Political risks for defined benefit pension schemes in the next Parliament

General Election, May 2015

CICERO

PENSION INSURANCE CORPORATION

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Pension Insurance Corporation plc (PIC) provides tailored pension insurance buyouts and buy-ins to the trustees and sponsors of UK defined benefit pension funds. Clients include FTSE 100 companies, multinationals and the public sector.

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About Cicero

Cicero Group is an integrated communications agency. Its political risk team specialises in analysing the impacts of politics and public policy on companies and markets.

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Introduction

Elections matter for markets and they matter for the pension system. They matter particularly for defined benefit (DB) schemes because liabilities are set on the basis of gilt yields which are uniquely exposed to political risk. Trustees of DB schemes should therefore think carefully about what this election could mean for their scheme and its members.

To illustrate the point, think back to the 2010 election. The bond markets were looking on watchfully as a highly indebted country with a dysfunctional banking system and no party holding a majority formed a new government. Ten year gilt yields were around 3.7 per cent.[1] A political crisis could easily have tipped into a sovereign debt crisis and a run on sterling. Under these circumstances David Cameron and Nick Clegg forged a coalition which, perhaps against the odds, has delivered five years of stable government. Given that backdrop, few people would have predicted that 10 year gilt yields would have fallen to 1.7 per cent.[2]

In power, the Coalition – in concert with the Bank of England – has pursued an unprecedented economic strategy combining quantitative easing (QE) with fiscal retrenchment. It has also introduced numerous reforms to the pension system. These policy choices have had a deep impact on DB schemes, their funding levels and their sponsors.

The road ahead

What might the 2015 election mean for DB schemes? While there is no longer any sense of impending crisis, the UK still faces some very significant challenges – including a debt to national income ratio of 80.2 per cent[3] in 2015, a wide current account deficit and chronically low productivity. The economic strategy of the next government will have an equally significant impact as that of the last. Yet the uncertainty surrounding this election raises concerns that the health of the economy – and therefore of DB schemes – could be put at risk.

This report

The politics of the 2015 election are unique and could provide a number of different outcomes.
This report looks at different scenarios for the election and considers what they might mean for the following areas:

- DB scheme assets and liabilities
- Companies that sponsor DB schemes
- Regulation of DB schemes
- The future of the pension system

The purpose of this report is to help trustees think about the political risks ahead in a world where the financial and political are inextricably linked. It is not about making bold predictions for the future, but about framing the potential risks and opportunities in the years ahead.

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[1] http://www.tradingeconomics.com/united-kingdom/government-bond-yield

[2] http://www.tradingeconomics.com/united-kingdom/government-bond-yield

[3] Office for Budgetary Responsibility (OBR) figures

Key things to think about

An uncertain outlook for the next Parliament…

- The next government will have a huge influence over the economic direction of the country at a key point in the post-crisis recovery.
- There is considerable uncertainty about the shape of the next government. The polls indicate that no party will achieve a majority. It is unclear which party will lead the next government and what support that minority government would need to call on from other parties.
- There are three likely outcomes: a Conservative minority acting with the support of the Lib Dems and DUP; a Labour minority acting with the support of the SNP and/or Lib Dems, Plaid Cymru and possibly the Greens; or, a total deadlock, which could result in a second election.
- Each of these outcomes carries additional medium-term risk in the form of possible referendums on Brexit, or on Scottish independence. All have risks for DB schemes.

…which carries numerous risks for DB schemes

Assets and liabilities:

- The UK remains highly indebted and has a large budget deficit even after five years of spending cuts. Both Labour and the Conservatives agree on the need for further deficit reduction, though they differ on its pace and how to achieve it.
- According to the Institute for Fiscal Studies, the budget plans of the major parties 'leave much unanswered'.[4] If sovereign debt markets lose confidence that the next government will deliver a credible fiscal plan, gilt yields, currently at record lows, could rise sharply. This would bring short-term gain by reducing the liabilities of DB schemes which are calculated with reference to gilt yields. However, it could result in long-term pain in the form of depressed asset prices and lower economic growth. This could also negatively affect the strength of sponsor companies.
- On the other hand, a government which is seen as a credible steward of the economy could mean a fall in yields, increasing scheme deficits in the short-term. However, schemes may benefit as the economy strengthens in the longer term.
- A stalemate could cause short-term volatility in markets. Without the formation of a stable, credible government, this could precipitate longer term economic problems.

[4] http://www.ifs.org.uk/publications/7726

Strength of companies that sponsor DB schemes

- Companies are struggling to close DB scheme deficits, which reached a record high of £367.5bn in January 2015.[5] This may be partly to blame for low levels of business investment. If this is coupled with new and unwelcome regulation, we could see a significant slowdown in the growth of UK plc. It is important, therefore, that the financial strain placed on sponsor companies by funding shortfalls is not exacerbated by political risk.
- The Conservatives in government have pursued policies to make the UK more competitive, for example by cutting corporation tax rates. However, business is concerned about the potential impact of an In/Out referendum on EU membership. Uncertainty about the UK's future in the EU could prove a drag on investment and may cause volatility in sterling and sterling-denominated assets.
- Labour's manifesto indicates that it will take a tougher stance on business – including substantial interventions in a range of consumer markets, leading to concerns from some business leaders that this could affect economic competitiveness. However, Labour has effectively ruled out an EU referendum, which is broadly welcomed by business.
- A prospective second Scottish Independence Referendum would add a further layer of uncertainty; the SNP, with a large number of Westminster MPs and Scottish elections in 2016, could put the issue back on the table in the next Parliament regardless of which party is in government.

Reform of the pension system

- Pensions remain an area of considerable political interest. After a major overhaul of the pension system in this Parliament, further reform in the next Parliament is inevitable. For example, we will see further erosion of the tax benefits for saving in pensions – and potentially the continuing shift towards the 'ISA-risation' of the pension system. We will also see the impacts of the recently introduced pension freedoms, which could present challenges for DB schemes in the form of transfers out into defined contribution (DC) schemes. The constant flux in the pension system will continue to be challenging for trustees.

