(AMNT WPC Summary 07 Dec 14)

PENSIONS PERSPECTIVES WORLDWIDE 2014

A report on the World Pensions Council's World Pensions and Investments Forum 2014: "Investment and governance excellence in a time of economic realignment": 23-24 October 2014: Paris Industrie Castle

By David Weeks
Committee Member of the UK Association of Member Nominated Trustees; Director of the defined benefit pension scheme of a leading UK PLC in engineering services

Copyright © David Weeks 2014
The right of David Weeks to be identified as author of this work has been asserted in accordance with Section 77 of the Copyright, Designs and Patents Act 1988.

VERSION 1.1: 11/12/2014

CONTENTS

1. INTRODUCTION

2. SUMMARY
2.1. Worldwide comparisons in pension systems
2.2. Investment techniques and yardsticks
2.3. Asset allocation and diversification
2.4. Governance issues
2.5. Round table discussions

3. WORLDWIDE COMPARISONS IN PENSIONS SYSTEMS
3.1. International review of pension reform
3.2. UK pensions: recent trends
3.3. Italy: pension reform
3.4. Ireland: review of the pensions landscape
3.5. US: modern pension design
3.6. Belgium: bold, multifaceted, pension modernisation
3.7. Dutch DC at the crossroads
3.8. French DC pension accounts: PERCO

4. INVESTMENT TECHNIQUES AND YARDSTICKS
4.1. Asset allocation: the great risk/ return inversion
4.2. The rise of indices and indexing
4.3. Fixed income and money markets in a low yield environment
4.4. Pension assets and asset allocation in a difficult time
4.5. Understanding the Europe 2020 Project Bond Initiative
4.6. Mortality assumptions and their impact on longevity risk

5. ASSET ALLOCATION AND DIVERSIFICATION
5.1. World Bank Group: infrastructure investment
5.2. European Investment Bank experience: financing infrastructure assets
5.3. China Construction Bank: long term bank financing

5.4. UK High Speed 2: principles and attributes of major transportation infrastructure
5.5. Fast tracking sustainable investments
5.6. Investing in international trade finance
5.7. Climate bond standards
5.8. Investing in ancient books, letters and manuscripts

6. GOVERNANCE ISSUES
6.1. Engagement and employee participation
6.2. A holistic approach to social protection
6.3. A holistic approach to risk supervision
6.4. Corporate sustainability reporting

7. ROUND TABLE DISCUSSIONS
7.1. Control by pension funds as asset owners
7.2. Short termism in investing
7.3. Increasing intervention in pensions by national governments
7.4. Risk supervision

1. INTRODUCTION

The World Pensions Council set out its objectives for its conference in Paris of October 2014 in its invitation to attend: "Join a host of pension and sovereign funds, central banks and government agencies from across Europe, Asia and the Americas to discuss the latest advances in asset allocation and diversification strategies, equity, private equity and infrastructure investments." A packed programme of 31 sessions was crammed into just two days. Conference sessions might be ordered into five main groups, as follows:

- Worldwide comparisons in pension systems
- Investment techniques and yardsticks
- Asset allocation and diversification
- Governance issues
- Round table discussions

I have summarised the conference sessions, under these headings, in the next section of this report. There then follow more detailed accounts of each session. I draw attention here to two aspects of editorial approach:

- I have omitted reference to one or two of the conference sessions
- I have added in notes of explanation from time to time, when the reports of sessions appeared to me to be in danger of reading too cryptically.

Trustees of pension funds and pension scheme members who approach retirement age are the readers that I have had most in mind.

2. SUMMARY

Several speakers shared the same perception about the most important background challenges that pensions policy makers face:

- Demographic changes: increasing longevity; declining birth rates, workplace replacement rates, and dependency ratios of active workers to support pension payments
- Current economic climate of low interest rates and low yields

The Melbourne Mercer Global Pension Index notes how individual countries are performing. At the top come Denmark, Australia and Netherlands.

2.1. Worldwide comparisons in pension systems

Nick Sherry, former Australian pensions minister, and subsequently worldwide consultant on the subject, gave a survey across the globe on how nations are facing the challenges. "International review of pension reform" was his title. As he saw it:

- Greece is "the big pension challenge of all time", but is addressing matters in ways that all European countries could well end up having to adopt
- UK and Eire are both moving from defined benefit schemes to defined contribution schemes. They continue, however, to allow more generous pension schemes in the public sector than is usually available in the private sector.

Overall, individual citizens will need to carry more of the costs of providing their own pensions. On the whole, Sherry was not optimistic: "I am not sure that there is an easy way out".

Darren Philp reviewed pension developments in the UK: "UK pensions: recent trends". His credentials included experience at HM Treasury, National Association of Pension Funds and the People's Pension. He said that the background to recent activity in the UK was the work of a Pensions Commission, which had first reported in 2004. The commission addressed three main challenges: (1) increased life expectancy; (2) the inadequacy of the state pension; and (3) decline in the rate of private pension saving. Philp described the actions that UK governments have taken subsequently. He noted that the UK is placed ninth in the Melbourne Mercer Global Pension Index, out of 25 systems covered. He listed measures that the UK would need to take in order to move up the scale.

Professor Elsa Fornero is a professor of economics at Turin University. She was called to serve as Italy's Minister of Labour, Social Policies and Equal Opportunities in Mario Monti's "technocratic" government of 2011-13. Her presentation was entitled simply: "Italy: pension reform". The Monti administration was formed to address Italy's debt crisis. Fornero described the unsustainable state of affairs that she faced on pensions. She set out the "cold shower measures" that she promoted in order to stabilise the situation. The course that the government pursued was by no means their first choice. They knew, however, that unpalatable action had to be taken.

Jerry Moriarty of the Irish Association of Pension Schemes reviewed developments in his presentation: "Ireland: review of the pensions landscape". Pension policy had developed in response to the roller coaster nature of the Irish economy. He described the scale of the Irish pensions set up. The problems that Ireland faces, and the options that are available to address these, are similar to those that apply across Western Europe. Moriarty thinks that pensions policy has the capacity to become something of a political time bomb in Ireland.

Joshua Franzel of the US's Center for State and Local Government Excellence reviewed pension arrangements in the public sector: "US: modern pension design: learning from the innovators". He examined the three main types of pension scheme that are in use: (1) defined benefit; (2) defined contribution; and (3) cash balance. He looked at the continued adoption of hybrid plans by the states' pension schemes. He set out some of the stated reasons for the adoption, and continued use, of hybrid plans.

Belgium in 2013 announced that 12 industry experts had been put in charge of preparing a new instalment of pension reform. Koen Vleminckx of the Belgian Federal Ministry of Social Affairs, reported on their work: "Bold, multifaceted pension modernisation at the core of a reformist policy mix". The committee concluded that the current arrangements were not sustainable. Vleminckx listed the measures that the new centre right government has implemented to date. Among these:

- Restrict early retirement

- Reduce the pension privilege of civil servants
- Increase pensionable age
- Increase pension contribution levels
- Assure the attraction of the Belgian market for pan European pension funds

The debate continues.

Erik Goris of PGGM NV described “Dutch DC at the crossroads”. He described how the Dutch pension system is coping with four significant changes: (1) increased regulatory pressures; (2) stricter requirements for board members; (3) focus on cost reduction; and (4) weakening sponsorship by employers. He noted that the Dutch government is taking the lead in charting the route ahead. He thought that defined contribution schemes do not presently often enable risk sharing between active and retired members. Much current thinking is, however, tending to favour the principle of intergenerational risk sharing.

Pierre Bollon of Association Francaise de la Gestion Financiere described: “French DC pension accounts: PERCO: the French Way”. Former French premier Francois Fillon launched PERCO in 2003, when he was still minister of social affairs. PERCO still remains small in scale, but Bollon described its progress to date.

2.2. Investment techniques and yardsticks

Paul Woolley of the London School of Economics, and formerly of the International Monetary Fund, spoke on: “Asset allocation: the great risk/ return inversion: who loses out?” He looked at what he sees as “an inverse relationship between risk and return”. He said that the solution is for principals to write contracts for their agents that are free from market capitalisation benchmarks and tight tracking. Principals should require managers to invest instead on the sole basis of fundamental income and value. “The best way of beating an index is to ignore it”, he reckoned.

Brett Hammond of MSCI Inc spoke on: “The rise of indices and indexing: from benchmarking to ‘beta factories’ and ‘smart passive’ funds”. He described the role that the MSCI Factor Indexes can play in balancing risks and returns. He noted that cyclicality is a key dimension. He charted for his indexes the average monthly gross active return, relative to MSCI World during 1975-2013, that applied in each of four economic scenarios. These four scenarios mixed inflation and growth in various combinations. He called the four scenarios: “Heating up”, “Goldilocks”, “Slow growth”, and “Stagflation”. He concluded by summarising why he thinks that factor investing makes sense.

Jean-Francois Bay of Morningstar France had as his theme: “Core versus non core: the quest for ‘new frontiers’ in fixed income and money markets in a low yields environment”. He argued that a feature of the bond market in Europe had been low interest rates. His view was that the importance of non core bond categories will continue to rise. He expects that contingent convertible bonds, “CoCo Bonds”, will increase in significance. Under current circumstances, extracting returns from assets is like mining. Sometimes, open cast mining produces results. At other times, extracting has to take place under conditions that are extreme. In this event, said Bay, Morningstar can be on your side!

