this has been developed, work should be done to merge the two documents, thereby mitigating additional burdens on those who offer defined benefit pension schemes.

36. The process of having to prepare the transparency statement will force trustees to think carefully about whether their investment strategy is sound. Making it publicly available will expose it to outside scrutiny, which should be encouraged. There are a number of bodies which might exercise this scrutiny:

- Individual beneficiaries and their advisers.
- Trades unions, where there are active members that are union members.
- Pensioner support groups.
- The media, particularly the personal finance media.
- Competitors of the advisers to the trustees.
- The credit rating agencies, and creditors of the sponsor company
- Sponsor company shareholders and capital market analysts.

37. The pension fund would be required to distribute the transparency statement to beneficiaries and to lodge it with Opra (Occupational Pensions Regulatory Authority), who would make it publicly available through the Internet. Beneficiaries would in the first instance raise any concerns they had about the investment policy of the fund and therefore the security of their pension, with trustees. If this proved unsatisfactory, then provided some minimum percentage by number of the members voted in favour, trustees would be required to commission an independent report on their funding and investment policy by an appropriate expert, paid for by the fund. This would provide a second opinion on whether the trustees had set out an appropriate and thought through strategy, given the circumstances of the fund, the employer and so on, and would be made available to all trustees.

38. What precisely the minimum percentage should be is for discussion. I have no firm views, but it seems to me that if it were much above 10% of the beneficiaries it could be difficult for beneficiary concerns to be raised effectively, and if it were much below 5% there would be a risk that a small number of beneficiaries with another agenda could disrupt the running of the pension fund without justification.

39. One might also provide that a similar number of beneficiaries could also trigger a Members' Meeting of the fund, at which trustees would have to explain their thinking, though again that would be for discussion.

40. Failure to act on the report would trigger involvement from Opra, who would have the ultimate sanction of its powers to disqualify trustees. As a further protective measure, Opra would also have its own power to require the fund to commission an independent report.

41. It might be argued that in the above process, scheme members would have an incentive always to demand a more conservative investment strategy and correspondingly higher contributions, as they would have nothing to lose from this and would gain security. In the first place, this is doubtful - it might equally be argued that beneficiaries have an incentive to demand a very risky investment strategy, on the grounds that the sponsor would have to pick up the cost if the strategy failed, and if it succeeded, the members could press for increased pension benefits from the resulting surplus. But more importantly, both these arguments miss the fundamental point. The continuation of defined benefit provision relies ultimately on a sensible and suitable funding policy for the fund based on consensus between the sponsoring employer, the trustees and ultimately the members. If such a consensus does not exist in the case of a particular fund, then it is better for this to be exposed and for provision to be switched to defined contribution than for defined benefit provision to continue on false pretences.

Smaller and larger funds

42. This approach must take account of the issue of fund size. I believe that for larger funds, the above approach would be appropriate, as there would be sufficient groups with both the expertise and interest to scrutinise the fund's plans effectively.

43. In the case of smaller funds, it is less likely that there would be people or organisations with the required skill or interest to exercise effective scrutiny. Many of the smallest schemes will be insured, but there is a middle tier of funds that are neither large enough to be able to rely solely on external scrutiny, nor small enough for insurance to be the preferred *modus operandi*. To ensure that pension scheme members are properly protected I therefore suggest that for smaller funds, there should be an additional specific and mandatory requirement for scrutiny, as follows.

44. Having prepared the transparency statement, prior to publishing it in the normal way, the trustees of a smaller fund would have to obtain a statement from the scheme's actuary that, having consulted investment experts as appropriate, he felt that the investment assumptions in the transparency statement were such that a prudent person knowledgeable in investment might reasonably make.

45. Opra would also have three points of involvement in this process:

- If the actuary were in any way concerned about the assumptions, he could ask Opra to exercise its power to call for an independent report.
- A refusal by the actuary to provide the statement would automatically involve Opra.

- Opra would have a general responsibility to take any representations from members of smaller funds to them particularly seriously, in view of the particular issues affecting smaller funds.
- It would have its usual powers of disqualification as a fallback.