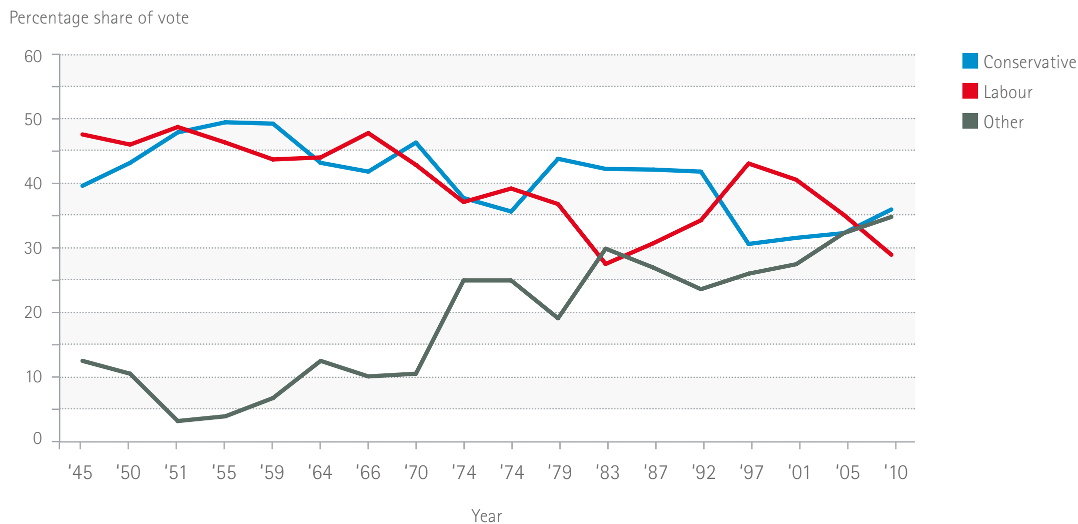
[5] http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/PPF_7800_underlying_data.pdf

Scenarios for the 2015 election

Why this election is different

The 2015 General Election will be the most closely contested election since 1974. However, unlike the February 1974 election, which was contested primarily between the two largest parties – Labour and the Conservatives – 2015 will include more players. This follows the long-term decline of two-party politics in the UK – as indicated by the decreasing total vote share of Labour and Conservatives and the increasing vote share of 'other' parties.

Figure 1: The decline and fall of Conservative and Labour party dominance, 1945 – 2010



Source: *House of Commons Research Paper 12/43*

Importantly, the SNP has changed the voting dynamic in Scotland and the UK more widely in a way that would have seemed outlandish even a year ago. It now looks on track to win over 40 seats, potentially making it pivotal after the election. The Lib Dems, while diminished, are the party of the centre ground and may still have a role to play in the formation of the next government. Meanwhile, UKIP and the Greens will split votes for the 'Big Two' in key marginals, though they may win few new seats.
With all this considered, what will the government look like post-May?

What we know about this election

While this election is unpredictable, there are a few near-certainties:

- Neither the Conservatives nor Labour will win enough votes to govern as a majority – the winning post for a majority is 325 seats[6] – and current polls suggest no party will win more than 290.
- Therefore the parties would have to govern in one of the following ways, from the least stable to most stable:
  - In minority, on a vote-to-vote basis – essentially a government surviving hand-to-mouth negotiating every vote;
  - On a 'confidence and supply' basis, where other parties agree to support the government's Budget and Queen's Speech in return for concessions; or
  - A full coalition, which is a formal agreement for two or more parties to govern in partnership with an agreed policy programme.
- There are unlikely to be any 'grand alliances' matching right-wing parties with left-wing parties. A Conservative-SNP alliance would be all but impossible, as would an alliance bringing together Labour with UKIP.

Constitutional upheaval

- Under a Conservative government Brexit is a risk. If the Conservatives can get the votes to pass the legislation required, a referendum would be held on EU membership in 2017 at the latest. The Lib Dems have said they would support attempts to legislate for a referendum in coalition, but would campaign in favour of EU membership.
- Either a Labour-led or Conservative-led government could potentially place Scottish Independence back on the table – either because the SNP demand a concession on another referendum from Labour in exchange for support or because a Conservative-led government would have almost no mandate from Scotland, therefore raising a question about its democratic legitimacy north of the border. A vote to leave the EU that went against the wishes of the Scottish people would also likely lead to a call for a further independence referendum.

[6] Technically, it could be as low as 318 if the Speaker, Deputy Speakers and Sinn Fein MPs – who do not take their seats – are excluded

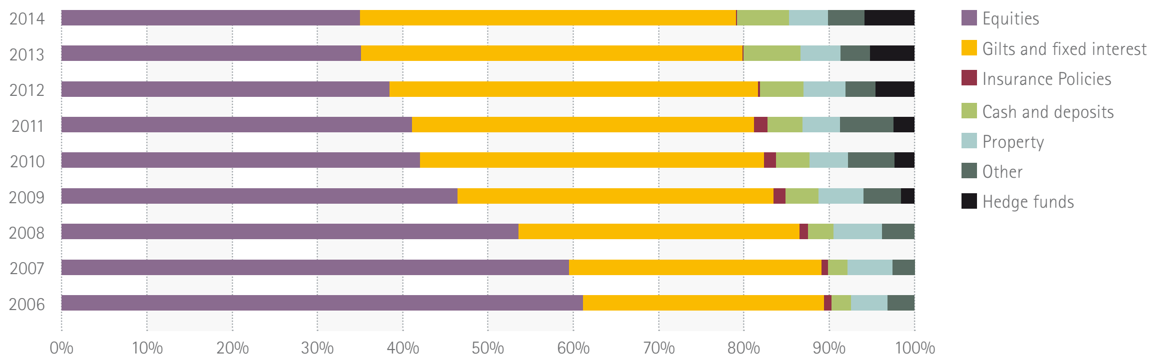
What the election means for DB scheme assets and liabilities

What might the 2015 election mean for the £1.3 trillion of assets and almost £2 trillion of liabilities of DB schemes?[7]

At the present time, the ECB's QE programme and the hunt for yield appear to be driving markets more than political risk arising from this uniquely unpredictable election. However, at the time of writing, there was evidence that international investors were selling gilts in response to political uncertainty ahead of the election.[8]

Had we been looking at this question ten years ago, equities would have been a bigger focus of the report. However, as the chart below shows, there has been a dramatic shift away from holdings of equities towards gilts, corporate bonds and other assets. This has been a result of schemes looking to match their assets and liabilities more closely. For this reason, the impact of the election on these asset classes is particularly important.

