



Association of British Insurers

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**A Perspective on Pensions in Crisis from Across the Pond –
Speech by Stephen Haddrill, Director General, Association of British
Insurers**

Thank you. I am delighted to step into the breach. It is a privilege to have the chance to share our perspectives from the UK. I will focus on the UK, simply because that is what I know best.

Pension saving in the UK has changed significantly over the last decade. Two years ago money flowing into defined contribution employer schemes exceeded that following into defined benefit schemes for the first time. This reflects the decisions by most employers to limit their liability in response to rapidly increasing longevity.

However, most corporations still have defined benefit schemes. They may be closed to new entrants or closed to new accruals but they remain in being and must be funded. Following the dot.com bubble crash in equities it became evident that many were underfunded. In response the Government set new funding obligations on companies and created a Pension Protection Fund. This supports schemes that fail, paid for by a levy on business.

The recent collapse in markets has left many employers with a hole in their schemes. Some estimate that corporate UK will need to find £97 billion to plug the gap. Not an easy task as we enter a recession, expected to be long and hard.

In these circumstances business is pressing Government to revisit the pensions legislation and reduce their liabilities. The main cause of concern is that the legislation inhibits corporate restructuring and merger. A company that proposes to merge must ensure that its pension scheme is funded fully. This is defined as being the full buy-out value of the scheme's liabilities. No allowance is made for the employers being stronger as a result of a prospective merger. The Government is now said to be considering whether the reduced default risk should be taken into account in calculating the appropriate funding level. That would benefit many corporations but the Government is concerned about putting the Protection Fund at risk.

That word, default, summons up the question that many, many people are asking. How secure are the insurance companies that stand behind UK pensions?

The industry's view is absolutely clear. It is safe and stable. It went into the crisis in good shape and remains robust. Over the last eight years it has reduced its equity expose greatly.

But what about its bond holdings – are they safe? The regulator requires the industry to hold the best quality instruments and for the time being it is allowing insurers to ascribe the marking down of bonds in the markets to problems of liquidity, not to a greater likelihood of default. It will review that position in the New Year.

Consumers in the UK can also take comfort from the Financial Services Compensation Scheme which guarantees pension savings pots and annuities at 90 per cent of their value, with no upper limit. This is important. As DC schemes are relatively new the average pension pot is relatively small and annuities are small too. The average pot on retirement is about \$38,000, producing an annuity of \$2,800 a year. Not much, but it is paid for life and people who have little do not want to lose it. After all, it represents a 40 per cent addition to the basis state pension. The Compensation Scheme should give people real confidence – or would if it was better known.

With such security, with the tax incentives that attach to pensions, with the housing market falling and with financial markets having exhausted much of their downside risk, money should start to flow into defined contribution schemes. Should, but it is not. Savings rates remain stuck at low levels: the lowest in the UK for fifty years.

Having been on a binge of debt, every spare penny is going into reducing their loans, not into saving more for old age. Perhaps in time the picture will change, but with average household debt at 170 per cent of average household income that will take time indeed.

The Government has no immediate answer to this. Indeed its apparent plan to reduce tax rates for those on lower incomes will reduce the tax incentive to save in a pension and may make the problem worse.

However, looking a few years ahead, it does plan to introduce a new money purchase pension scheme in 2012. It will require all employers who do not already have a good pension scheme to set up a standard low cost pension and automatically enrol all their employees into it. The employer will contribute 3 per cent of earnings between £5,000 and £33,000. The employee will put in 4 per cent and the state one per cent. Employees can opt out if they wish but the Government estimates – optimistically in my view – about three quarters will stay in.

The Government has agreed that after 2012, employers with existing good insurance-based pension schemes should also automatically enrol. We are now

calling on them to allow that immediately to boost saving. We are also urging them to mount a major campaign to explain the need to save for retirement.