46. This proposal, while fully consistent with the approach for larger funds, meets the particular needs of members of small schemes. It provides additional safeguards:

- specific mandatory scrutiny of the investment assumptions;
- a more specific requirement to involve investment expertise.
- Opra acting as a backstop.

At the same time, it does not place unrealistic weight on the opinion of the actuary alone or require him to claim investment expertise which he does not have.

47. Beneficiaries would also be able to vote for independent reports as with large pension funds.

48. There is of course no precise figure for when a fund is considered “small”, and this would be for further discussion. My preliminary thought is that a dividing line of perhaps 4,000 members might be right. I believe that this equates to a fund size of approximately £250m. The number of members, rather than the level of funds, would be a better measure, since this is unlikely to rise and fall as much.

Assessment of preferred option against criteria

49. I believe this option meets the criteria which I have set out and fulfils my objectives of providing effective protection for members of defined benefit pension schemes while minimising investment distortions. Funds will have to make clear both their current financial position and their future plans, which will reveal if they are planning to pursue inappropriately risky strategies. They will not be able to pursue these policies in the face of clear opposition from beneficiaries and other interested parties. But at the same time, if strategies are appropriate for the fund and its particular circumstances, then trustees will be free to pursue them without distortion. This approach will encourage investment decision-making which is well-informed, skilful and properly debated.

50. The proposal also differentiates effectively between large and small schemes.

51. I therefore believe that my proposal is the right one for both defined benefit pension fund members and the economy and society at large. It will provide

effective protection for members of defined benefit schemes. At the same time, it will facilitate the rational and well-informed deployment of the major capital flows controlled by defined benefit pension funds.

Other options

52. The DSS/Treasury consultation document raised various other possibilities for an MFR alternative. I have considered some of these.

Other options: insurance

53. I have had some preliminary discussions with major participants in the reinsurance markets about the possibility of insurance replacing the MFR, and have concluded the following.

54. Effectively, defined benefit pension funds would be buying insurance against the insolvency of the sponsoring employer. In the event of employer insolvency the insurer would have to make up a proportion of any shortfall that emerged between the value of the pension fund's assets and their liabilities. They would not take on the long-term liability to pay pensions; rather, they would pay out a single sum based on independent actuarial valuation of the value of members' pension entitlement. It would then be for the trustees of the fund to decide whether to wind up the fund or to continue it on an ongoing basis.

55. This insurance would effectively be credit insurance against the possibility of the employer becoming insolvent. The state of the fund would determine the size of the payout. The major issues for such insurance would be:

- Could it be practicably provided?
- Who would provide it?

56. Various markets in credit insurance already exist. The major hurdles would be, as for any insurance product, moral hazard and adverse selection. Adverse selection would be dealt with by making insurance compulsory. A defined benefit fund that was not able to get insurance would have to wind up.

57. Moral hazard covers a wider range of issues. There are some specific areas of concern such as small director-only schemes. The primary moral hazard is the concern that the existence of insurance would lead to funds undertaking reckless investment policy safe in the knowledge that pensions would be covered. It is important to bear in mind that this would generally only arise where the pension fund was already underfunded to such a degree that meeting its obligations would bankrupt the company. In such a situation, it would be rational for the company and for the trustees to want the pension fund to be invested in high-risk, high-return assets.

58. There could be two mechanisms for mitigating moral hazard:

- Insurance would not be 100%. This is normal with insurance arrangements and compensation schemes in financial services.
- The insurer would use risk-based pricing, raising the premium if the fund's investment policy was felt to be too risky, on the grounds that this increased the size of the possible payout.

These measures would mitigate moral hazard, though they could not remove it.

59. The simplest method for supplying this type of insurance would be from the commercial markets. My investigations suggest that in principle these risks can be priced and that a market could exist in them - indeed, such a market already exists through credit derivatives and credit insurance. However, the discussions have also confirmed that the willingness of insurance markets to take on risk can and does change over time. In my judgement, one could not rely on the markets to provide sufficient cover at all times – and it is precisely when such cover would most be needed, at times of economic difficulty, that it would not be available.