Figure 2: Average asset allocation by year



Source: *Table 7.2, PPF Purple Book, 2014*

[7] http://www.pensionprotectionfund.org.uk/News/Pages/details.aspx?itemID=393 – as at end March 2015

[8] http://www.ft.com/cms/s/2/8bc337c8-e206-11e4-bb7f-00144feab7de.html#axzz3YWDk3uD1

Impact of the election on gilts

State of play

Despite UK public debt growing to more than 80 per cent of national income this year, an annual fiscal deficit that is wide by European standards at around 6 per cent, high levels of private debt and a current account deficit of over 5 per cent, the bond market is remarkably sanguine.[9] Indeed, yields have fallen to unprecedented lows. This has made life difficult for DB schemes, which discount liabilities based on gilt yields. In other words, the low yield environment has made DB scheme deficits bigger.

This low yield environment can largely be explained by three factors:

1. The suppression of yields caused by the QE programmes, first and most directly in the UK, in the US and now in Europe.

2. Strong post-crisis demand for 'safe haven assets' – primarily bonds issued by historically creditworthy governments such as the UK, driven by financial regulation and reduced appetite for risk.

3. Market confidence in the UK government's fiscal and monetary policy, even if the pace of deficit reduction originally outlined by George Osborne in 2010 has been dramatically slowed down.

The ability of the UK government to issue debt cheaply has therefore been partly due to external factors and partly due to a perception that the Cameron government has been a credible steward of the economy. This latter perception could be at risk after the election.

Where next?

It is our view that bond markets currently take a 'glass half full' view of the UK, and that this sentiment could be tipped over to 'glass half empty' by the perception that an incoming government (or lack of government) will put public finances at risk. This would be accompanied by an increase in yields. The following scenarios are possible:

- The clearest immediate risk is our 'stalemate' scenario where a lack of political direction could see flight from sterling-denominated assets in the short-term. This would cause market volatility which may only be repaired by the formation of a stable, fiscally responsible, government – possibly after a second election.

- A Labour-led government could see a rise in yields if markets grow suspicious that it will increase borrowing to fund public spending, especially if supported by the anti-austerity SNP. Labour has attempted to reassure markets by saying that none of their manifesto commitments will be funded by unannounced borrowing and that it will reduce the deficit each year. However, the reality is that its deficit reduction plan is less sharp than the current government's.

[9] http://cdn.budgetresponsibility.independent.gov.uk/March2015EFO_18-03-webv1.pdf

- A Conservative/Lib Dem government, which represents some level of continuity, could see steady yields as the 'known quantity' remains in power. However, anticipation of a possible post-referendum exit from the EU could reverse this and see gilt yields increase, as could a loss of fiscal discipline.
- Finally, either outcome from this election potentially places Scottish Independence back on the table in the medium-term. HM Treasury has previously said that it would stand behind the entire stock of national debt.[10] However, a break-up of the Union would raise questions about the creditworthiness of the new Scottish sovereign and may lead to a reassessment of the sovereign risk of the remaining UK.

In summary, whilst the low yield environment has been helpful for the government, by holding down borrowing costs, it has proved a challenge for DB schemes trying to close funding gaps.

A return of gilt yields towards a 'normal level' could be helpful for DB schemes, so long as there was no material risk of default and that there was confidence that the UK could bear the higher cost of borrowing. Sterling would be likely to weaken, which could have the beneficial effect of reducing the current account deficit and counteracting deflation.

However, if this happens in a disorderly fashion and is viewed as a loss in confidence in UK economic policy, the longer term impacts would be very detrimental to the economy. In this sense, short term pain for DB schemes in the form of low gilt yields widening deficits may well be worth bearing in return for long term gain from a more positive economic outlook and higher asset prices.

Next Governor of the Bank of England and the future of QE

The Bank of England Governor Mark Carney will complete his five year term in summer 2018. He has indicated he will not seek another term – meaning that whoever is Prime Minister at that time will be charged with appointing a new Governor. The key question is how the Bank of England's £375bn of QE holdings – primarily gilts – will be managed. Will they be held to maturity, sold or simply cancelled? These are important questions for the future of gilt yields and, by implication, the level of DB scheme deficits. A new Governor would have a key responsibility in determining this strategy, so the choice is an important one.

[10] https://www.gov.uk/government/publications/uk-debt-and-the-scotland-independence-referendum

Impact of the election on UK equities

State of play

QE is designed to boost risky assets and this is one of the key reasons UK and global equities have performed well. The ECB's QE programme is having a similar impact in Europe. In the UK, only 35 per cent of DB scheme assets are now held in equities of any kind. Of that equity component, UK equities now form less than one-third.[11] Taking into account the fact that perhaps 75 per cent of FTSE 100 revenues are earned overseas,[12] the exposure of schemes' equity holdings to the performance of the UK economy is increasingly limited. However, confidence in the UK economy overall is important for schemes and is therefore worth attention.

There is no doubt that some industries are particularly exposed to political risks, in particular highly regulated industries such as finance and energy. One of the UK's most successful fund managers, Neil Woodford, underlined the potential impact on equities when he told The Telegraph recently "Many [previous elections] have, quite frankly, been pretty unimportant for stock markets and equity asset prices particularly in the UK. I think now we're in a slightly different place."[13]

Where next?

The performance of equity markets cannot be easily isolated from the impacts of QE, which has clearly driven asset prices up. The FTSE was trading at around the 7,000 mark as of 27 April 2015 – but the election could spark a risk off-period.

- Under a stalemate or highly unstable minority government, lower levels of investor, business and consumer confidence would weigh on the index in general terms. Investment flows may be diverted to other opportunities outside of the UK until a stable government is formed.
- Under a Labour-led government, political risk could weigh on particular sectors such as banking and energy due to proposals to instigate substantial reforms of market structure. This could affect shares in large banks and the big four energy companies. There would also be apprehension about market intervention and higher levels of corporate taxation – particularly if reliant on SNP votes.
- Under the Conservatives, the prospect of a Brexit referendum could prove to be a headwind for investment, particularly for firms reliant on open access to the European Single Market. This may not be priced in immediately, but would become a bigger issue as companies begin to discuss the risk of Brexit in their financial reporting.
- In the longer-term, the issue of Scottish Independence could be raised again, impacting particularly businesses domiciled in Scotland but with significant interests across the UK.