Philippe Desfosses of the French Public Service Additional Pension Scheme spoke on: “Pension assets and asset allocation in a difficult time: a cautionary examination” His thesis was that economies across the world had become unsustainable even before the financial crisis . He looked to corporate bonds. The new global threats are the risks of debt overhang and deflation. Government securities might be the nearest thing to a risk free asset. Carbon debt might provide an opportunity by which to chart a way ahead.

Dominik Zunt, of the European Union Economic and Financial Affairs Directorate General, spoke on "Understanding the Europe 2020 Project Bond Initiative". He describes how the initiative aims to stimulate financing by capital markets for large scale infrastructure projects. The EU looks to institutional investors as well as to banks. The EU itself acts as an enabler, to unlock private finance. The new Juncker Commission will produce further proposals before the end of 2014.

Pablo Antolin-Nicolas of the Organisation for Economic Cooperation and Development (OECD) addressed: "Mortality assumptions and their impact on longevity risk: gauging the 'known unknowns'". He described the work of an OECD study "to assess how pension funds, annuity providers such as life insurance companies, and the regulatory framework incorporate future improvements in mortality and life expectancy".

2.3. Asset allocation and diversification

Bayo Oyewole of the International Finance Corporation spoke on: "World Bank Group (WBG): Infrastructure investment: with focus on middle income nations and frontier markets; presentation of the Global Infrastructure Facility (GIF)". He said: "The GIF is an open platform established by the WBG for collaboration between public and private partners to prepare and structure complex, commercially viable, infrastructure projects in emerging markets and developing economies". Private investors have their own needs:

- Financing packages that are competitive
- Banks need exit options, especially at a time when the long term lending environment is tightening
- Institutional investors seek long term investments with predictable cash flows.

The needs of national governments and the demands of potential private sector investors can certainly be made compatible with each other, said Oyewole. He examined in detail how the WBG tackles the challenge of project preparation and structuring. "What's in it for you?" he asked in conclusion of his audience. He was looking for partners, and he set out his stall to attract them.

Cormac Murphy of the European Investment Bank spoke on: "European Investment Bank experience: financing infrastructure assets across the European Union". He said that the EIB can offer long term infrastructure projects for investment. These can offer higher yields than those of Government bonds. At present, large pension funds have no more than one per cent of funds invested in infrastructure. The Project Bond Initiative has now successfully completed some pilot projects and is moving to post pilot stage. His conclusions were that much progress has been made in the past year, and that the EIB has achieved a strong catalytic impact.

Feng Liying of the China Construction Bank spoke on: "China Construction Bank: long term bank financing, with focus on People's Republic of China and neighbouring jurisdictions". "How can a foreign investor knock [at] the door of China's infrastructure?" asked the CCB's presentation team. They set out their stall. Of significance are the roles of:

- China Council for the Promotion of International Trade: CCPIT
- Investment and Infrastructure Research Committee: IIRC

The presentation team described how these two organisations can aid the progress of potential investors.

Andrew McNaughton of the UK rail project High Speed 2 had a grand title for his presentation: "UK High Speed 2: principles and attributes of major transport infrastructure in the northern hemisphere". He described the project, and the opportunities that it could bring to enhance values of land and property close to the route. HS2 will keep under review when will be the best times to

bring in private sector investment. HS1 (from Channel Tunnel to London) had demonstrated already, and HS2 will now reaffirm, that the UK is proficient at planning and project managing a major infrastructure project.

Guido Schmidt-Traub of the United Nations Sustainable Development Solutions Network (SDSN) spoke on: "Fast tracking sustainable investments to foster quantifiable development goals". "The SDSN supports the development of Sustainable Development Goals (SDGs) to address the challenges of economic development, social inclusion, environmental sustainability and good governance." Three main conferences during 2015 will together define the agenda ahead: in Ethiopia in July, at New York in September, and at Paris in December. Schmidt-Traub looked at the roles that institutional investors might play in developing plans. Institutional investors in total accounted for USD $79 trillion in assets. Of this figure, however, only one per cent was invested in infrastructure. He suggested some measures by which to increase finance for development:

- Reform global regulation
- Better use of public funds to secure leverage
- Streamline infrastructure assets
- Reduce short termism in capital markets

Jean-Louis Laurens of Rothschild spoke on: "Investing in international trade finance within a risk controlled fixed income framework". He described the Rothschild asset management business. He went on to explore how trade finance and Exchange Traded Funds (ETF) can form a new asset class. In this task, natural resources finance has a role to play. For Western Europe to finance West Africa, say, was "financing the real economy".

Sean Kidney and Nick Silver of Climate Bonds Initiative spoke on: "Climate bonds standards; climate bonds initiative". The Climate Bonds Initiative is: "the only organisation in the world focusing on mobilising the USD $80 trillion bond market for climate change solutions". The past year has seen rapid growth in a market for Green Bonds and Climate Bonds. These are the main mechanisms by which to tap the global bond market in order to finance solutions to problems of climate change. From a starting point of USD $1 billion in 2011, the Climate Bonds Initiative expects a total of USD $40 billion in 2014, with USD $100 billion in 2015. Further debate will ensue on whether, or how, the sector adds value to the portfolio of a pension fund.

Directors of Aristophil, art market specialists, gave a presentation on: "Investing in ancient books, letters and manuscripts". They noted that the art market is booming, and produced explanations as to why this is the case. They said that the market is a steady one, albeit different segments behave differently at different times. Thus, there is importance in pinpointing niches. To be desirable, assets need to combine both rarity and also significance. Manuscripts can provide this combination, and, in consequence, see some good appreciating values. The Aristophil directors answered questions on whether art can provide an attractive investment for pension funds.

2.4. Governance issues

The chief executive of the Association of Superannuation Funds of Australia (ASFA), Pauline Vamos, gave a keynote address to the conference: "Engagement and employee participation". She listed features of her organisation:

- Member activism has caused some Australian pension schemes to move out of investment in tobacco and coal
- ASFA has regard for three goals: (1) engage the community; (2) manage the political risk; and (3) adjust asset allocation accordingly

- Large numbers of people are moving into the drawdown segment of the pensions market, yet staying with the system itself. This represents the largest part of their retirement income. People are staying out of annuities. There is a decline in state pensions
- Generally speaking, pension scheme members tend to prefer personalised methods of communication, such as emails. Some financial providers now offer interactive methods of communication.
- It could be an appropriate diversification target for pension funds to invest 10 per cent of funds in infrastructure

Francesco Briganti of the European Association of Paritarian Institutions (AEIP) took as his theme: "A holistic approach to social protection: gauging pension liabilities in conjunction with healthcare requirements". He sought a comprehensive approach to social protection. Funding for all schemes is rendered more difficult by a climate of low interest rates. The route ahead requires a combination of adequate pensions and accessible healthcare. AEIP has set up a working party to explore "integrated welfare". "The integrated welfare debate has finally started", said Briganti. The traditional welfare state model is disappearing.

Arnaud Claudon of BNP Paribas Securities Services spoke on: "A holistic approach to risk supervision".

- He said that shadow banking was widely held to be a prime factor in the sub prime mortgage crisis of 2007-08 and in the global recession that ensued.
- Could best practices for pension schemes be transplanted worldwide, he mused? If so, then would the same apply to worst practices, too? In any case, can oversight ever catch up with innovation?

Robin Edme of the French Ministry of Ecology addressed: "Corporate sustainability reporting: why institutional investors and society at large will profit from solid metrics". He recapped on the history of reporting environmental, social and governance issues (ESG) in recent years. He outlined the concepts of fiduciary duty, sustainable ventures and reporting on sustainability. He drew attention to the work of the International Corporate Governance Network: ICGN. "ICGN's mission is to inspire and promote effective standards of corporate governance to advance efficient markets and economies worldwide".

2.5. Round table discussions

Barry Parr of the UK Association of Member Nominated Trustees (AMNT) of pension funds raised two substantial points:

- A new scheme that AMNT has started, in order to increase the control that pension funds, as asset owners, exercise over the companies in which they invest. The initiative goes under the title "Red lining"
- The problems for pension funds caused by short termism in investing

Other points raised in round table discussions were:

- Nick Sherry of Australia saw an increasing regulatory pressure from national governments on issues of governance for pension schemes since the 1980s
- Anton van Nunen of Syntrus Achmea presented to the conference on issues of risk supervision
- Various panel members opined about hedge funds, and whether or not they offered good value for money.

3. WORLDWIDE COMPARISONS IN PENSION SYSTEMS

3.1. "International review of pension reform": Nick Sherry: former Minister for Financial Services, Superannuation and Corporate Law: Australia (Conference session 1). Subsequently, Sherry had provided consultancy on pensions issues across the world. He gave a hands on, comparative, overview of pension reform.

Sherry spelt out the nature of pensions. Nowadays: "paying people not to work for 20 to 25 years: that's what it's all about". In the past, by contrast, pensions had acted as no more than a safety net for those who did not die soon after they ceased to be active in the workforce. He noted some profound changes that have taken place:

- Increased longevity has been a consistent trend for 150 years. The flow line for life expectancy moves steadily upwards, like an escalator. Improvements in health and increased availability of medicines have been the main drivers.
- A decline in birth rate has become a trend in many countries during the last 50 to 60 years. In consequence, there has been a collapse in the replacement rate of economically active populations. In China, the "one child" policy has been a factor. In other countries, such as Japan and Italy, changing attitudes to the role of women in society has been a leading contributor.