60. That means that insurance could only provide effective protection if there were also a mutual insurer for defined benefit pension funds, to ensure that there was always a source of insurance. Creating such an insurer would be a complex task. It would have to have effective risk-based pricing in order to control moral hazard. This in turn would be difficult if there were not a strong alternative available from the commercial insurers to provide market discipline. The aggregate cover offered by the mutual would need to be capped in some way, as it could not provide cover against a major and sustained collapse in the value of assets in the world economy.

61. As I have said above, my preliminary investigations suggest that it would be possible to create such a system, subject to further work over some months on the details. However, my investigations also suggest that it has some very significant disadvantages, which in my view mean that it is not an attractive option.

62. Most importantly, it would represent an additional cost for providers of defined benefit schemes – at times, possibly a considerable one - and as such would create additional incentives for employers to move away from such schemes. I do not think that this is an effective way of meeting the objective of protecting members of defined benefit pension schemes.

63. There are also good grounds for thinking that it would be as distortionary towards investment as the current MFR. Insurers might very well impose some sort of funding standard themselves. Even if they did not, since the insurer would be

scrutinising the fund at regular intervals and altering the premium to reflect the current risk – that is to say, the current level of funding - it would be much more difficult for pension funds to take a long-term view, as any short-term investment underperformance would be likely to lead to a rise in their premium. Given my remit to investigate distortions in investment decision-making, this is a serious additional disadvantage.

64. I therefore do not recommend insurance as a way forward.

Other options: the proposal of the Faculty and Institute of Actuaries

65. As the DSS/Treasury consultation document acknowledged, the Faculty and Institute of Actuaries was asked to answer a tightly-defined and specific question in its review of the MFR. It is therefore no criticism of the excellent work that they did to say that it still shares the same problem as other funding/solvency standard approaches. It imposes standard assumptions on investment returns to determine whether a fund is either side of a line in the sand at a particular moment in time. This could be distortionary and affords neither consistent nor effective protection. The specific proposal to move to a bond-based discount rate does not address these wider concerns. If pension fund trustees choose to shift their fund's assets more into bonds because they believe that this class of assets offers the best chance of meeting liabilities cost-effectively, then that is their decision. We should not create artificial incentives for them to do so through a funding standard.

Other options: regulation

66. The DSS/Treasury consultation paper raised the possibility of a regulator being used to protect pensions through a system of more active prudential regulation. In many ways, this is a variant of my preferred option, where the fund's strategy and assumptions are subjected to external scrutiny. But I feel it is a variant which is very undesirable unless the regulator has little or no direct power over the investment strategy.

67. We are dealing here with matters of subjective judgement, about which there should be the maximum of debate in the widest possible arena. Giving responsibility for this assessment to a regulator with significant power places a great reliance on the judgement of the individuals employed by the regulator. Some may very well have excellent judgement, possibly better than the beneficiaries of the fund and other interested parties. But inevitably others will not, and there will be a general tendency to take a bureaucratic and overcautious approach. This itself will make running defined benefit schemes more burdensome and costly, accelerating the move away from defined benefit. Nor indeed is there any guarantee that the result will always be better protection for members of defined benefit schemes. Regulators can underestimate risk as well as overestimate it.

68. If a regulator is but one voice among many, or a backstop as part of a more flexible system, that might be different. But I suspect that this is not what is envisaged.