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[11] http://www.pensionprotectionfund.org.uk/Documents/purple_book_2014_chapter7.pdf

[12] https://server.capgroup.com/capgroup/Content/GIG/Europe/pdf/CoD_UK_press_release.pdf

[13] http://www.telegraph.co.uk/finance/personalfinance/investing/11512830/Neil-Woodford-on-avoiding-future-turmoil.html

Impact of the election on infrastructure investment

State of play

The UK, in common with many Western nations, has a need for infrastructure investment in areas such as energy, transport, health and communications far beyond what can be funded out of general taxation. There is an increasing recognition that long-term investment from pension funds and insurance companies may help bridge the gap.

Only insurance companies and the largest UK pension schemes have the necessary scale to make direct infrastructure investments to compete with, for example, the Canadian pension funds. These projects are very long-term in nature and generally have government support, either explicitly or implicitly through a regulatory or tariff driven regime.

From the perspective of DB schemes, infrastructure investments can be attractive as they often offer long-dated, inflation-linked debt which is suitable for liability matching. However, there is concern that the UK lacks the long-term decision making and planning apparatus required to create a pipeline of infrastructure investment opportunities suitable for pension funds. There has also been some concern that sovereign wealth fund investment, which this government has courted, has crowded out pension fund investment.

Where next?

Infrastructure is certainly no panacea, but it is a valuable component in the investment mix as schemes seek out assets with a higher return than gilts, but which also generate the cash flows to match liabilities. A more coherent long-term policy on infrastructure could kick start pension fund investment in infrastructure assets.

- It is possible that we see some level of 'pork barrel' politics emerge in the next Parliament i.e. where public funds are diverted to certain regions in order to secure political support. The SNP, for example, has already said they would only support HS2 if it starts in Scotland. Decisions made on the basis of political expediency are likely to be poor investment opportunities. Indeed, they may displace more rational infrastructure investments.
- Labour is offering a concrete reform of long-term infrastructure policy by creating an independent National Infrastructure Commission, which would set long-term plans for infrastructure to then be approved by Parliament. This, on balance, should create more visibility on investment opportunities and allow greater certainty for investors.
- Conservative infrastructure policy hinges primarily on mega projects – such as London airport expansion, HS2 and nuclear power. A greater array of smaller projects may be more appropriate for most investors. However, a focus on localism and devolving decisions to local authorities, such as Manchester could provide a promising pipeline of investment opportunities.
- A potential rerun of the Scottish Independence Referendum could carry risks for infrastructure bonds issued for projects in Scotland. The uncertainty around this might throw into doubt potential investments in Scotland, as we saw prior to the referendum last year.

Infrastructure in the manifestos

Labour manifesto infrastructure commitments:

- Set up a National Infrastructure Commission to take a long-term approach to major investment decisions.
- Create a state rail firm to compete with failing rail franchises.
- Devolution of £6bn a year in housing, infrastructure and transport funds to local authorities representing city regions.
- Support the construction of HS2 but ensure costs are kept down.
- Improve and expand rail links across the North to boost regional economies.
- Make a swift decision on expanding airport capacity in London and the South East.
- Introduce greater transparency in the land market and give local authorities new 'use it or lose it' powers to encourage developers to build.

Conservative manifesto infrastructure commitments:

- Investment of over £100bn in infrastructure over the next Parliament and continuation of the National Infrastructure Plan.
- Continue with construction of HS2.
- Create a Northern Powerhouse through transport improvements.

What's up for grabs?

- Green investments – including wind, solar and tidal power.
- Future of nuclear power in the UK.
- London airport capacity.

What the election means for the strength of sponsor companies

State of play

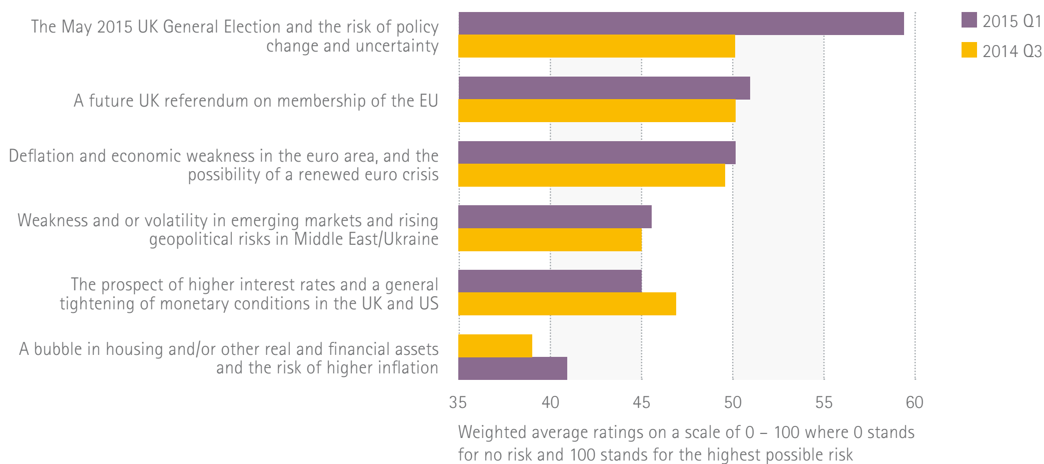
"Perceptions of political uncertainty have dampened corporate risk appetite and fed through to a softening of investment intentions. A majority of CFOs told our Q1 2015 survey that they foresee adverse changes on regulation and taxation. Their expectation is that post-election changes will be negative for fiscal, monetary and labour market policies."

Ian Stewart, Chief UK Economist, Deloitte

Companies are struggling to close DB scheme deficits. According to the Bank of England this drain on company finances may be curtailing business investment and lowering dividends.[14] There are some concerns that this drag on investment is partly to blame for the UK's poor productivity. With deficits reaching a record high – £367.5bn in January 2015 according to the PPF – the problem is not going away.[15] If this is coupled with new and unwelcome regulation, we could see a significant slowdown in the growth of UK plc. It is important, therefore, that the financial strain placed on sponsor companies by funding shortfalls is not exacerbated by political risk.

It is of some concern that against the backdrop of a relatively positive economic outlook, the two biggest risks to business identified in Deloitte's regular CFO survey relate to the forthcoming election. If political risk arising from the election weakens the corporate sector it would be negative for DB schemes which are reliant on sponsor companies. This section looks at what those political risks could look like in practice.

