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Pension reform and the role of the state

Sir, In the old Soviet Union, centralised State planning was much in vogue to ensure the means of production met the needs of the military and consumers. In modern Britain we are not at all sure the State should play such a pivotal role, especially when it comes to directing or influencing consumer behaviour in deferring current consumption for future retirement savings.

The comment from the National Association of Pension Funds (NAPF) that the UK Pensions Commission's recommendation for a National Pensions Savings Scheme was 'Stalinist' goes to the heart of a fundamental argument: should people be compelled or persuaded to save for retirement and what role should the government play? In the UK's case, a half way house is suggested: automatic enrolment coupled with prescribed compulsory contributions to a low cost pension. The State is directing debate on pension reform.

In Sweden the role of the State has been to guide policy direction on the development of a Notional Defined Contribution system along with encouraging individuals to save more effectively on a fully-funded basis. The infrastructure for this is largely State-run, and today Sweden still grapples with the refinements necessary to make the system efficient in respect of determining the ideal number of investment participants.

The United States, by contrast, firmly aligns itself with the notion that generous taxation incentives are necessary to encourage individuals to save for their retirement, largely through 401(k) plans and Individual Retirement Accounts. In effect, the role of State is largely confined to regulation and giving general guidance to industry and employers about the way pension infrastructure should be established and maintained.

Germany and France have turned their backs on the 'Anglo Saxon' approach the State is firmly embedded in directing how an individual saves for their retirement. High social insurance contributions based on a Pay-As-You-Go structure sees high replacement rates in the first pillar, with subsequent retirement savings being 'crowded out' through the high levels of taxation needed to support the first pillar.

Finally Australia and New Zealand seem to be diverging in the role of the state in encouraging retirement savings. Australia has had for the last 20 years some form of compulsory contributions by the employer, on behalf of the employee into retirement accounts. Such a stance has been modified recently with the current government pushing through legislative measures to allow the individual choice of fund over their retirement savings. New Zealand still remains heavily reliant on its first pillar, citizenship based, PAYG pension through New Zealand Superannuation. To address poor second pillar retirement savings, the government intends to develop Kiwisaver that will see automatic enrolment promoted in the work place, with contributions collected and co-ordinated via the taxation system, and pooled and invested via a government agency's direction.

So we see across the globe many countries experience a tension in how the State interacts with the encouragement and development of pension savings. The calls of Stalinism may increasingly occur where stakeholders and vested interests deem that the State has overstepped the public policy line in directing pension savings.

David Harris
Managing director
TOR Financial Consulting

The rise of cross-border pensions

Sir, More and more multinational companies are asking: what are pan-European pension schemes and can they work for us? Pan-European pension schemes are pension funds that are based in one EU member state which have sections applicable to employees based in other EU member states.

The Directive on Occupational Pension Funds (IORPs Directive) provides a common legal framework for pan-European pension plans. There are still remaining issues to overcome, including taxation and the lack of harmonisation of European regulation but the development of pan-European pensions is a logical step in achieving the European Union's key goal: free movement of people and goods within a single European market. It is, therefore, vital that the IORP's Directive is properly incorporated into national legislation.

The Occupational Pension Schemes (Cross–border Activities) Regulations 2005 came into force in the UK on 30 December, 2005, bringing the provisions of the IORP's Directive into UK law. Although many of the requirements of the Directive already existed within UK pension legislation or were introduced by the Finance Act 2004 and the Pensions Act 2004.

If a UK scheme is to continue operating as a cross-border scheme, there is limited time to apply to the Pensions Regulator for authorisation and approval, with the deadline being 29 March, 2006.

Many UK schemes have employees who are seconded abroad to other companies within the group. Such secondments could now unwittingly turn a UK scheme into a cross-border scheme. The consequence would then be that the scheme would have to comply with the requirements of the IORP's Directive and therefore must be fully funded at all times.

It is anticipated that UK companies will prefer to exclude their employees who are on secondment to another EU member state from their UK occupational pension scheme. This is not an intended or desirable consequence of the IORPs Directive. Rather, the aim of the IORP's Directive is to establish effective regulation and a level playing field across the EU member states.

The Department for Work and Pensions and the Pensions Regulator are welcoming involvement and applications from UK pension schemes that wish to operate cross-border. In addition, they are working out arrangements to assist these companies to comply with the cross-border regulations.

Frances Phillips Taft
Of Counsel, International Benefits Practice
Hammonds

Do the PBGC's assumptions overstate liabilities and is it time for a change?