And we are pursuing other ways to boost confidence in pensions and savings. We have called on the regulator to improve the quality of sales intermediaries whether agents or independent advisers. We wish to see adviser commission and the bias it causes in sales eliminated. We also want to see higher professional standards in the advice giving industry. It appears that later this month the FSA will set out proposals to deliver both those goals over the next three years. If that is what they do, we will welcome it wholeheartedly.

Poor experience of advice has damaged confidence for too long. And commissions have encouraged too much churning of investments. Our research showed that 50 per cent of pensions are surrendered after only four years, creating cost for little if any benefit.

So the regulation of sales may be about to change. What about other areas of regulation?

In the UK we have confidence in prudential regulation. There is, however, one area that concerns us. Fair value. To be clear we do support fair value for accounting purposes. But not in all circumstances for regulating capital. There does come a point as markets crash when fair value becomes pro-cyclical. Regulators need to judge when such rules must be suspended.

That does not mean abandoning fair value for accounting, nor for regulatory purposes in almost all conditions. It is just a practical response to extreme circumstances. And regulators should plan for it and explain it in advance so that it does not signal panic to the markets. Let's write the warbook before the war starts.

What else is there for the regulator to do? Greater transparency through regulation of hedge funds and credit rating agencies would help. And existing rules for all sectors need to be better supervised and enforced by better qualified people.

We also look to regulators to collaborate better. At the moment, for insurance and pensions collaboration is virtually none existent. Indeed it is fading from view. To quote one leading insurance regulator, "of course we must collaborate, but we all hate each other".

The current crisis has shown what contagion means. How risk can spread across markets. And yet regulators seem determined to be nationalistic. The Irish unilaterally guarantee deposits, and half a world away, Hong Kong and Singapore have to follow, without substantive need to do so.

In Europe, regulators were on the point of agreeing in Solvency II to a system of cross border capital requirements for multinationals and lead supervision from the company's home state. In the turmoil politicians are threatening to remove those provisions. They are likely to be lost just as they are needed. An opportunity to make insurance capital more flexible may be denied. We face protectionist anxieties. Well, we all know where that led once before.

So much for what we ask of regulators. What should we ask of ourselves. Markets should as far as possible regulate themselves. Clearly they have not. Corporate governance has failed. Pension funds and life companies are major institutional shareholders. We hold stock and bonds for the long term. We want to see stable markets. In the UK shareholders have extensive rights, over the appointment and pay of directors, over the conduct of capital raising and, in scrutinising the work of the audit committee, over the management of risk. It is our job to exercise those rights to protect the interests of fund beneficiaries, often poor people with small investments.

Well, it seems to me that there is room for improvement in how well we do this. Better consultation is needed of beneficiaries by trustees and fund managers. More active use of our rights in voting is also called for. If we do not do so we will see our rights removed, replaced by rules policed by regulators not by markets.

And that would be wrong. Rules police yesterday's problems. Rules leave too many gaps in which bad behaviour can develop. Dynamic markets need active shareholders flexibly and quickly expressing a clear view on new risks. We can do and must do it better.

To achieve that we need to be more interventionist. We also need to secure stronger rights in many countries across the world. Shareholders, unlike regulators, look across national boundaries. They know what is going on elsewhere in the world. But without similar and strong rights in all countries they are hampered.

The weakness of shareholder rights in the US, at the heart of capitalism and in the largest capital market undermines their effectiveness not just here but in the rest of the world. We hope that will now change. We hope Congress will not focus narrowly on new restraints on markets but will empower shareholders to markets work better.

Ladies and gentlemen, thank you for listening to these reflections. In the UK and across Europe we have a hard road ahead. The pensions market is an innovative place in the UK but is not well supplied by its raw material – savings. Confidence will be slow to recover. But perhaps the Government's plans to promote a new pensions scheme will change our culture of consumption and, if so, the industry will be able to benefit. It is and will remain sound. And in current circumstances that at least means rather a lot.