Figure 4: Risk to business posed by the following factors



Source: *Deloitte CFO Survey, Q1 2015*

[14] http://www.bankofengland.co.uk/publications/minutes/Documents/mpc/pdf/2015/mar.pdf

[15] http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/PPF_7800_february_15.pdf

Where next?

Polling suggests that business considers a Conservative-led government preferable. This is partly born out of perceptions that Ed Miliband either does not understand business or is instinctively hostile to it. There have been some rather lurid headlines about a Labour government being 'catastrophic' in the words of one senior business leader. This risk is overplayed. However, there are legitimate concerns that a Labour-led government would toughen its stance on business.

On the other hand corporate Britain tends to regard Conservatives as instinctively pro-business. However, a Conservative-led government brings risks of its own. First, a Conservative minority could easily choose to pursue a more consumerist and less business-friendly agenda in order to shore up support. Secondly, business is worried about the risks from a potential Brexit from the UK under the Conservatives – an eventuality that is not open under a Labour-led government.[16] In other words, all outcomes from the election carry political risk.

How hostile will the post-election environment be for business? In this section we have identified a range of policy areas where the parties have stated policy – and looked at how they might affect sponsor companies.

[16] http://www.theguardian.com/politics/2015/apr/07/british-business-leaders-back-tony-blair-warning-over-possible-eu-exit

Possible business policies arising from different government formations (High/Medium/Low impact)

Policy area	Labour-led	Conservative-led	Stalemate
Business Policy	**High:** Ed Miliband's promises of significant government intervention in markets is of concern to many business leaders. Intervention will mainly focus on firms that affect household finances – utilities, banks, house builders etc. Likely to refocus Foreign Office away from commercial diplomacy agenda.	**Medium:** Cameron and Osborne are typically regarded as pro-enterprise. However, they are also keen not to be seen as 'soft on business' so consumer-focused policies likely to be a major feature of next Conservative government. Will preserve commercial diplomacy mandate for Foreign Office.	**Medium:** Risk of anti-business populism becoming a feature of a stalemate.
EU/In out	**Low:** No referendum on EU membership – preserves status quo.	**High:** Referendum on EU membership by 2017 – a major concern for business leaders.	**Low:** The EU question will remain on the table, but no legislation for a referendum.
Scottish Independence rerun	**Medium:** The SNP's price for support of a Labour minority could include further fiscal powers – and could include a timeline for another referendum.	**Medium:** The SNP may use lack of mandate from Scotland for a Conservative-led government as a reason to call for another referendum. If UK votes as a whole votes to leave the EU in a referendum, it is a certainty that the SNP would demand another referendum.	**Medium:** Stalemate in Westminster may lead to calls that Scotland is best run from Edinburgh.
DB schemes	**Medium:** The size of liabilities may shrink in the short-term if gilt yields rise due to shifting market perceptions – giving sponsor companies breathing room on the liability side. However, the longer-term situation may be negative *if* the fiscal outlook of the UK deteriorates and asset prices fall. This would prove a serious burden on sponsor companies.	**Medium:** The current perception of Conservative fiscal discipline may hold down gilt yields, creating pressures on the liability side of the equation in the short term, forcing sponsor companies to fill the gap. In the longer term, fiscal rectitude – if maintained – could pay off in the shape of stronger economic performance and higher asset prices.	**High:** Potential for significant short-term dislocation in markets. Long-term outlook uncertain Unpredictability could prove very negative for sponsor health.

Policy area	Labour-led	Conservative-led	Stalemate
Corporate Taxation	**Medium:** Corporate tax rate will remain at 21 per cent and most competitive in G7. General principle that 'those with the broadest shoulders' should carry the highest burden will inform tax policy. This could mean windfall taxes on certain industries. Potential review of the Controlled Foreign Companies regime. Likely to be a major focus on tax transparency, compliance, and scrutiny of the use of offshore financial centres.	**Low:** Corporate tax will decrease to 20 per cent as planned and remain most competitive in G20. Tax transparency will moderately increase and will incorporate business thinking. Strong and proven Conservative commitment to lowering tax burden on firms (apart from banks). Implementation of 'Google Tax' to prevent artificial profit shifting.	**Medium:** Outlook for corporate taxation uncertain but rate will decrease to 20 per cent as planned.
Regulation	**High:** Energy price freeze and market share caps for banks indicate interventionist approach which could damage business confidence and investment.	**Low:** Will cut £10bn of red tape over next Parliament through the Red Tape Challenge and One-In-Two-Out rule.	**Low:** Unlikely to be substantial new domestic regulatory initiatives.
Sterling	**Medium:** Potential for sterling to weaken if deficit reduction is slowed.	**Medium:** Risk of EU exit would lead to volatility in sterling market.	**High:** Markets will be concerned by uncertainty and political instability.
Research and development/ innovation	**Medium:** New long-term funding policy framework for science and innovation will provide stability, but no financial commitment made.	**Medium:** Invest £6.9bn in the UK's research infrastructure up to 2021, but no commitment to increase spend as proportion of GDP, in line with other developed nations.	**Unlikely to be any major changes**
Governance and transparency	**High:** Heightened scrutiny of executive pay, tax arrangements and board diversity.	**Medium:** Support for voluntary improvements in governance, transparency and long-termism.	**Unlikely to be any major changes**

Policy area	Labour-led	Conservative-led	Stalemate
Immigration	**Medium:** No significant change in direction. Cap on workers from outside the EU will be maintained.	**High:** More stringent immigration controls including extending 'deport first, appeal later' rule to all immigration appeals and judicial reviews.	**Medium:** No change, with no liberalisation for high-skilled immigration.
Labour market regulation	**Medium:** Increase in National Minimum Wage to £8 an hour by 2019 and ban 'exploitative' zero-hour contracts.	**Medium:** Increase in National Minimum Wage to £8 an hour by 2020. Reform industrial action rules to make it harder to strike, particularly for essential services.	**Medium:** Continuity with current rules.

What the election means for the regulation of DB schemes

State of play

An incoming pensions minister is going to be faced with a range of important decisions. The Coalition government has seen pensions policy dictated largely by the Lib Dems, with Steve Webb taking a strong lead within the Department for Work and Pensions. This has led to a particular policy direction which could change following the election.