The effect of these two trends has been to produce a decline in the dependency ratio: that is the numbers of those who are in work and who contribute to pay for the pensions of those who are in older generations.

At the same time, a number of economic trends do not help matters. Servicing of government debt takes rising percentages of GDP. The demographic changes that are taking place act as a brake on economic growth. Population growth is more often led by migration than by increase in birth rate. Unemployment levels are rising in many countries. Electorates, meanwhile, prove reluctant to pay increased taxes to fund social security expenditure.

Sherry looked at how some countries are responding to these trends. Greece is "the big pension challenge of all time". Many Greeks have access to generous defined benefit pension schemes when still aged only in their 50s. At the same time, many in the younger generations are emigrating, and so moving out of the tax net. Greece has a bloated public sector. The country is, however, now making some massive changes to pension arrangements. The age at which pensions became payable is being increased: to 67, and will move to 68. Benefits to existing pensioners are being cut. The state is improving the collection rate of tax revenue. Sherry "feared" that most European countries will end up having to take similar measures.

In both UK and Eire, the private sector is reducing provision of defined benefit pension schemes, with moves instead towards defined contribution schemes. Nonetheless, more generous schemes in the public sector are allowed to remain open. The cost is high of providing pensions for some retired public servants, such as teachers. In some Asian countries there is also a contrast between pensions in the public and the private sectors. A general trend is towards state pensions reducing to no more than a safety net approach, with a contraction of more generous schemes. In much of Western Europe, however, this has all been left very late. Mandatory increases in contribution levels might provide something of a way ahead, but it is likely to prove a difficult challenge to implement.

Sherry listed two further topics that currently attract attention:

- Regulation of pension schemes
- The potential of pension schemes to provide finance for infrastructure.

What are the options for the future, asked Sherry? "It's depressing!" he responded, speaking as a former politician, and as one who had an understanding of the limits that exist on political realities. He thought that the tasks ahead remained challenging.

- Governments could become more open, but they would need to spell out what they could not afford to undertake.
- Politicians could seek to raise the age at which pensions become payable, but experience in France highlighted the difficulties that could be encountered in this
- It would be beneficial to increase workforce productivity and levels of participation, but this would be difficult to achieve with a lower birth rate. In Japan, for example, 40 per cent of women do not wish to have a child; but wish to work at a career instead.

Politicians are finding it difficult to deliver promises either on pensions or on healthcare. Extremist parties on both right and left have gained ground, in consequence, as disillusionment sets in. It is tempting to blame migrants, big banks, or whoever. On the whole, Sherry was not optimistic: "I am not sure that there is an easy way out".

3.2. "UK pensions: recent trends": Darren Philp: Head of Policy: Building and Civil Engineering (B&CE) Pension, provider of The People's Pension; formerly of National Association of Pension Funds and of HM Treasury (Conference session 26)

Philp described his B&CE pension scheme. He said: "The People's Pension is a workplace pension designed to take the hassle out of setting up and administering auto enrolment. It's particularly suitable for low to moderate earners in industries with high staff turnover, such as construction, manufacturing, facilities management and retail". It was launched in November 2011. It is run by independent trustees, and is administered by B&CE, a not for profit organisation, founded in the construction industry. It is a Master Trust, multi employer, scheme. Each employer has its own section of the scheme. Members can choose to remain in a default investment option throughout the life of their account. Their funds then move automatically to more secure investments as they approach retirement. Alternatively, members can choose investment funds for themselves. The low annual management charge (AMC) of just 0.5 per cent applies to all members' pension pots. To date, the People's Pension has auto enrolled 1.2 million people. Nearly 4,000 employers use the scheme.

Philp went on to describe some recent milestones in the development of pensions in the UK. The Pensions Commission, or Turner Commission as it became known after its chairman, was a "non departmental public body" (NDPB). Its remit was to keep under review the regimes for UK private pensions and long term savings. The Commission published its first report in October 2004, in which it set out a detailed and comprehensive analysis of the UK pension system. A second report, of November 2005, presented its conclusions on the likely evolution of the UK pension system if policy remained unchanged. It then set out the Commission's recommendations for a new policy direction. The Turner Commission addressed three main challenges: (1) increased life expectancy; (2) the inadequacy of the state pension; and (3) decline in the rate of private pension saving. There had been a sudden explosion in life expectancy after 1990. Now, as many as one third of all those who were born today would live to the age of 100. In 2000, some nine out of ten (90 per cent) of defined benefit pension schemes remained open to new members. That figure had since dropped to just over one out of ten (12 per cent). The combined average contribution rates of employer and employee for a defined benefit scheme is 19.2 per cent. In defined contribution schemes, which increasingly take their place, the figure is no higher than 9.4 per cent.

The Government is implementing a package of pension reforms, following the Pensions Act 2008:

- State pension: increasing the age at which pensions became payable; reducing the level of National Insurance contributions that are required in order to secure eligibility for a full pension; introducing a single flat rate for the state pension.

- Private pensions: introducing new duties on employers to provide access to a workplace pension scheme for most workers; requiring workers to be automatically enrolled into a pension scheme; introducing NEST: National Employment Savings Trust.

The overall objective is to ensure that more people save more money towards their future pension in retirement.

Auto enrolment represented a gamble when it was introduced. There was no certainty that it would gain acceptance. The Pensions Regulator said to employers: "This is called automatic enrolment. It's called this because it's automatic for your staff – they don't have to do anything to be enrolled into your pension scheme. But it's not automatic for you. You need to take steps to ensure that you're enrolled." In the event, it did gain acceptance. Opt outs from auto enrolment have amounted to only about 7 per cent. To date, however, only larger companies have passed their "staging date", after which they need to comply. It will be a challenge to ensure that small and medium enterprises (SMEs) comply also. By 2018, the minimum level of contribution that UK law requires will be 8 per cent of qualifying earnings. At present, the actual contribution rate is lower than that: more like 6.9 per cent. Philp did not consider that even 8 per cent is sufficient to generate a pension of 60 or 66 per cent of final salary.

He cited the Melbourne Mercer Global Pension Index, which said that the UK would need to do better. Mercer explained why. "The overall index value for the British system could be increased by:

- raising the minimum pension for low income pensioners;
- introducing a level of mandatory funded contributions;
- increasing the coverage of employees in occupational schemes;
- raising the level of household saving."

Overall, Mercer gives the UK pension system a B grade. It places the UK at ninth position out of 25 systems monitored (which together covered around 60 per cent of the world's population). Denmark, Australia and Netherlands take the top three slots in the index. "Denmark's well funded pension system with its good coverage, high level of assets and contributions, the provision of adequate benefits and a private pension system with developed regulations are the primary reasons for its top spot."

What next for UK pensions, Philp asked? He highlighted various questions, and answered some of these himself:

- Are people joining pension schemes in sufficient numbers? We should aim for more.
- Are we saving enough? Clearly we are not.
- Do pensions represent good value? There is now a huge downward pressure on the level of charges.
- What about insurance related aspects of pensions? Pension providers could do more to develop imaginative products.
- Is there any capacity crunch in the pensions industry? There has certainly been much change recently, prompted by both regulators and politicians.
- Small pension pots present scope for improved service
- European regulations may need to be watched carefully for potential damage to UK schemes. This applies to issues of both solvency and governance.
- Budget 2014 contains a number of new provisions, some of which still require full implementation.

As far as the individual is concerned, four questions are of especial significance:

- What arrangements exist for tax relief?
- The Chancellor of the Exchequer, in Budget 2014: "revealed new freedoms allowing savers to treat their pension pot as a bank account from April next year" (The Guardian). There was an end to the requirement for pensioners to buy compulsory annuities with their pension

pots. “Pensions Minister Steve Webb said that under the new freedoms people could buy a Lamborghini if they liked.” The new mantra is: “What you want; when you want it!” Philp asked how this all would work out in practice? The devil would be in the detail.
- Budget 2014 also offered that those who approach retirement will be offered free, independent, impartial guidance. Again, many questions arise about how this aspiration will operate in practice.
- Pensions register: Philp lobbied for such a facility for each individual. It should list all the benefits and entitlements for which they have become eligible. It should allow them to track all pension pots, and to compare different products in order to match their aspirations.

[By way of background to this session, it may be worth noting the main recommendations of the Pensions Commission. Its report of November 2005 made two core proposals: (1) the creation of a National Pension Savings Scheme: NPSS; and (2) reforms to the state system to underpin private saving. Hamish Wilson and Co, actuaries, commented at the time on these recommendations: “The Commission’s calculations suggest that, based on reasonable assumptions about rates of investment return and years of contributing, the NPSS may provide the ‘median earner’ (an earner who would be in the middle if all earners were ranked by their earnings) a pension of about 15% of median earnings. This would sit on top of the 30% or so that would be delivered by the state under the Commission’s proposals, giving about 45% ‘earning-replacement’ in total.” Hamish Wilson and Co went on: “The Commission recognises that many people will want to aim for a higher level of pension relative to their pre-retirement earnings. So, it also recommends that voluntary contributions on top of the default level should be permitted, subject to a cap. For the median earner, this would increase the target pension to about two thirds of pre retirement earnings.”]

