Rethinking the Economics of Pensions: Is there a crisis of pensions or a crisis of pensions governance and regulation?

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Welcome to the conference "Rethinking the economics of pensions: Is there a crisis of pensions or a crisis of pensions governance and regulation?". It is really good to see so many people here today and that we have so many high quality papers to be presented today and tomorrow.

I think I should begin by explaining how this conference was conceived and what we hope to get out of it.

The idea stems from a letter I had published in the Financial Times in November 2011 under the headline "Actuaries should reconsider how they value pension funds", which argued that the volatility observed in the funding levels of many private occupational pension schemes is much too great to be a fair reflection of their intrinsic health. Previously to this I had, in common with most of the working population, thought little about pensions, assuming that others were looking after my interests. But I was compelled to take an interest in the subject by the problems emerging in my own pension scheme, the universities scheme, the USS. Universities in the UK are not part of the state as they are in other European countries, but autonomous institutions, and their collective pension scheme is a private funded scheme, and it is currently the second largest in the country.

We had been told its funding level had gone from 103% in 2008 to 74 % in 2009 and was back up to 92% in 2011. This is an extraordinary amount of year-to-year variation. Since then it plummeted back down again to 77% in 2012. These are not only massive, but astronomical changes that, to me as an economist, are incomprehensible because they cannot be explained in terms of the scheme rules and normal day-to-day factors that drive the liabilities of a DB scheme: things such as longevity, salary inflation, years of service and price inflation all of which change relatively slowly.

The deficit in the scheme increased between March 2011 and March 2012 from £2.9bn to £9.8bn. This is a truly massive change in a scheme with assets of £32bn. Yet we found serious commentators in the specialist press putting it down to increasing life expectancy, an explanation that realistically is not even close, but one that is too readily believed by many members and has led to suggestions that the scheme is unaffordable, and forecasts that it will have to close to future accrual.

I discovered that similar changes have occurred in many other funded schemes, both company schemes in the private sector and funded local government schemes in the public sector. Reported large deficits have led to the regulator requiring recovery plans with large additional payments that have made them

unaffordable in many cases leading to their closure. Such is the nature of the crisis affecting funded pensions.

But if we ask how they arise we find that the real causes of such changes actually have to do with the complex set of economic assumptions and ideas that lie behind the 2004 funding rules within which we have to operate. Volatility in funding levels is an inevitable consequence of the very different principles on which assets and liabilities, the two sides of the funding-deficit calculation, are evaluated. Assets are valued at market prices while liabilities are estimated as a discounted present value. Neither figure has any practical reality but both are obtained from highly theoretical and stylised economic ideas; including that of perfectly efficient markets. Yet this is the approach insisted upon by the regulator and enshrined in legislation. That is why it is necessary to rethink the economics of pensions regulation, and to ask the question whether the regulation system itself is doing what it is supposed to do.

My letter in the FT produced a lot of interest within the pensions industry, and, among others who contacted me, was Con Keating, who has, for a long time, worked hard within the industry to draw attention to these failures, and made serious proposals for better alternatives, and Chris Sier of the FSKTN who has been working to bring about greater awareness of the scale of fees and charges levied on pension funds. We discussed the issues and decided on the idea of a conference, bringing together researchers and industry practitioners, focussing not only on funded schemes but on the wider crisis surrounding pensions in general, including unfunded public sector schemes. We chose the title "Rethinking the Economics of Pensions" to signal the radicalism of what we thought was needed. In the Call for Papers we listed a number of questions that we thought needed answering and that we hoped would be addressed by the papers.

I am delighted that there was such a good response, both in terms of presentations and participation, and I think we will have a good conference over the next two days as a result. Papers and sessions cover a wide range of aspects of what is a vast field. They are a good mix: papers on funded private schemes and unfunded public pensions, from both economists and actuaries, academics and industry experts, contributions to the academic literature and policy oriented papers, some polemical, some optimistic, some pessimistic. We hope there will be plenty of discussion both in the sessions and outside.

I am very pleased that our opening keynote speaker the leading expert on pensions economics and the economics of the welfare state, Professor Nick Barr of LSE, who will give an overview of the economics of pension schemes. The next session is two talks, the first by Chris Curry of the Pensions Policy Institute, will show the scale of the reduction in public sector pensions that will result from the current Coalition government's reforms, and the second, by Michael Johnson of the Policy Studies Centre, will argue that public sector pensions are becoming unaffordable, even after the reforms.

We are privileged that the shadow pensions minister, Gregg McClymont MP, will give a presentation of current Labour Party thinking. He will be followed by two American speakers, who will argue strongly for the superiority of DB pensions over DC. William Fornia, of Pension Trustee Advisers, Denver, will show that DB schemes are far cheaper than DC, and Professor Teresa Ghilarducci, of the New School, will talk about the neglected but important topic of the short-run macroeconomic effects of pension schemes. She will show that DB schemes tend to be countercyclical and act as a benificial automatic stabiliser, while DC schemes have the opposite effect, amplifying recessions and booms.

We round off the day with two parallel sessions. The one on accounting has two papers by Ian Clacher of Leeds Business School, and Con Keating, who will present his radical proposal for reforming the valuation methodology so as to minimise the problem of volatility that I referred to. The other has papers by Samuel Sender of EDHEC Business School, France, and Alexander Andonov, of Maastricht University, on sponsor risk and asset allocation and the liability discount rate.

Tomorrow we begin with a panel discussion by three speakers on the hot topic of private pension charges, which is currently the subject of an OFT investigation. We have two presentations showing the very high level of charges, by David Norman of TCF Investments and David Pitt-Watson of RSA, to which Daniel Godfrey, chief executive of the Investment Management Association will reply.

This is followed by 'Actuary of the Year' Hilary Salt, of First Actuarial, giving an overview of the future of defined benefit pensions provision.

Marek Naczyk of Oxford University will explain what has been happening recently to pensions in Poland. After lunch we have two more parallel sessions. Professor Edward Ponds, of Tilburg University, Netherlands, will give a paper on the optimal degree of funding in public sector schemes, and Professor Sohnke Bartram of Warwick Business School will give a paper on the effect of pension schemes on leverage and real investment. The other two papers are by Professor Paul Klumpes of EDHEC Business School, France, on sustainability and Bernard Casey of Warwick University on the crisis.

We hope this conference helps both academics and industry practitioners to better understand the economics of pensions and contributes in some way to better policy making.

Without further ado, I would like to introduce the first keynote speaker. I gives me great pleasure to introduce Nick Barr whose talk is entitled "Designing pension schemes: lessons pitfalls and some solutions".