Where next?

Prospects for Defined Ambition (DA), Collective DC and alternatives

Rising longevity continues to push up the cost of providing DB pensions. Every year, improvements in life expectancy add another 40 days to the lives of the average citizen.[17] The closure of such schemes is now widespread. Whereas 67 per cent of such schemes were closed to new members in 2008, this had risen to 84 per cent by 2013.[18]

The prospects for the further development of DA pensions may be limited. These proposals – contained in the government consultation paper, 'Reshaping workplace pensions for future generations' published in 2013 – set out a range of options including a move towards conditional indexation and new freedoms for sponsors to change the scheme Normal Pension Age (NPA) in line with changes in longevity assumptions. Two years on, and faced with a potential change in government, the impetus for such reforms may be fading. One voice at the regulator said the proposals were a 'ministerial hobby horse' likely to die once the incoming pension minister takes office in May 2015.

Unlike the Netherlands, which has been proactively engaged in a process of reducing liabilities in its pension funds (for example, legislation was enacted in 2014 to introduce DA pensions), the mood in the UK remains somewhat cool towards DA. The Pensions Policy Institute has highlighted the cost to DB scheme members as a result of removing the statutory indexation for future accruals at around 5 per cent of member's salaries.[19] It would be highly unlikely that a future Labour pensions minister would consider such reforms given the potential impact on highly unionised workforce in the public sector. More fundamentally, the policy debate surrounding the legislative change to liabilities of such schemes is unlikely to have a major impact on dealing with the current funding issues facing DB schemes. With well over 80 per cent of schemes closed to future accruals or new members, the liabilities associated with pre-2016 accrued rights are likely to dominate employers' funding positions. Proposed legislative changes will have only a marginal impact in reducing DB schemes' costs.

[17] http://www.telegraph.co.uk/news/health/elder/8459936/Life-expectancy-rises-by-44-days-in-just-one-year.html#disqus_thread

[18] http://www.pensionspolicyinstitute.org.uk/briefing-notes/briefing-note-65-defined-ambition-in-workplace-pension-schemes

[19] Defined Ambition in workplace pension schemes, PPI Briefing Note Number 65

Fixing the funding conundrum: closing deficits in a low yield environment

The biggest challenge over the coming five years will be the need to review, and potentially amend, the current regulatory approach to funding pension liabilities. Politicians of all political persuasions will be tempted to kick the pension deficit ball into the long grass. If politicians can defer taking action, then it is highly likely that it will be left for a future Parliament beyond 2020. But events might dictate that the politicians need to act earlier. The sheer scale and speed of the impact of low yields on pension funds is demonstrated in the Netherlands, where schemes held assets covering 152 per cent of their promised benefits in 2007. This had fallen to just 102 per cent by 2012 on the back of low interest rates which have the effect of making liabilities balloon.[20] In that country the regulators were forced to intervene. A similar move could be on the cards in the UK.

The current rationale underlying the regulatory approach is that pension fund deficits will eventually come good. The Pensions Regulator's (TPR) statutory requirements were updated in July 2014 to incorporate the need to minimise any adverse impact of funding pension obligations on the sustainable growth of the sponsoring employer. This 'softer' regulatory requirement takes some of the pressure off employers to increase their contributions levels. There are questions being asked within Parliament, and by the regulators, about whether we should be more worried about schemes that are never likely to be 100 per cent funded. However, the regulators seem to be content as long as sponsors can meet their current liabilities and have sufficient recovery plans in place. The UK's current approach is in sharp contrast to that adopted in other major pension fund markets such as the Netherlands, where funds are required to maintain 105 per cent funding of asset over liabilities at all times. In contrast to the Dutch approach, where almost all funds enjoy a surplus, over 80 per cent of UK pension funds are currently in deficit.[21] Given UK schemes have latitude to set longevity assumptions, the comparison between the UK and the Netherlands may be even less flattering than these figures suggest. Regulators have themselves acknowledged that the UK's approach is perhaps too principles-based and doesn't focus sufficiently on the hard numbers – though changes that risked driving lots of sponsor companies into insolvency would clearly be unpalatable. A more quantifiable European-styled approach to measuring and managing deficits could be on the cards. For now, policymakers are still sticking with the current long-term plan for nursing DB funds back to good health.

Under the current regulatory approach, the anticipated tipping point is expected to come around 2030,[22] by which time most UK funds should be restored to a fully-funded position. But whether this situation materialises will depend on a number of variables, not least the implied rate of return on pension fund assets during the coming 15 years.

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[20] http://www.ft.com/cms/s/0/ae66abba-9e07-11e2-9ccc-00144feabdc0.html#axzz3YUr7awWU

[21] http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/purple_book_2014.pdf

[22] PPF's 2014 Purple Book, pg 17

However, the prospect of the current low yield environment to drag on could upset many of the current assumptions and the regulatory approaches currently being adopted. Christine Lagarde, the Managing Director of the International Monetary Fund, has recently warned that the 'new mediocre' typified by low economic growth could become the 'new normal' for years to come. She indicated that "the new mediocre growth environment is not a comfortable place with respect to financial stability."[23] This uncomfortable reality is as true of pension funds as it is of financial institutions. Low economic growth is likely to defer the withdrawal of QE policies around the world meaning a continued squeeze on gilt yields. While this will have impacts across the DB sector, it is likely to be felt more on smaller and mid-sized DB funds given their greater investment in government bonds.

Prospect of a DB 'shock'

One unknown factor which could prompt a sudden rethink, would be the potential for a high profile or major sponsoring employer to collapse leaving behind unfunded pension liabilities. Such an event is unlikely to produce the same political response witnessed in the early 2000s, following the collapse of ASW and other firms, given that the Pension Act 2004 put in place the Pension Protection Fund (PPF) as a safety net to deal specifically with such events. However, a collapse would still place ministers on the spot – especially if the PPF is put under pressure. Given that companies have collectively made deficit reduction and special contributions of £225bn between the start of QE and March 2014 alone, and that the auto-enrolment of new members into schemes could also create larger liabilities going forward, ministers would be forced to re-examine whether the current approach to funding DB schemes is fit-for-purpose.[24]

Impact of the single tier state pension in 2016

For sponsoring employers there is a major development on the horizon whichever party forms the next government. The introduction of the single-tier pension in 2016 – to which all the parties are committed – will bring with it the end of contracting out of the State Second Pension. The loss of contracted-out rebate from April 2016 (worth 3.4 per cent of employers' National Insurance contributions 2013/14) will mean that sponsors still offering contracted-out DB schemes will either need to restructure those schemes, increase their employer contributions or manage an increase in costs.[25] The loss of contracting out will have a further impact in the area of automatic enrolment. Current legislation stipulates that a qualifying scheme must either contract out or have benefits equivalent to the level needed for contracting out. With the abolition of contracting out in 2016, the government will need to set out new qualifying requirements for those employers looking to apply automatic enrolment to their DB scheme.