3.3. “Italy: pension reform”: Elsa Fornero: Professor of Economics: University of Turin: former Minister of Labour, Social Policies and Equal Opportunities in Italy’s “technocratic” government of 2011-13 (Conference session 16)

In 2011 Italy faced a debt crisis. Mario Monti’s cabinet was appointed on 16 November 2011 to provide a response. Emergency measures were needed. The country demonstrated its capacity to introduce major economic reforms that were dictated by the force of circumstances. A government of technocrats and economic experts replaced the previous government of politicians. The new government introduced major enactments, including a tax on housing wealth and reform of the pension system. Pensions reform and labour market reform were needed which had to run counter to explicit commitments that the last government had made. In this, the incomers did not have time available for consultation.

Italy, together with Japan, had one of the worst dependency ratios in the world, with decreasing numbers in the active workforce to support growing numbers of pensioners. The Italian pension system was also badly constructed. The cost of pensions was high, and amounted to as much as 16.1 per cent of GDP. The age of retirement was low, at only 59 years. Pensions were used to mask the numbers of unemployed. There was a maze of regulations in a set up that was fragmented. Some favoured client groups had secured for themselves treatment that was overly preferential.

Professor Fornero gave a blow by blow account of the pension reform process that she put in place, from the immediate “cold shower” measures of 2011. Pensionable age was henceforth linked to life expectancy. A defined contribution formula was introduced for all workers, in place of the selective defined benefit formula that gave favoured treatment to some groups. Pensionable age was increased immediately to 66. There was to be a “solidarity contribution” taken from high pensions. There was a squeeze on the preferential arrangements that were accorded to some client groups. There was a temporary freeze placed on indexation for high pensions.

These measures contributed to the government's objective of working towards economic sustainability. Economic sustainability would lead, in turn, to social sustainability. It would lessen the scope for the political interference that had so distorted the system in the past. There is protection afforded for those who have been caught out in the sudden changes. Older workers and unemployed who were aged over 50 are cases in point. Nonetheless, problems of transition and communication remain. Notions of "acquired rights", in particular, prove difficult to break. The government has had to spell out some unpalatable political realities to its citizens. The course that is being pursued is by no means the government's preferred choice. They know, however, that it has to be done.

3.4. "Ireland: review of the pensions landscape": Jerry Moriarty: Chief Executive Officer: Irish Association of Pension Funds (Conference session 12)

Moriarty described the Irish Association of Pension Funds: the IAPF. Established in 1973, the IAPF represents the interests of Irish pension savers, not those of the pensions industry. In 2013, IAPF members accounted for EUR €91 billion in retirement savings. "For our members, we seek to educate, represent and inform, with a view to achieving secure, fair and simple retirement provision."

The background to the IAPF's current operation is the roller coaster that the Irish economy had been in recent years. Irish 10 year yields in 2011 paid 14 per cent; by 2014, the figure had dropped to just 1.9 per cent. Irish GDP during 2009 fell by 9 per cent; in 2014, by contrast, it powered ahead by 7.7 per cent.

There are three pillars to the Irish pension system: (1) state pensions, (2) occupational pensions and (3) voluntary pensions. The state pension pays out EUR €230.30 a week. It is funded by contributions from the employee of 4 per cent, and from the employer of 10.4 per cent. It is payable at age 66, which will rise to 67 in 2021, and then to 68 in 2028. There is currently an annual deficit on the scheme. Public sector pensions operate on a pay as you go basis. These were funded by contributions of 8.5 per cent in 2007, but the figure has now risen to 14.8 per cent. The pensions are payable at a variable factor, based somewhere between a factor of one thirtieth and one forty fifth for each year of work completed. Private sector pensions are voluntary. Some 480,000 members are covered by such schemes. Overall, around half of those in the workforce have a pension.

Defined benefit pension schemes number 993 in total. DB assets amount to EUR €58 billion. Around 40 per cent of DB schemes would have a deficit on a wind up basis. Only 10 per cent of DB schemes still remain open. DB asset allocations have seen equities fall in significance from 64 per cent to 47 per cent. Bonds have lifted their share of investment from 24 per cent to 37 per cent. Moriarty attributed this change in balance largely to pressure from regulators to hold less risky assets. DB schemes face the same pressures as in the UK: low asset returns, increased longevity of members, and so on.

Defined contribution scheme assets amount to EUR €33 billion, with 239,000 employees covered. DC asset allocation is currently 53 per cent equities, 21 per cent bonds, and 17 per cent cash. (The cash figure is said to have risen, oddly enough, because lots of Irish people moved out of equities at low points, and are now waiting for markets to recover before returning.)

Moriarty suggested that pensions have the capacity to become something of a political time bomb in Ireland. The issues are much as they are across Western Europe. The options are the same: reduce

pensions or increase tax and savings rates. Crisis measures have been introduced from time to time, with varying consequences in the longer term:

- Reduce incentives to save for pensions
- Pension levy
- National pensions reserve funds have been plundered by government to bail out banks
- OECD's review of pensions worldwide (see section 4.6, below) might provide useful pointers for future action.

IAPF's communications issues with its members are the same as apply elsewhere. In broad terms, most people simply do not understand how the pensions system works. It is difficult to persuade people to contribute more when the Government keeps moving the goalposts.

3.5. "US: modern pension design: learning from the innovators": Joshua M Franzel: Vice President of Research: Center for State and Local Government Excellence (Conference session 30)

Franzel described how pension arrangements operate in US states and local government. There are 50 states, and about 90,000 local government regimes. The combined workforces in 2012 came to a total of 14.4 million full time employees. There are around 4,000 state and local government public employee retirement systems. These contain 19.6 million active and inactive members and around 9 million retirees. Of these (figures for 2014):

- For state workers: 86 per cent had access to a defined benefit pension plan; 43 per cent had access to a defined contribution plan
- For local government workers the comparable figures were 82 per cent and 30per cent.

In terms of plan assets (figures again for 2014):

- Defined benefit scheme plan assets: aggregate for state and local government: USD $3.7 trillion
- Defined contribution scheme plan assets: aggregate for state and local government: USD $538 billion.

Franzel gave an overview of the benefits, risks and responsibilities of different employer sponsored retirement plans. He looked at three main types of scheme:

- Defined benefit
- Defined contribution
- Cash balance

[Notes about cash balance schemes: (1) Definition: "A defined benefit retirement plan that maintains hypothetical individual employee accounts like a defined contribution plan. The hypothetical nature of the individual accounts was crucial in the early adoption of such plans because it enabled conversion of traditional plans without declaring a plan termination." (2) Scale: In 2003, over 20 per cent of US workers with defined benefit plans were, in fact, in cash balance plans, according to Bureau of Labor statistics. Most of these plans resulted from conversions from traditional defined benefit plans.]

Franzel examined each of these three types of scheme for:

- Funding sources: employer or employee, or a combination of the two
- Whether the scheme is portable with a move to a new employer
- Responsibility for carrying the investment risk: employer and/or employee, or indeed an annuity provider
- How benefits are accrued: whether evenly over a career, or front loaded towards the start of a career, or back loaded towards the end of a career
- Whether the plan type has the potential to outlive funds

Franzel looked at the continued adoption of hybrid plans by the states' pension schemes:

- DB/DC combinations had started in Indiana in 1955. Washington State had followed in 1996, with Ohio in 2003. A group of five came after the financial crash of 2008: Georgia in 2008, Utah in 2010, Rhode Island in 2011, Virginia in 2012, and Tennessee in2013.
- Cash balance plans: Nebraska had started in 2002. Kansas followed in2012, with Kentucky in 2013.

Franzel set out some of the stated reasons for the adoption, and continued use, of hybrid plans:

- Nebraska (implemented in 2002) identified the issues involved: “Risk averse employees would benefit from the defined benefit form; whilst investment savvy employees can choose the defined contribution plan.” From the taxpayers’ point of view: “one of the things that helps keep Nebraska’s pension liability low is that it has a cash balance plan.”
- Tennessee (implemented in 2013) listed the advantages: (1) “provide a sustainable pension plan going forward”; (2) “control employer pension cost”; (3) “control unfunded liabilities related to pensions”; (4) “provide a sufficient level of benefits for career employees to maintain a reasonable standard of living at retirement”.

Plan contributions for cash balance schemes tend to be in the region of 4.5 per cent to 6 per cent for employees, with 4 per cent to 7.5 per cent from the public employers (the state governments). Franzel looked at the levels of employee retirement incomes that are offered. He speculated on factors that might come into play in the future:

- Hunger of state governments (and of their electorates) further to reduce liabilities
- Requirements of future legislation.

3.6. “Belgium: 4Q 2014: bold, multifaceted pension modernisation at the core of a reformist policy mix”: Koen Vleminckx: Director: research and publications: Belgian Federal Ministry of Social Affairs (Conference session 13)

Vleminckx listed some key facts about the Belgian pension system: level of public spending, life expectancy, proportion of the population aged over 65, normal working career of 45 years, gross replacement rate. The overall picture is that of an ageing population that is increasing in number. Longevity is rising. A huge generation of civil servants will soon retire.

In April 2013 the Belgian minister for pensions announced that 12 industry experts had been put in charge of preparing a new instalment of pension reform, the second such reform, that would cover the period ahead, of 2020-40. They were asked to report within a period of one year, and to have regard to three factors: (1) financial sustainability; (2) ensuring a system that had public legitimacy; and (3) coherence and transparency. The committee reported that the present scheme was not sustainable. They recommended:

- Structural reform to end the current tripartite division into civil servants, other employed, and self employed
- The principle of a social insurance system would represent the best social contract.

