IAPF CONFERENCE ON GOVERNANCE

I understand that the theme of your conference is governance. My intention is to focus on this topic first in the context of certain adverse global trends affecting pensions, and then, since it is my first opportunity to address an IAPF audience, and if time allows, to make a few more general remarks about the pensions landscape as I see it.

A few years ago I spent a very pleasant holiday in Cambridge. One of the attractions of the town is that you can take a boat trip on the river Cam by the backs of the colleges which make up the university. An interesting fact conveyed by our guide is that the colleges are very wealthy by virtue of endowments of some antiquity.

One of Cambridge's best known figures is the great economist, John Maynard Keynes. But Keynes was not just a great economist, he was a very shrewd investor. He was in charge of the University investments and beat the markets every year for eight straight years during the 1940s.

That kind of investment performance is rare today. Not only that but long term secular trends in the global economy make it difficult for pension funds to make the kind of returns they need to cover liabilities.

According to the French economist, Thomas Piketty, the enormous destruction of capital which took place during the two world wars of the 20th century led to unusually high growth rates and investment returns in the second part of the century. The experience of 3 per cent real GDP growth and 4 per cent inflation in most developed economies over the last fifty years is not a best estimate over the next fifty years. Piketty considers that we are entering an era of much lower growth.

As well as that long-term interest rates have been in decline and may have fallen by as much as 450 basis points over the last thirty years. Economic secular stagnation post 2008 has compounded this trend.

Efforts to reflate the global economy, particularly in Japan, Europe (and Britain), have relied almost exclusively on monetary policy using a combination of low interest rates and quantitative easing (QE). This involves the ECB and the Bank of England buying government and corporate bonds to the amount of €80 Billion a month in the case of the former.

This is intended to force investors to look for better returns by investing in the productive economy and for Banks to lend more money. However, a side effect of this monetary strategy is that it results in lower bond yields with consequences for pension funds. Yields on sovereign debt in the UK, Ireland and Spain tumbled to record lows. In fact the total volume of sovereign and corporate bonds with negative yields is now $13 Trillion.

The *Financial Times* claims that for every percentage fall in long gilt yields (UK Government Bonds), there will be an increase in a pension fund's liabilities of 20 per cent while the value of the assets will climb by only 7 to 10 per cent. FT 350 companies combined deficits increased by £50 Billion in August 2016, the biggest monthly widening on record. The combined pensions deficits of these 350 largest UK companies stood at £189 Billion on 31st August. Precise data on Irish scheme accounting deficits is not available but Mercers, who carried out the UK research, estimates that the accounting deficits for the 18 companies in the ISEQ with DB liabilities amounted to € 5.7 Billion on 31st July 2016.

Paradoxically, the monetary policy being pursued by the ECB is very helpful to a highly indebted country like Ireland, but it seriously disadvantages pensions and savings, which explains the current level of anxiety.

However, the election of Donald Trump and recent statements by Mario Draghi suggest that the era of quantitative easing may be coming toward an end. If not quite a Keynesian turn, Trump's proposed shift towards fiscal measures and infrastructure investment suggest at least an inflection point.

Before the US election, International financial institutions were distinctly cool about the economic consequences of a Trump victory. But in recent days the OECD economic outlook has expressed concern that governments not spending on capital investment run the risk that advanced economies could become stuck in a low growth trap.

The OECD is now saying that infrastructure investment in the US could increase growth by between 0.25 per cent and 0.5 per cent in 2017. The chief economist is quoted as saying that US policies might help the world out of a rut and should revive expectations for faster and more inclusive growth, "thus allowing monetary policy to move towards a more neutral stance".

Markets opinion seems to be moving in a similar direction. Since the US election $1.5 Trillion has been wiped off the value of bonds. Even Irish 10 year bond yields have risen from 0.33 per cent in September to 1 per cent now.

Nevertheless, pension trustees have to perform their duties in very uncertain times. There is something of a perfect storm for pensions in the combination of long-term trends in the global economy and an ageing demographic about which I know you are well aware.

Keynes famously drew a distinction between risk and uncertainty. You can take steps to mitigate risk but managing uncertainty is much more problematic. In the aftermath of Trump's election the *Financial Times* described the situation as "The bonfire of the certainties".

So this is a difficult and challenging environment for governance and for the role of pension fund trustees. Not only must they contend with the conditions I have described but do so in a way that is fair to active members in different age cohorts, deferred members and pensioners.

In the context of this era of uncertainty Boards of Trustees will not just have to do things right but to do the right things.

What might this mean in practice?

It is in the nature of pensions that they are complex and rarely understood by members. Very often they show little interest until they are close to retirement. This means that the trustees' role is of crucial importance. The trustee is the repository of a dependence and responsibility to determine best possible outcomes for members. It is why they are so valued.

For that very reason the basic criteria for responsible trusteeship are knowledge, ability, good faith and willingness to act. It is the trustees' responsibility to be on the members' side to act for them. If the communications are not going to make sense, the trustee should do something. If the costs are too high, the trustee should do something. No conflict of interest or lack of willingness to act should ever affect putting the members' interest first.