[23] http://www.ft.com/cms/s/0/d5151102-dec4-11e4-b9ec-00144feab7de.html#axzz3YUr7awWU

[24] http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/purple_book_2014.pdf

[25] Defined Ambition in workplace pension schemes, PPI Briefing Note Number 65

Pension fund governance

The emergence of automatic enrolment in 2012 has placed renewed political interest on the governance of pension funds. The number of people in the UK who are saving into a DC pension is projected to grow rapidly from around 4 million in 2012 to almost 14 million by the 2020s.[26] A growing proportion of the market will be sitting in DC default funds. Governance over the suitability of default funds, pricing levels and investment strategy will be key issues for politicians during the next Parliament given the growing volume of retail investors entering the DC market. We have already seen a regulatory response with the new duties for DC schemes taking effect from April 6 2015. These include the need to meet the new charging controls for their default arrangement where the scheme is being used by employers to comply with their automatic enrolment duties, including investment management fees, payments to administrators, IT and other professional support.[27] Schemes are also obliged to communicate to members the implications of the new pension flexibilities. The creation of Independent Governance Committees (IGCs) will ensure better oversight of the member interests in contract-based workplace pension schemes. These changes are unlikely to be the end of the process particularly given the impact of further reforms. Over time this process will require further improvements to the technical and ethical competence (and qualification requirements) of lay trustees.

Linking increases to State Pension Age (SPA) and Normal Pension Age (NPA)

An incoming pensions minister will be required to undertake a further review of the State Pension Age (SPA) during the course of the next Parliament. Currently, the UK is planning to increase the SPA for both men and women to age 66 by 2022. As in 2010, we could see the timeline escalate with future increases brought forward. This raises the important question of what happens to NPA in occupational pension arrangements. With sponsoring employers hit by low yields and growing pension deficits, they could look to review their contribution levels or they could look to reduce the value of the liabilities by reducing the value of benefits. Increases in NPA could achieve this alongside the proposed changes to SPA. This would be a drastic measure but it is not without recent precedent. In April 2013, under instructions from the Dutch central bank, 66 of the country's 415 pension funds made cuts to their pay outs. The average cut was around 2 per cent of monthly pay outs.[28] The freedom to cut accrued benefits exists only as a last resort in the Netherlands. Such raids on accrued benefits are not permitted under UK law and would require a major change in the political landscape, not just the legislation. As with other potential pension, the landscape is less likely to change under a Labour-led coalition.

[26] How will Automatic Enrolment affect pension saving? PPI, 2014

[27] The Pensions Regulator website, April 6, 2015

[28] Financial Times, May 27, 2013

The regulatory architecture beyond pension freedom reforms

The current government has introduced reforms to liberalise the annuity purchase requirements from April 2015. Further reforms are planned for the creation of a secondary annuity market for the 5 million existing annuity policyholders.[29] The ongoing impact of pensions freedoms is likely to be felt throughout the new Parliament.

The reforms have raised concerns about massive mis-selling or a proliferation of investment scams. Such fears are already prompting discussions between politicians and policymakers about the need to reform the regulatory architecture. Any Labour-led coalition government is likely to commit itself to performing yet another overhaul of the pensions regulatory framework. Regulatory reform would be, at least in part, politically driven. Incoming governments like to reorder the regulatory landscape if only to put their own stamp on it. Currently, the FCA and TPR cooperate in numerous areas of pension policy, for example, ensuring that contract-based workplace pension schemes are high quality and offer value for money. Labour has proposed bringing together all pensions regulation within TPR so that there is a one-stop-shop watching over the retirement income space. Yet, this reform itself has the potential to cause disruption to the day-to-day business of pension regulation, as TPR takes on responsibilities in which it has no historic experience.

[29] Financial Times, March 18, 2015

What the election means for the future of the pension system: views from the experts

We asked a range of eminent pension experts what they thought were the biggest political risks for the pension system in general and the DB system in particular.[30] Key themes that emerged from their contributions include:

- Concern about the impact of political uncertainty on assets and liabilities
- The roll-out of pensions freedoms, and the potential challenges presented by transfers out of DB schemes
- The impact of the changes to the State Pension on DB schemes
- The doubtful future of higher rate relief
- Realigning the pension system to match modern needs – for example the emergence of new flexible savings vehicles which combine features of ISA's and pensions

Dr. Ros Altmann CBE, pension expert and government adviser

"There are two key things DB schemes should watch out for. First, a rise in interest rates which could damage scheme funding. This could be due to political uncertainty and sterling weakness, or the Bank of England pushing up short rates which then drive up long rates, or markets driving up gilt yields due to economic uncertainty and perhaps concerns about the fiscal deficit. It could also arise from a stronger than expected economic recovery, or indeed the Bank of England deciding to sell its long gilt holdings in an unwinding of QE. All of these could increase bond yields and could cause significant losses to UK schemes that hold large proportions of fixed income assets in their portfolios. The gilts and fixed income assets might not then match the pension liabilities well enough to avoid problems with rising deficits as asset values fall, while liabilities could fall by less than the assets held.

Secondly, a rush to transfer money out of schemes if members fear the 'transfer window' might close. Many members may decide to transfer out of their defined benefit schemes to take advantage of the new pension freedoms. I don't believe this is the most likely scenario but if too many members want to transfer out, there could be problems for scheme cash flow and it could result in larger deficits as trustees may be advised to hold more assets in cash. This would jeopardise long-term investment performance. Trustees may also need to reduce the transfer values but may be too slow to recognise the need to do so and this could jeopardise the security of the benefits of the remaining scheme members; trustees are currently encouraged to offer transfer values that may actually be too high for the sustainable long-term future of the scheme, but this would not become apparent for many years."