A new centre right government came to power in Belgium in June 2014. They committed to implement the proposals of the reform commission as part of their moves to cut government expenditure. Among the specific features are the following:

- Restrict early retirement
- Encourage paid employment after retirement age
- Introduce pensions for part time workers
- Reduce the pension privilege of civil servants
- Increase pensionable age, at first to age 66, and then to age 67
- For non statutory public employees, increase contribution levels to 3 per cent

- The Belgian Government will assure the attraction of the Belgian market for pan European pension funds.

The debate continues.

3.7. "Dutch DC at the crossroads: reexploring a leading pension system": Erik Goris: Managing Director: policy advice: PGGM NV (Conference session 17)

The Dutch pension system is coping with four significant changes: (1) increased regulatory pressures; (2) stricter requirements for board members; (3) focus on cost reduction; and (4) weakening sponsorship by employers. They faced new requirements for sustainability: in both financial and social issues. In the face of these pressures, Dutch pension schemes are consolidating. Corporate funds are flowing from defined benefit schemes to defined contribution or to collective defined contribution schemes. The Dutch Government is taking the lead in shaping the way ahead:

- Limits on tax facilitated pension saving (with a cap on the income level at which tax relief at source applies)
- Introduction of new pension vehicles
- Start of a national discussion on the future of pensions
- New financial supervision of defined benefit schemes
- The bottom line is that the Government seeks to protect nominal pension values, but not inflation linked pensions.

Goris listed the characteristics of individual defined contribution schemes. He noted that such schemes did not, however, often enable risk sharing between active and retired members. Much current thinking tends to favour the principle of intergenerational risk sharing. It is seen as a means by which to promote affordability in pension schemes.

The Melbourne Mercer Global Pensions Index gave Netherlands a B+ grade. It placed it third in its world rankings, behind only Denmark and Australia.

3.8. "French DC pension accounts: PERCO: the French Way": Pierre Bollon: Chief executive: Association Francaise de la Gestion Financiere: the French trade association for investment funds and asset managers (Conference session 18)

France's collective retirement savings plan, PERCO, was introduced in 2003. PERCO attracted workers because of its flexibility, but by 2011 only 10 per cent of companies had adopted the system. Laure Delahousse, director in charge of pension saving vehicles at Association Francaise de la Gestion Financiere (AGF), the French trade association for investment funds and asset managers, thought that there was still a long way to go: "Traditionally, in France, public pension benefits are relatively high. As a result, French people use savings vehicles, but not necessarily for their pension. It is a cultural problem, and the French need a clear message from the state to understand their pension benefit will decrease over time due to the growing deficit."

Former French premier Francois Fillon launched PERCO in 2003, when he was still minister of social affairs: the so called "Fillon Law". His aim was to encourage French workers and companies to use a capitalisation system to complement the traditional system of pension distributions: that is, to receive payments based on the employee's desire to save. Employees have the option to pay sums from profit sharing and incentive schemes, and they can make voluntary payments. Usually, the amount paid is then supplemented by the employer, who saves a certain sum on behalf of the employee.

Bollon reported on progress. French retirement is on a pay as you go basis. The national savings rate is high, at 15 per cent of disposable income. Even so, arrangements are not really sustainable. Defined benefit schemes have never been commonplace. PERCO still remains small in scale. Occupational defined contribution schemes tend to offer a lump sum at retirement, with access to an annuity.

4. INVESTMENT TECHNIQUES AND YARDSTICKS

4.1. "Asset allocation: the great risk/ return inversion: who loses out?" Paul K Woolley: Chairman, Centre for the Study of Capital Market Dysfunctionality: London School of Economics; former Head of Borrowing and Investment: International Monetary Fund (Conference session 2)

Woolley said that conventional wisdom and common sense suggested that high risk assets should deliver higher returns than did low risk assets. This was not borne out by evidence. It had not been the case, what is more, for 40 years or so. New research highlighted how risk/ return inversion could be caused by benchmarking to market capitalisation indices. The argument was set out in an article of 2014: "Asset management contracts and equilibrium prices" by Buffa, Vayanos, Woolley.

In this article, they say: "We study the joint determination of fund managers' contracts and equilibrium asset prices. Because of agency frictions, investors make managers' fees more sensitive to performance and benchmark performance against a market index. This makes managers unwilling to deviate from the index and exacerbates price distortions. Because trading against overvaluation exposes managers to greater risk of deviating from the index than trading against undervaluation, agency frictions bias the aggregate market upwards. They can also generate a negative relationship between risk and return because they raise the volatility of overvalued assets. Socially optimal contracts provide steeper performance incentives and cause larger pricing distortions than privately optimal contracts."

Woolley himself defined "Beta" as the variability of an asset that cannot be diversified away. He set out some background factors that lay behind the analysis in the article:

- Pension funds are wont to select assets on the basis of the highest return for a given level of risk
- Asset owners do not spread knowledge about their assets
- Markets tend to acquire their own momentum in rising or falling

There is really an inverse relationship between risk and return. It is what Woolley calls the "Beta anomaly". This can be seen in an analysis of US equities during 1970-2011. It can be seen also in an analysis of global equities. Woolley listed three factors that had contributed: firstly, momentum; then value; and, finally, delegation (by principals to their fund manager agents).

Principals, such as pension funds, typically constrain the freedom of their agents, the fund managers. They seek to cap risk by laying down benchmarks which are based on market capitalisation indices, or peer group performance. This can result in fund managers being obliged to buy stocks in which they have little confidence. Overvalued stock can then make up a large component of an index. This led, for example, to the tech stock bubble that burst at the turn of the present century. In particular: a "manager has to be most vigilant of underweight positions in high volatile assets with large weights".

Woolley quoted an example of a fund manager who was instructed to hold Vodafone, even though it was overpriced, in order to conform to a yardstick. The lesson was that being underweight should not count as a charge against a fund manager. There was over valuation of some high risk, high beta, stocks (and of their asset classes). Double distortion could then ensue. "The tighter [are] the

constraints, the greater [is] the inversion of risk and return." Some unconstrained funds did "bet against beta". Hedge funds were an example. Most, however, exploited momentum opportunities that were created by the constraints. Woolley was wary of both short termism and benchmarking. Both of them tend to distort incentives and prices.

What is the solution? Woolley said that it was for principals to write contracts for their agents that are free from market capitalisation benchmarks and tight tracking. Principals should require managers to invest instead on the sole basis of fundamental income and value. "The best way of beating an index is to ignore it", he reckoned. What should be the role of policy makers? They have a role in setting a code of best investment practice. They also have an opportunity to improve alignment between private gain and public social benefit.

4.2. "The rise of indices and indexing: from benchmarking to 'beta factories' and 'smart passive' funds": Brett Hammond: Managing Director and Head of Index Applied Research: MSCI Inc (Conference session 28)

In preparation for Hammond's presentation, I reminded myself of some investment terminology from the "Jargon Buster" published by BlackRock:

- Alpha: "The return generated by an active portfolio relative to the return generated by its investment benchmark."
- Active manager: "An investment manager who seeks to outperform an investment benchmark through, among other things, asset allocation, market timing, duration selection or security (company or bond) selection."
- Beta: "The correlation of an asset's or [a] portfolio's return to a benchmark portfolio or index. If beta is greater than 1.0 the asset or portfolio will move more than the market or benchmark, while if it is less than1.0 it will move less. If the beta is negative, the portfolio will move in the opposite direction to the benchmark."
- Passive manager: "An investment manager who seeks to closely match the return of an investment benchmark without generating additional return, or alpha."

Hammond started by noting the evolution of equity investment theory. First, there had been straightforward investment returns. Next, there had been a division into Alpha or Beta. Then Beta benchmarks became sub divided: by region of the world, by country, or by trade sector. Then there came a further sub division: "Factor Beta". Hammond asked: "what causes factor risk premia, and how persistent are these effects?" He noted two answers:

- Systematic risks: "Certain stocks are highly correlated with the economic cycle and earn a risk premium"
- Systematic errors: "Certain stocks may be systematically under priced and subsequently earn a high return".

There is passive investing, based on market returns. There is active management, based on active returns. Between the two, Hammond identified a third way: "Factor Investing". This factor investing is rules based. It requires transparent implementation. The factors of which this factor investing takes note are six in number: (1) Low size, (2) High value, (3) Momentum, (4) Quality, (5) Yield, and (6) Low volatility. Each of these factors is: "grounded in academic finance theory". Each of the factors has: "been expressed in a family of research-based investable MSCI Factor Indexes".

What attracted investors to factor investing? Hammond charted annualised return against annualised risk during1975 to 2014. The four poles are:

- Low risk and high return (including high dividend yield, and risk weighted)
- High risk and high return (including momentum, and equal weighted)

- Low risk and low return (including quality and minimum volatility)
- High risk and low return (including value weighted; and also MSCI World, which came in at highish risk and low return)

Hammond noted that cyclicality is a key dimension. He sketched out the relative performance during 1975 to 2014 of six (again) factor indexes:

- MSCI Equal weighted/World: "Equal allocation across parent index constituents"
- MSCI Momentum/World: "Momentum opportunity set and weights derived from market cap times a momentum score based on short- and long-term momentum signals"
- MSCI High dividend yield/World: "High dividend yield opportunity set within parent index constituents"
- MSCI Quality/World: "Quality opportunity set and weights derived from market cap times a quality score based on D/E, ROE, earnings variability"
- MSCI Minimum volatility/World: "Constructed using minimum variance optimisation"
- MSCI Risk weighted/World: "Weights based on the inverse of historical variance"

Could factor indexes capture the returns of alpha investing? Hammond said that he had analysed over 1,000 actively managed funds during 2001-11. His conclusions are that:

- "Factor indexes turn some alpha into systematic beta"
- "Combining active funds with factor indexes could be attractive"

He turned his attention to constructing factor indexes. He covered eight of these: (1) Minimum volatility; (2) Value weighted; (3) Quality; (4) Momentum; (5) Risk weighted; (6) High dividend yield; (7) Quality/mix; (8) Equal weighted. All factors are not alike. He set out something of the correlations amongst them. He recommended building blocks for multi factor combinations. He set out the performance (in terms of active return versus passive) that each of the various factor indexes had achieved across the main regions of the world during the most recent 12 months.