Other options: a Central Discontinuance Fund

69. This option has been promoted by some. It would involve schemes with insolvent employers being combined into a central fund which instead of having to buy out its liabilities or seek transfer values to other schemes, could run on, investing in a broader range of securities. This involves a continuing risk of underfunding. It could therefore take one of three forms:

- A fund with a guarantee from the industry. This, it seems to me, is effectively a less transparent and effective method of mutual insurance, since it introduces an intermediary body, the central discontinuance fund, between the source of the risk (the funds) and the insurer (the rest of the industry). This would seem to raise the problems of insurance, particularly moral hazard, in a more stark form.
- A fund with a guarantee from the Government. This in my view could not be defended. Effectively, taxpayers, increasing numbers of whom are members of defined contribution schemes, would be underwriting the pensions of members of defined benefit schemes. This is inequitable.
- A fund with no guarantee. I cannot see what benefit this would bring to the industry, except insofar as it might allow small funds to continue as self-standing entities rather than buying out their liabilities from a life insurance company or transferring to another scheme, and therefore to secure higher returns. If this is a benefit, then it suggests that there is a problem with securing a fair transfer value of pensions when schemes wind up, which is a separate problem to the one which an MFR replacement is seeking to address, and it should accordingly be tackled separately.

Conclusion

70. I believe that the MFR is not providing effective protection for members of DB pension schemes. I have put forward a proposal which I believe does provide such protection since it asks the right question – how will the fund meet its liabilities – of the right people – the trustees, who are ultimately responsible. Tougher controls on fraud, a regime of transparency, with the right for members to call for

independent review, and Opra acting as ultimate backstop make up a package which does provide effective protection.

71. I have set out my preferred option in sufficient detail to demonstrate how it might work in practice, and I have explained why I think it is the right one both for members of defined benefit schemes and for the economy as a whole. Consultation on the MFR is continuing and will conclude in January 2001. I hope that my ideas will contribute to stimulating a constructive and open debate on how best to proceed. I stand ready to discuss my ideas further with you and your colleagues.

B. FINANCIAL SERVICES LEGISLATION AND INVESTMENT IN PRIVATE EQUITY

72. As part of my consultation exercise, a number of respondents raised an issue concerning the seemingly unintended impact of the financial services legislation on investment in limited partnerships, the dominant vehicle for investment in private equity. I would like to raise this at this point to meet the timetable for consultation on the By Way of Business Order, which I believe could address the issue.
73. The financial services legislation states that trustees of occupational pension funds are to be considered as carrying on investment business unless they delegate all “day to day” decisions to an authorised person under the Financial Services Act. Anyone carrying on such a business must be authorised to do so by the relevant financial services regulator. Pension funds are typically not authorised in this way.
74. Investment in private equity usually takes the legal form of the investing pension fund becoming a limited partner in a limited partnership (which is not itself regulated under financial services legislation). The management of the funds of this partnership are given to the partnership’s manager, a separate legal entity (which is regulated) which makes all the investment decisions. Because the investment by the pension fund takes the form of investing in a single partnership, it is held by many to be a “day to day” investment decision. A number of pension fund trustees have therefore been advised that they may be acting illegally in investing in private equity limited partnerships because they are not themselves authorised to engage in investment business.
75. However, the economic substance of a pension fund’s decision to invest in private equity is little different to the substance of investment in any other asset class. The pension fund’s trustees select a firm with expertise in the asset class who will invest their money in a portfolio of securities within that asset class. In the case of quoted equities, this would be a fund manager; in the case of private equity, a private equity manager. Both of these firms will be authorised under the financial services legislation to conduct investment business. (In addition, the fund may or may not take investment advice from an investment consultant, who is also FSA-authorised but typically only as an adviser, on selecting their manager or private equity partnership.)
76. Nor is the risk for the fund necessarily different in private equity investment as compared to public equity investment. Private equity is generally higher-risk and less liquid than public equity, but not always so.

77. The only difference from an investor protection point of view is that an investment manager has a duty to ensure that the investments they make are suitable for their client. In the case of investment in public markets via a fund manager, the client is simply the pension fund. In the case of investment in a private equity limited partnership, the customer is the partnership, of which the pension fund is only one partner. The duty is therefore more diffuse. But I am not persuaded that this represents a significant difference.
78. I do not think that this constitutes a major barrier to investment in private equity, but it is an obstacle which seems to be the product of an unforeseen consequence of the law, rather than explicit considerations of investor protection.
79. It seems to me that the problem could be addressed without too much difficulty by amending the relevant financial services legislation so that where an investment takes the form of an investment in a limited partnership solely for the purpose of that money being invested onward in private equity investments, it is exempt from the prohibition in the Act on unauthorised persons engaging in investment activity. The precise legal mechanics of this would be for discussion, but preliminary investigations suggest that something along these lines would deal with the problem, and that the change requires only secondary legislation, so could be done relatively quickly. I am happy to do further work with the relevant officials and regulators if this would be helpful.