Sir, It is time to reconsider the appropriateness of the Pension Benefit Guaranty Corporation's (PBGC) policy of pricing its product as if it were a private-sector insurance company selling group annuities. A measure that reflects the PBGC's own expected experience, rather than one that incorporates insurance companies' expected experience, along with their sales and marketing expenses and profits, is called for.

When the PBGC first developed its policy, an employer could terminate an underfunded plan at will and transfer it to the PBGC, with the resulting PBGC claim limited to (at most) the plan's underfunding for guaranteed benefits. Against this legal backdrop, the PBGC decided it did not want to be competing with insurance companies.

Had the PBGC offered better pricing than private-sector insurers, virtually all employers would have had an incentive to take advantage of the PBGC's plan termination insurance programme. Thus, the PBGC has been charging employers based on the prices charged by private-sector insurers.

The law has since changed so that only an employer who can demonstrate financial distress is permitted to terminate an underfunded plan voluntarily and transfer it to the PBGC, and now the resulting PBGC claim is for the plan's underfunding for all benefits rather than just for guaranteed benefits. The need for PBGC pricing that matches insurance company pricing has thus been lessened significantly. Only a handful of employers are eligible to turn their underfunded plans over to the PBGC, and the vast majority of those lack the resources even to consider adding the funds needed to purchase annuities for all plan benefits from a private-sector insurer.

Instead, the PBGC, which now has well over 30 years of experience to rely on, should charge employers on the basis of its expected loss resulting from the termination of an underfunded plan. An actuarial determination of, among other things, the PBGC's expected investment earnings would be reflected in the charge. The PBGC's own administrative costs associated with taking the plan over and determining the benefits to be paid would also be included.

The PBGC has also used insurance industry pricing as the basis for reporting its own financial position. This should change too. So long as the PBGC reports its financial position on the basis of assumptions that bear no necessary relationship to the PBGC's own costs associated with satisfying its liabilities, the resulting numbers will not reflect the PBGC's true financial position.

In the interest of the same "transparency" that the PBGC is encouraging employers to embrace, the PBGC should issue transparent financial statements that reflect its true financial position based on reasonable estimates of its own future experience.

Jim Keightley
Partner
Keightley & Ashner
Former General Counsel, PBGC

When investing in Africa, listen to the BBC

Sir, It appears even the most emerging of emerging markets have now come of age. Judging by the interest in the more remote markets of Africa, there is no part of this higher beta quadrant where the intrepid investor will not venture forth.

But tracking down big game on an investment safari in the wilder parts of Africa requires different skill sets than those needed for hunting in the concrete jungles of Stockholm or Singapore.

Whilst the catch-all sector of 'services' increasingly dominates the landscape of the developed economy, frontier markets still have a much more 'natural' feel.

This is because their industries are still concentrated on those sectors which harvest the fruits of our Earth – mining and agriculture – or are built upon admiring the magnificence of that same Earth – tourism. These three flywheels – mining, agriculture and tourism (MAT) – drive every African economy.

So does the portfolio investor seeking returns in Africa start by investing in a listed copper mine, sugar state or beach hotel? Generally not. Whilst there are a handful of listed counters in these sectors, more often there is better game to bag elsewhere.

In my opinion, the best returns are found by tuning into the BBC – 'banks', 'brewing' and 'cement'. And, in the wake of the privatisation wave that has recently washed over the Continent, one might add a 'T' for 'telecommunications'.

So why are the BBC and T's better investment prospects? With MAT collectively generating over 80% of the foreign exchange earned by most African nations, these high profile sectors tend to be the preserve of multi-nationals or, in some cases, the state.

The trick is to find a country where the three primary flywheels are spinning mightily, and then invest in companies that prosper from the consumer spending that is thrown off by these core activities.

Indeed when the flywheels are turning fast, the gearing effect is nearly always a healthy multiple of nominal GDP growth. But there is a caveat. The BBC & T sectors offer little or no protection against the predations of devaluation. Consequently where a nation is living well beyond its means and running a large current account deficit, even great profit growth may not be able to compensate for the haircut to capital values that a sharp fall in the currency would entail.

In short, my rule of thumb with investing in Africa is that, when a nation is powering ahead, tune into the BBC & T rather than the primary generators of that power. But when devaluation threatens, either get out altogether or, buy the primary MAT flywheels. There is nothing like a devaluation to rejuvenate a country's natural competitive advantages: ask Argentina.

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