London International Financial Futures Exchange, "LIFFE", listed seven MSCI factor index futures in 2014: three of these were minimum volatility indexes (World, Emerging Markets and Europe); the remaining four were equal weighted indexes (US, World, Emerging Markets and Europe).

Hammond charted for his indexes the average monthly gross active returns, relative to MSCI World during 1975-2013, that applied in each of four economic scenarios, or "bivariate environments" as he called them. His two bivariate factors were inflation and growth. He combined them in his four scenarios thus:

- Heating up: high inflation; high growth
- Goldilocks: low inflation; high growth
- Slow growth: low inflation; low growth
- Stagflation: high inflation; low growth

Hammond returned to his six factors for factor investing: (1) Value; (2) Momentum; (3) Low size; (4) Quality; (5) Low volatility; and (6) Yield. He looked at: "considerations for combining factor indexes". For each factor he set out the risk comparable to the market. He then noted the correlation with others of the six factors. Finally, he noted how each factor was affected by the business cycle: whether it was pro-cyclical or whether it was defensive.

Hammond concluded:

- Smart beta: "Strategically investing in factor indexes"
- Alpha: "Tactically rotating in and out of factor indexes"

He left two "key takeaways":

- “Factor investing makes sense as they are shown to outperform historically, and their outperformance can be explained”
- “Factor investing is suitable for passive investors in a strategic allocation framework, and for active managers and hedge funds as a dynamic investment”.

4.3. “Core versus non core: the quest for ‘new frontiers’ in fixed income and money markets in a low yields environment”: Jean-Francois Bay: Chief Executive Officer: Morningstar France (Conference session 3)

A feature of the bond market in Europe has been low interest rates. For how much longer, asked Bay? Return on fixed income investments will, in all probability, continue to be depressed by the impact of government policies designed to keep down unemployment. The policies of central banks will probably work in the same direction. It is sometimes difficult to distinguish between longer term trends and short term blips.

Bay’s view was that the importance of non core bond categories will tend to rise. He looked at the well known chart showing performance by asset class for each year during recent decades. It showed how diversification can boost returns and reduce risks. He expected that contingent convertible bonds, “CoCo Bonds”, will increase in significance. Under current circumstances, extracting returns from assets is like mining. Sometimes, open cast mining produces results. At other times, extracting has to take place under conditions that are extreme. In this event, said Bay, Morningstar can be on your side!

[Note: Investopedia defined contingent convertibles, CoCos: “A security similar to a traditional convertible bond in that there is a strike price (the cost of the stock when the bond converts into stock). What differs is that there is another price, even higher than the strike price, which the company’s stock price must reach before an investor has the right to make that conversion (known as the ‘upside contingency’”. Investopedia explained: “Issuing contingency bonds is more advantageous to companies than issuing regular convertibles. Until an investor exercises the option, the company does not need to count shares in its calculation of diluted earnings.” It noted, however, that: “as of July 2004, the FASB’s Emerging Issues Task Force proposed an accounting change that, if passed, would eliminate the accounting advantage of CoCos”.]

4.4. “Pension assets and asset allocation in a difficult time: a cautionary examination”: Philippe Desfosses: Chief Executive Officer: French Public Service Additional Pension Scheme (ERAFP) (Conference session 15)

Desfosses thought that economies across the world had become unsustainable even before the financial crisis of 2008. The steady growth of 30 years was already in danger. Fault lines have started to appear. Boom and bust is reemerging. There is a firm downward trend in Treasury yields: from 15.4 per cent in 1980 to 1.4 per cent today. Public indebtedness is rising troublesomely. He thought that all signs pointed to: “getting closer to a very scary situation”. Searchers after liquidity in investments looked to corporate bonds. Here again, there is a picture of decline in yields; although high yield (junk) bonds could be worth consideration. In addition, it is not clear how governments will extricate themselves from quantitative easing (QE). Will they gradually decrease the easing, or will they gradually grow lean?

The new global threats are the risks of debt overhang and of deflation. Debt restructuring could become a trend. “Govies”, or government securities, might become the nearest thing to a risk free asset. Desfosses himself thought that the International Monetary Fund would lay down the blueprint for the way ahead. There might also be an emergency exit through inflation.

Pension systems might need to move towards a restructuring of social benefits. Liabilities may have been priced too low. The architects of pension systems might need to address what should happen when they had been too optimistic in their assumptions. Pension defaulting might follow. It could be time, therefore, to change tack.

Desfosses looked at carbon debt. It was a debt that could not be restructured. Fiduciary duty and carbon footprint transparency both pointed to the need for action. Was carbon a risk? You had only to read the "Risky Business" report to know that it is a risk.

I took his advice on reading the "Risky Business" report. Its co chair, Michael R Bloomberg, was interviewed about it in June 2014. He said then: "Damage from storms, flooding and heat waves are already costing local economies billions of dollars. We saw that first hand in New York City, with Hurricane Sandy. With the oceans rising and the climate changing, the Risky Business report details the costs of inaction in ways that are easy to understand in dollars and cents – and impossible to ignore."

Desfosses saw a way to launch a virtuous circle. We should aim for transparency on carbon footprints. As a start, we should lay down a mandatory requirement for public investors to release the carbon footprint of their portfolios. We should work to bring public opinion on board. The European Union should adopt a package by 2030 to place a price on carbon.

4.5. "Understanding the Europe 2020 Project Bond Initiative": Dominik Zunt: Policy Officer: European Union Economic and Financial Affairs Directorate General (Conference session 23)

The Europe 2020 Project Bond Initiative is a joint initiative by the European Commission (EC) and the European Investment Bank (EIB). Its objective is to stimulate capital market financing for large scale infrastructure projects in the sectors of transport (TEN-T), energy (TEN-E), and information and communication technology (ICT). According to the Commission, the European Union's infrastructure investment needs, in order to meet its Europe 2020 objectives in these sectors, could rise as high as EUR €2 trillion.

The Project Bond Initiative is designed to enable eligible infrastructure project promoters, normally public private partnerships (PPP), to attract additional private finance from institutional investors. Insurance companies and pension funds are prime targets. This will be achieved by providing credit enhancement to the project promoters. In essence, their debt will be divided into two tranches: senior and subordinated:

- The subordinated debt, or Project Bond Credit Enhancement (PBCE), can take the form of a loan from the Bank, with the support of the European Commission. It is given to the promoter at the outset. It may also take the form of a contingent credit line, which can be drawn upon if the revenues generated by the project prove to be insufficient to secure senior debt service.
- The PBCE underlies the senior debt, and thus improves its credit quality. It offers peace of mind to institutional investors.

The bonds themselves will be issued by the project promoters, and not by the Bank or the Member State in question. The support will be available during the whole life of the project, including the construction phase.

Zunt said that investment in infrastructure has always been at the heart of EU policy. The budget for the Trans Regional Network is EUR €57 billion a year, with regional infrastructure as the biggest

component. The European Investment Bank lent EUR €30 billion a year on infrastructure. Infrastructure investment is now more important than ever. Plans over the next three years will require EUR €300 billion. Public support is important. Project promoters seek to show potential investors that their involvement is both welcome and needed.

"Private financing is an integral part of the road map", said Zunt. "The EU seeks a transition from public sector funding to more private funding. It looks to institutional investors as well as to banks." The EU acts as an enabler, to unlock private finance. "Not all infrastructure projects can be financed on financial terms", he added. Strategic arguments may be needed in some cases. It is crucial to keep up a robust pipeline. The EC and the EIB had set up a joint task force to do this. They had laid the groundwork, and introduced two clear principles: secure good leverage rates, and do more with less. The newly installed Juncker Commission will produce further proposals before the end of 2014. The Bank has used a range of financial instruments to date. These include loan guarantees and equity investment. Bonds have become a more mainstream financing model. Non banking private sector involvement is recognised. Public support remains vital.

4.6. "Mortality assumptions and their impact on longevity risk: gauging the 'known unknowns'": Pablo Antolin-Nicolas: Principal Economist and Head of the Private Pension Unit: Organisation for Economic Cooperation and Development (OECD) Financial Affairs Division (Conference session 14)

OECD defines longevity risk as: "the uncertainty surrounding future mortality and life expectancy outcomes". The organisation said: "Pension funds and annuity providers need to effectively manage the longevity risk of their members. Members may live longer than expected or accounted for in the actuarial calculations involved in the provision of pensions. Mismanaged longevity risk can deteriorate finances, cause bankruptcy and expose members to the risk of losing their pensions. To safeguard against this risk, pension funds and annuity providers must provision for future improvements in mortality and life expectancy. Further, effective management of longevity risk must be supported by the regulatory framework."