ANNEX: Possible example of outline Transparency Statement

ASSETS

Funding Adequacy

1. On current contribution rates, your pension fund needs to make annual investment returns of 3.5% above inflation if it is to meet its likely pattern of pension liabilities without requiring additional funding from the sponsor XYZ Ltd.
2. In practice, your trustees believe it is reasonable to expect your pension fund to make an annual return over the long term of almost 4.5% above inflation on its investments. This reflects the asset allocation of the fund and the trustees' assessment of the returns that can be expected from each asset class. The trustees therefore believe your pension fund is adequately funded.
3. The planned asset allocation of your fund and the relevant returns anticipated are as follows.

Asset class	Allocation	Assumed real return i.e. return in excess of inflation
UK large quoted equities	40%	5.00
UK small cap quoted equities	5%	5.50
UK private equity	5%	6.00
US quoted equities	5%	5.00
Continental equities	10%	5.00
Rest of World equities	5%	6.00
Index-linked gilts	5%	1.75
Conventional Gilts	10%	2.00
UK investment grade bonds	5%	3.00
Overseas investment grade bonds	5%	3.00
Real estate	5%	5.00
	100%	4.46

The trustees believe these to be reasonable for the following reasons.
[General justification of returns].

- There is a case for expecting a higher premium for UK small cap over large cap equities. However, the trustees prefer to assume a premium of only 0.5% because [insert explanation].
- [Similar for other asset classes].

The returns are somewhat lower than historical experience in most markets over the last twenty years, as the chart below shows. This is because [explanation].

The exception is bonds, where the trustees believe [].

In making these judgements the trustees have been advised by ABC Consultancy Ltd.

Historical performance of asset classes over last twenty years

[Insert chart]

SENSITIVITIES

Economic modelling has identified the following as the most likely risks to the fund:

- Sustained underperformance of UK large quoted equities. A real return of 3% per year for the next 10 years would lead, other things being equal, for liabilities to exceed assets by []%. However, the trustees believe that this would be mitigated by [] which would result in improved returns from both domestic bonds and overseas equities, reducing the gap to []%.

[Further discussion of risks].

LIABILITIES

The liabilities of the fund are the money which it has to pay out for your pension and the pensions of other members of the schemes. These will be determined by a number of factors, about which we have made the following assumptions.

Members' contributions: 3% of their pensionable pay

Employer's contributions: 20% of pensionable pay.

Earnings growth: 4.5% a year (or approximately 2% above inflation)

Pension increases after retirement: 2.5% a year

Deferred pension increases before retirement: 2.5% a year

[Justification of assumptions].

Demographic assumptions: mortality of scheme members is assumed to be in line with that of the standard mortality tables PMA92 (for men) and PFA92 (for women)

published by the Faculty and Institute of Actuaries, projected as appropriate for the year of birth of the member.

Scheme size: there is no change over time in the number of active members of the scheme.

These assumptions are all the same as used for the last assessment.

The actuary has undertaken an assessment of the level of pension outgo in future years on the basis of the above assumptions, together with more detailed assumptions on matters such as the pension increases before and after retirement on the Guaranteed Minimum Pension element of pensions, the proportion of company employees leaving and retiring from the scheme at each age and the pattern of new entrants to the scheme. On these assumptions, your pension fund needs to make annual investment returns of 3.5% above inflation if it is to meet its likely pattern of pension liabilities without requiring additional funding from the sponsor XYZ Ltd. More detail on the actuarial assessment is available from the Secretary to the Trustees.