[30] These are the views of the individuals concerned – not necessarily those of Pension Insurance Corporation or Cicero Group

Chris Curry, Director, Pensions Policy Institute (PPI)

“There are a number of policy issues that will arise in the next Parliament that will have a direct impact on DB schemes. All of the political parties are committed to the introduction of the new state pension, which will mean the ending of contracting-out and a decision for scheme sponsors as to whether to increase contributions or to reshape the scheme – be that continuing as a DB scheme, moving to the newly available Defined Ambition or moving straight to Defined Contribution.

All of the major parties are also proposing changes to Pensions Tax Relief – either introducing restrictions for very high earners or consulting on a complete re-structuring of the system. Given the recent history of cutting the allowances for Pensions Tax Relief, and the perceived relative generosity of tax relief for DB schemes relative to DC pensions, further change is almost inevitable. DB scheme sponsors or members might find themselves more likely to be facing tax charges if allowances or tax relief rates are reduced further in the next Parliament.”

Huw Evans, Director General, Association of British Insurers (ABI)

“All parts of the UK pension system will feel the impact of a more unstable political environment after the UK General Election with likely changes to tax relief and uncertainty about how the pension flexibility reforms will work out in practice. DB scheme trustees will be watching closely to examine the proportion of scheme members transferring out and whether further changes are made to the regime.

More broadly the wider economic environment will continue to pose significant challenge to trustees and policymakers alike as interest rates remain abnormally low and investment strategies remain challenging. It will be vital for trustees to continue to speak up so that ministers and central bankers take account of the needs of pension schemes in their wider economic decision-making.”

Baroness Greengross, President, International Longevity Centre – UK

"While the advent of the new Pension freedoms available for DC Scheme members has recently grabbed the headlines, trustee based schemes have been rather left out in the cold. In my view, despite the recent changes, DB schemes remain the gold standard for pensions as, depending on the company behind them, they are generally much more secure and more generous than DC pensions.

In order for a DB scheme member over 55, who is not in a government-backed publicly funded scheme, to take advantage of the new freedoms, transferring into a DC scheme would currently be the only way of accessing their pension fund value as cash. So, if they need the cash now, or are in ill health or have a shortened life expectancy, while this may not be the best idea in the accumulation phase, falling gilt yields, and consequent increased notional cost for scheme sponsors to provide benefits, may mean improved transfer values becoming available to members of DB schemes approaching retirement.

For the scheme member there are obvious lifetime-limit, tax and IHT implications here and so, before undertaking such a transfer, it is now a statutory requirement that the scheme member must take advice from a regulated independent financial adviser. For trustees the propensity of high-value 'fund' holders, or 'short-livers', to transfer out their notional valuations may potentially be of great risk to the long-term solvency of the scheme, and therefore to the funds available for dispersal to remaining members.

Ahead of the forthcoming election the major parties have already promised to make significant changes to the structures of all the fiscal instruments mentioned above and so trustees will have to pay particular heed to the amended guidance issued by The Pensions Regulator, which reminds them of their ability to reduce or delay transfer values in order to avoid detrimental effects on the remaining members. It is very likely therefore that the outcome of this election, whichever way it goes, will present trustees with a very challenging landscape indeed. I would go as far to suggest that as the ensuing fiscal, regulatory and legal changes bed in, ensuring fairness and equity to all of the schemes members, will be one of the major challenges facing trustees over the coming months and years."

Henry Tapper, Editor, Pension Playpen

"The Trustees of Britain's Defined Benefit Pension Schemes risk presiding over a social economic anachronism, the preserve of public sector workers and a fast diminishing sub-set of the private sector workforce. At a time when all other pensions are changing, they need to realign these schemes to the new retirement contract brought in by auto-enrolment and the pension freedoms. They need to look at continental models and in particular to Canada to see how this can be done. Defined benefit schemes need to release themselves from their guaranteed benefits and return to the "best endeavours" model which served them well in the second half of the last century."

Michael Johnson, Centre for Policy Studies

"Defined benefit pensions are a concern, but just as important is the role of pensions in saving for the future. We currently have pensions, with tax relief on the way in, whereas ISA withdrawals are exempt from Income Tax. ISAs are becoming increasingly popular, with shares ISA subscriptions increasing by 90 per cent over the last six years. Contributions to private pensions have reduced by 25 per cent over the same period. Savers value access to savings now, something DB pensions, though they are usually more generous, do not offer.

It would make sense to merge the ISA and pension regimes, with a single tax structure that offers relief on savings withdrawn, rather than paid in. It seems likely that a 'Workplace ISA' could eventually become a reality. Transitioning to a new framework could, however, add (temporary) complexity, as old and new regimes co-exist.

Today's DB scheme members should not, for example, be able to benefit from tax-exemption in retirement, in respect of contributions on which they received tax relief. Meanwhile, given DB schemes' significant legacy liabilities and ageing membership, DB pension policy considerations cannot be completely ignored, not least because in 2016, contracted out schemes will lose their NICs rebates with the introduction of the single tier state pension. And then there is the delicate issue of public service pensions..."

Mark Hoban, former Financial Secretary to the Treasury

"The last government significantly reformed the pensions landscape. Whilst we can see the initial impact of changes such as raising the state pension age, the introduction of auto-enrolment, the reduction of pension contribution tax relief, and the new pension freedoms, radical reforms bring unforeseen consequences. These will only manifest themselves once behaviour changes. For example, what will be the impact on DB schemes as members will take advantage of the pension freedoms? So we shouldn't assume that changes to the legislative framework for pensions is over. And, despite growth returning to the UK economy, sustained low interest rates and continuing pressure on businesses' bottom line mean that the current pressures on scheme funding will persist.

Whilst it may seem that all the political interest is in DC schemes, DB schemes will not be immune from the economic, social and political events that will shape the next Parliament."

Conclusion

All outcomes from this election have the potential to create new challenges for DB schemes. Whether it is the trade-off between short-term pain in the form of low gilt yields and long-term gain in the form of a more robust economy and appreciation in asset prices, the risks to sponsor companies of excessive regulatory intervention, constitutional upheaval or constant reform of the pension system, there are many things for trustees to think about. We don't pretend to have a crystal ball, but thinking about the possible scenarios can only be a prudent and worthwhile exercise as we approach an unprecedented moment in UK politics.

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