OECD initiated a study: "to assess how pension funds, annuity providers such as life insurance companies, and the regulatory framework incorporate future improvements in mortality and life expectancy. The study will examine the regulatory framework as well as the actual market practice, with the purpose of identifying best practices, introducing policy recommendations and providing guidelines to improve how longevity is managed when calculating pensions and annuity payments."

OECD noted: "Longevity risk is a very long term risk. Its impact runs from the time an individual joins a pension fund, let's say age 25, until s/he passes away, around age 80-90. Consequently, assumptions allowing for future improvements in mortality and life expectancy need to run for around 60 years at least."

The project focused on a few OECD countries: Canada, Chile, France, Germany, Korea, Japan, Mexico, Spain, Switzerland, USA and UK. Antolin-Nicolas reported some of the findings:

- It is important to calculate annuity payments using a range of mortality assumptions. Figures should be updated regularly.
- There should be appropriate instruments to hedge and mitigate longevity risk.
- Longevity swaps constitute the most attractive option, although they bring in counterparty risks.
- Governments could encourage the development of such markets through increased transparency.
- Even after all of this, longevity risk remains a concern that is of significance in scale.

<u>5. ASSET ALLOCATION AND DIVERSIFICATION</u>

5.1. "World Bank Group: Infrastructure investment: with focus on middle income nations and frontier markets; presentation of the Global Infrastructure Facility (GIF)": Bayo Oyewole: Principal Operations Officer: International Finance Corporation (Conference session 21)

Oyewole described the work of the Global Infrastructure Facility: GIF. "The GIF is an open platform established by the WBG [World Bank Group] for collaboration between public and private partners to prepare and structure complex, commercially viable, infrastructure projects in emerging markets and developing economies."

Governments seek:

- Long term finance for more investment in infrastructure. In particular, this includes: (1) investment in climate friendly energy; (2) investment that enables trade; (3) growth of, and expanded access to, basic services.
- Diversification in sources of finance. Currently, over 80 per cent of infrastructure relies wholly on public finance. Over half of the "private" funding comes, in fact, from public sources. It would be good to shift the balance from debt funding to equity funding.

Private investors have their own needs:

- Financing packages that are competitive
- Banks need exit options, especially at a time when the long term lending environment is tightening
- Institutional investors seek long term investments with predictable cash flows

The needs of national governments and the demands of private sector investors can certainly be made to become compatible with each other, said Oyewole. What, then, is not working? There is: "no pipeline of well prepared and structured projects that represent attractive investments". Oyewole addressed in detail how the World Bank Group is tackling the challenge of project preparation and structuring:

- Identification and preparation, leading to investment decision
- Transaction, leading to commercial close
- Financing, leading to financial close

At each stage, WBG has examined the question "what could we do differently?" They have identified what would be the potential impact of well structured private investment in infrastructure. (1) They surmise that distribution losses would be lower. (2) Labour productivity would probably be higher. (3) Frequency of interruptions would be lower, and so too (4) would the duration of the interruptions. (5) Operational expenditures would be likely to drop significantly. (6) There would be improvements in cost recovery ratio. In the case of energy production, (7) consumer tariffs would fall.

Oyewole examined a specific case where GIF had brought management to pull together a major project: a 300 MW combined cycle gas to power plant. He looked at the activities that the Global Infrastructure Facility would put in place to nurture progress towards each project milestone. GIF would follow five key steps, as follows:

- End to end development and structuring that would be appropriate for complex private infrastructure projects
- Gap filling support to complement other resources
- Partnership approach to implementation
- Leveraging that could be obtained through the capacity of WBG
- Revolving facility: as a means to share cost and risk

Oyewole outlined how the WBG Partnership Program will control the Global Infrastructure Facility Management Unit. He then set out how WBG and GIF will address the global infrastructure challenge. Addressing infrastructure services and the finance gap have now achieved great momentum. It has become a central theme of both the G20 major economies and of the 21 Pacific Rim economies in APEC (Asia Pacific Economic Cooperation). A main challenge remaining is to catalyse private wealth, such as pension funds, insurance companies and sovereign wealth funds. Currently, only a tiny part of these resources are invested in infrastructure finance: say one per cent of assets. The long term goal of GIF is to: "make infrastructure assets in emerging markets and developing countries more attractive to a broader range of investors". The two main methods are likely to be:

- "Building a pipeline of well prepared and commercially viable projects"; and
- "Structuring projects to address the regulatory, political and reputational risks associated with investments in emerging economies"

WBG is currently at the pilot stage, working together with International Bank of Reconstruction and Development: IBRD (for which WBG is the parent organisation). IBRD will transfer USD $15 million to catalyse donor contributions. From this, the target leverage for initial capitalisation will be USD $80-$100 million. The launch programme is on course to start GIF operations in 2015, with a review after a pilot phase of three years.

"What's in it for you?" Oyewole asked in conclusion of his audience. He was looking for partners. What he could offer was:

- Early stage participation in infrastructure projects;
- Regular meetings with other partners; and
- Opportunity to influence project structuring in order to enhance investment appeal.

5.2. "European Investment Bank experience: financing infrastructure assets across the European Union": Cormac Murphy: Head of Structured Finance/ Infrastructure – Project Bonds: European Investment Bank (Conference session 22)

Murphy talked of the Europe 2020 Project Bond Initiative. He said that there are three main investment needs for infrastructure up to 2030: airports, water and power generation. At present, there is a funding gap for these. The European Investment Bank (EIB) seeks private sector institutional investors to fill that gap. The Bank is aware of what potential investors seek: in particular, long dated assets that match liabilities. EIB could, indeed, offer long term projects, and with yields higher than those of Government bonds. At present, however, large pension funds typically have no more than one per cent of funds invested in infrastructure.

He said that the Project Bond Initiative was now moving to post pilot stage. The Project Bond Credit Enhancement (PBCE) has been tested in a variety of market environments. These are described in a report from the European Commission dated 19/12/2013: "Interim report on the pilot phase of the Europe 2020 Project Bond Initiative". Murphy described some of the pilots:

- First was the Castor gas storage facility in Spain: The EIB had supported the issue of a EUR €1.4 billion bond, without the use of EU budget. The bond was launched in July 2013 with a coupon of 5.756 at a spread of 100 basis points over Spanish Government bonds. The bonds financed the construction and operation of underground gas storage and associated facilities off the northern Spanish Mediterranean coast. Standard & Poors accorded a BBB rating to the bonds. There were 30 investors in the bond, with insurers and pension funds taking over 60% of the issue. The remainder went to agencies, fund managers and banks (only 4%). The

investors were diversified geographically, with more or less equal shares going to Germany, France, Spain, Italy, UK and Luxembourg. The bond was issued by Watercraft Capital, an SPV based in Luxembourg. They on lent the proceeds to the project company in order to refinance the outstanding loans of shorter date that they had used to finance the construction of the gas storage facility. The project company acquired thereby finance that was more suited to its 30 year concession.

- The Project Bond Initiative also supported the issue of a GBP £305 million bond for the Greater Gabbard OFTO (offshore transmission) project in the UK. This involves electricity transmission assets, which link 500 MW of offshore wind farms to the UK onshore grid. It is the first OFTO project to be funded through the capital markets. The bond benefited from an unfunded PBCE (Project Bond Credit Enhancement) of around GBP £46 million. As a result, it received a rating of A3 from Moodys, pricing at a competitive 125 BPS over gilts. The OFTO licence was granted by Ofgem, the UK regulator of electricity and gas markets. It entitles the project company to own and operate the assets for a period of 20 years and, in return, to receive availability based revenues. A public bond of GBP £305 million, paying a fixed coupon of 4.137% and maturing in November 2032, was issued to finance the deal. The European Commission report said: "This is the first round one OFTO of sufficient size to have attracted the interest of the capital markets. Such funding has long been viewed as a good fit for the OFTO sector as the tariff paid to the operator is RPI linked and 90% of the revenue is guaranteed."

- In Belgium, the A11 Brugge PPP is a new motorway, which links the harbour of Zeebrugge with the E40 to Ghent and the E34 to Antwerp. It will be the first transport TEN-T project under the PBI, and the first "greenfield" transaction. It is expected that bonds for EUR €575 million will be supported by around EUR €114 million of unfunded PBCE in the form of a subordinated letter of credit issued by the EIB.

Murphy summarised the progress that had been made to date. The new bond market has become established. Benchmarks have been fixed. There is now standardisation in approach. He turned to look at what still needs to happen. A critical mass should be built up, in order better to establish the asset class. Risk projects will prove to be more challenging than private finance initiative (PFI) schemes. The Connecting Europe Facility (CEF) will need funding for high speed broadband Internet and access to digital service infrastructures. Otherwise, it is not clear whose job it is to come up with new candidate projects. Murphy's conclusions, however, are that much progress has been made in the past year, and that the European Investment Bank has achieved a strong catalytic impact.

5.3. "China Construction Bank: long term bank financing, with focus on People's Republic of China and neighbouring jurisdictions": Feng Liying: General Manager, Pension Management Department: China Construction Bank; Executive Deputy Director General, Pensions Committee: China Banking Association (Conference session 29)

China Construction Bank (CCB) was established in 1954. It is a major player in infrastructure projects. It is the prime financial institution of China. It has strength in loans for four infrastructure domains: housing, pensions, harbours and high speed rail. CCB has secured licences in the pensions business. The World Bank estimates that the total value of China's pension funds will be around USD $1,800 billion by the year 2030. Two new regulations allow encouragement of private equity companies and capital markets: SC (CBRC) No 9 and CSRC No 50 Regulations. CCB has been in discussion with other organisations "for the cooperation of the pension business". Some of these partners are from within China, such as SDIC. Some of them, also, are from outside, such as Credit Suisse. "China Construction

Bank is also a major player for the policy making towards the pension regulations of the Chinese Government."