Trustees will almost always outsource the work of running the scheme – in particular contribution collection, record keeping, investment, benefit payments and member contribution. However, trustees' responsibilities are not reduced by outsourcing. The trustees must always keep tabs on how well these jobs are being done.

Defined Benefit schemes are financially complex. Trustees should recognise that there is no single number that summarises the position of the scheme.

The interests of members are not always the same, and this is one of the greatest challenges for trustees. But no trustee should think of themselves as having being a representative of a particular group of members: all trustees have responsibilities to all members.

Because of the complexity of defined benefit, trustees will always need advice, especially actuarial advice. However, the trustee must not simply follow the proposals of the actuary, but must understand the options available and make informed decisions. If the actuary is not making these clear, ask again. Ultimately if the actuary is not being clear, replace the actuary (which is certainly not the same as saying replace the actuary if you don't like what they are telling you).

The trustees' responsibilities are to the members, not the employer. Any trustee who does not wholly prioritise members' interest should not be a trustee.

The interests of the members and the employer are sometimes aligned but they quite often are not.

The DC reform proposals, about which we recently consulted you, are aimed at improving governance.

Ireland is unique in having a very large number of pension schemes. There are 160,000 Schemes which account for more than half of all pension schemes in Europe (The Netherlands by comparison has only 400 schemes for a population of 16 Million). Small DC schemes, with 50 members or less, make up 99 per cent of all DC schemes and 48 per cent of all active DC membership. This situation cannot be in the best interest of members generally as schemes are usually expensive and do not always deliver the best outcomes including, for example, costs for members; bargaining power in terms of reducing costs is decreased and adequate oversight of governance by the Pensions Authority is difficult to achieve. Moreover, it is doubtful that having upwards of 200,000 trustees is optimal.

But I would like to assure you on one point. It is not the intention of the Pensions Authority to eliminate lay trustees. Technical competence is becoming increasingly important but we cannot lose sight of the fact that trustees exist to represent the interests of pensions fund members. There is a need to reconcile the imperatives of legitimacy through representativeness and of a capability for strategic thinking backed by requisite collective skill and experience.

Since this is my first opportunity to address such an important audience I would like to conclude with some general remarks about the pensions landscape as it seems to me.

Pensions are an important element of the global economy representing $30 Trillion worth of investments. Even in the domestic economy pension funds amount to €100 Billion.

Private pensions in Ireland are regulated within the parameters of the 1990 Pensions Act, but the broad pensions regime is essentially a voluntary one with most large schemes having their genesis in collective agreement between employers and Trade Unions.

In the short time that I have been in office I have heard many people question the sustainability of both the State Pension and Private/Occupational pensions. I think this is a viewpoint that needs to be interrogated in a more forensic way.

According to the CSO, less than 47 per cent of people have any kind of pension provision over and above the State Pension. This is compared to 51.2 per cent in 2009, suggesting that the recession had a significant adverse effect on coverage.

Moreover, we also know that around 90 per cent of elderly people receive a Social Welfare pension and this accounts for 62.7 per cent of their retirement income. Consequently this pension will remain central to avoiding poverty in old age.

The point is that sustainability has both a financial and a social dimension.

The same is true for occupational schemes. For sure it is the case that adverse economic and monetary conditions are increasing liabilities at an alarming rate. But it is also true that FTSE 500 companies have paid out five times more in dividends since the 2008 crisis than they have paid into pensions. An increasing number of large companies are using surplus cash for share buybacks and mergers and acquisitions activity

Of course this is not the case for all companies but my point is that sustainability is as much a distributional issue as anything else. When pension schemes do not produce expected outcomes people can be badly hurt.

Unfortunately, new approaches to accounting standards have had the unintended effect of contributing to an increasing transfer of risk when schemes migrate from DB to DC.

Apart altogether from pension adequacy I cannot see that it is socially sustainable to expect individuals to manage risk in a way that will provide security for perhaps 30 years of post-retirement life. This decumulation phase currently has to be managed without the independent advice of trustees.

In my view it cannot be right in the space of 20 years to move from a no risk to a total risk environment. Some *via media* – whether via defined ambition or other type of collective risk sharing – must be found. The one thing that is definitely not sustainable is a contract based regime of pension provision.

This is an international problem certainly. But all of us in this room have to do what it is in our power to do to protect the interests of our fellow citizens. I found it alarming that in the recent Trinity longitudinal study on ageing (TILDA) that two thirds of people surveyed hadn't a clue what to expect by way of pension.

The ambition of the Pensions Authority, working with the Minister and the Department of Social Protection, is to effect a coherent strategy of reform. This means that we must try to move concurrently on DC reform, the universal 2nd tier pension, and transposition of the IORPII directive. That said our role is advisory and the final policy decisions are ultimately for the Minister.

Providing for a sustainable pensions regime requires a balance between security and viability in circumstances of fragility and uncertainty about the future. It also involves issues of gender, intergenerational and distributional fairness. It would be good if we could arrive at some consensus as a society about these questions.