"How can a foreign investor knock [at] the door of China's infrastructure", asked CCB's presentation team? Their answer was concise: "Negotiate with CCB". They were involved in promoting private equity investment in China. The joint venture business model is one that they back. The net profit of CCB fluctuated from year to year, but the trend pointed clearly upwards. The return to shareholders in terms of yield pointed more clearly upwards. The Bank had won a sheaf of awards from across the world. Amongst these were Fortune Magazine, The Banker, Forbes, Euromoney, Visa and the China Banking Association.

The China Council for the Promotion of International Trade (CCPIT) was established in 1952. It claims to be the most important and the largest institution for the promotion of foreign trade in China. "The aims of the CCPIT are to operate and promote foreign trade, to use foreign investment, to introduce advanced foreign technologies, to conduct activities of Sino-foreign economic and technological cooperation in various forms, to promote the development of economic and trade relations between China and other countries and regions around the world, and to promote the mutual understanding and friendship between China and peoples and economic and trade circles of all nations around the world, in line with law and government policies of the People's Republic of China."

The Investment and Infrastructure Research Committee (IIRC) is: "a high-level platform for national government, bi-, multi- and supranational agencies, institutional investors, the construction and financial services industry in order to promote and actively realise infrastructure and infrastructure investments in China as well as internationally. CCPIT-IIRC promotes infrastructure and international strategic cooperation as [a] model for stability and driver of growth. While the opening Chinese market offers interesting opportunities for international investors and bi- and multilateral cooperation, international infrastructure and industry projects can as well be realised with the help of the network and support of CCPIT-IIRC. CCPIT-IIRC acts [as] a bridge between the infrastructure stakeholders providing support and solutions."

CCIPT: "offers a platform which takes the mediator and facilitator role for the interest groups". Its five key objectives are stated to be:

- Promote currently available, and develop new, "suitable investment vehicles, particularly for large institutional investors, to gain access to Chinese infrastructure in close cooperation with the authorities"
- Collect and match-make between specific projects in China and abroad and potential investors, in order to provide investors with available investment and project opportunities
- Realise infrastructure, by providing financing and investment solutions
- Improve research and data collection in the field of infrastructure investment
- Facilitate bi- and multilateral cooperation.

5.4. "UK High Speed 2: principles and attributes of major transportation infrastructure in the northern hemisphere": Andrew McNaughton: Technical Director: High Speed 2; Vice Chair: European Union Transport Advisory Group (Conference session 19)

McNaughton described how high speed rail originated in Japan, 50 years ago. It has seen a period of expansion in recent years. France is a good example of how the typical financial model works. In this, trunk lines produce a good rate of return. Branch lines, by contrast, have to be justified with "strategic" arguments. Britain's background is of a population that is presently growing. Increasing numbers of people live in city regions. The population growth is extraordinary for a mature nation.

Rail demand has doubled in 20 years. The Government has set as a strategic target to rebalance the economy across the country, which will impact further on the transport network. The vision is one of "cities working as one economic powerhouse". HS2 aims to bring northern cities closer together in travelling time, and thereby to create jobs.

HS1, running from the Channel Tunnel to London, is in effect an extension of the French railway network, said McNaughton. HS2, as with HS1, requires complex technical solutions. They both have life expectancy of 150 years or more. Both need to be designed for individual passengers, as well as for business travellers. Siting of stations is a key issue: city centre or fringe locations. "Wherever you put a station, you change the city" he suggested. This is: "not a probability, [but] an inevitably". Two stations are planned in London: one at the existing terminal at Euston, and the second at Old Oak Common, in the decaying industrial areas of Acton, to the west. Land prices around HS2 stations may be expected to rise by a factor of 10 or more.

Issues of risk management are being addressed. Among these:

- Analysis of technical considerations certainly plays a role
- Aiming for cross party political support is probably more important. Consultation and dialogue are the order of the day, with "local community forums" and the like. "We can never do enough of it", said McNaughton
- Parliamentary procedural arrangements are required. The London to West Midlands line needed what was known as a "Hybrid Bill", in this case entitled: High Speed Rail (London-West Midlands) Bill 2013-14. ("A Bill with characteristics of both a Public Bill and a Private Bill is called a Hybrid Bill. Such Bills are examined in Parliament by a combination of both Public Bill and Private Bill procedures.")

Overall, the risks attached to HS2 will abate over time. The completion of each stage will signal a reduction in uncertainty. In sequence, there will be enactment of legislation, then start of work on site, then completion of construction work, and so on. The project team will keep under review when will be the best times to bring in private sector investment. HS1 has demonstrated, and HS2 will reaffirm, that the UK is proficient at planning and project managing a major infrastructure programme. McNaughton conceded that the Scottish question (which was topical at the time) might present some political risk. Nonetheless, he thought, people would still wish to travel.

5.5. "Fast tracking sustainable investments to foster quantifiable development goals": Guido Schmidt-Traub: Executive Director: United Nations Sustainable Development Solutions Network (Conference session 6)

"The SDSN supports the development of Sustainable Development Goals (SDGs) to address the challenges of economic development, social inclusion, environmental sustainability and good governance. These goals will build on the success of the Millennium Development Goals (MDGs) and finish the job of ending extreme poverty in all its forms."

Schmidt-Traub said that 2014 seems likely to be the hottest year on record. Global warming appears to be increasing in pace. There is impact on agriculture, and loss of bio diversity. What could the world do, he asked? The Rio summit in 1992 had highlighted concerns, and galvanised action. Three major international conferences during 2015 will together define the agenda ahead:

- In July 2015, world leaders will meet in Ethiopia for the Financing for Development (FfD) conference that will adopt a financing framework for the sustainable development priorities. The conference will draw on the findings of the Intergovernmental Committee of Experts on Sustainable Development Financing.

- In September 2015, a summit of Heads of State will adopt the Sustainable Development Goals (SDGs) at the United Nations in New York.
- Finally, in December 2015, governments will meet in Paris for the 21st Conference of the parties to the UNFCCC (United Nations Framework Convention on Climate Change) to adopt a climate agreement. This conference will pull together negotiations over several years on climate change.

Together, these conferences will seek five major transformations for long term sustainable development. Two of the themes involved are those of energy and cities. Schmidt-Traub looked at the roles that institutional investors might play in developing these. These institutional investors, in total, account for USD $79 trillion in assets. Of this figure, however, only one per cent is invested in infrastructure. He suggested some measures by which to increase finance for development:

- Reform global regulation
- Better usage of public funds to secure leverage
- Streamline infrastructure assets
- Reduce short termism in capital markets

5.6. "Investing in international trade finance within a risk controlled fixed income framework": Jean-Louis Laurens: General Partner and Chief Executive Officer: Rothschild & Cie Gestion; Global Head of Asset Management: Rothschild Group (Conference session 4)

Laurens described the Rothschild asset management business. Assets under management had increased steadily in recent years: from EUR €26 billion in 2009 to EUR €42 billion in 2013. There were three core centres of expertise:

- High conviction
- Open architecture and solutions
- Smart Beta: including ETF: Exchange Traded Funds

Trade finance could form a new fixed income asset class. In this, natural resources finance has a role to play:

- To provide short to medium term funding facilities
- To support the physical flow of production of natural resources

The significance of the finance requirement arises because:

- Global trading is set to keep accelerating. Global commodity flows are expected to increase, regardless of volatility
- It includes a wide range of products and services, offering a mix of short and longer term investment opportunities
- There can be an attractive risk/ return profile, involving both secured and diversified asset classes
- For Western Europe to finance West Africa, say, was "financing the real economy"

Laurens described the market environment in a chart of some complexity. In essence, the opportunity arises to move from "originate to keep" to "originate to distribute". His conclusion was that trade finance involves real, economy based, transactions. The asset class enables diversification, but without exposure to the underlying volatility in price of natural resources. Energy assets provide good security. Energy trades, historically, have a default rate that is low.

[Note: By way of background, Investopedia says: "Natural resource investing has a wide scope that covers everything that is mined or collected in raw form. From its raw form, the natural resources may go through further processing – cutting a tree into 4x4s, 2x10s, 2x4s and so on – or simply cleaned up, packaged and sold (a barrel of oil or a bottle of water)."]

5.7. "Climate bonds standards; climate bonds initiative": Sean Kidney: Co founder and Chief Executive Officer; Nick Silver: Director: International Climate Bonds Standards, Climate Bonds Initiative (Conference session 27)

"The Climate Bonds Initiative is an international, investor focused, not for profit. It's the only organisation in the world focusing on mobilising the USD $80 trillion bond market for climate change solutions." The governors of the initiative included Sean Kidney, chair, and Nick Silver, director. The organisation is based in the City of London. Their target is for a low carbon world. Methods by which to work towards this objective include infrastructure, carbon pricing and green business.

The past year has seen rapid growth in a market for Green Bonds and Climate Bonds. These are the main mechanisms by which to tap the global bond market in order to finance solutions to problems of climate change. From a starting point of USD $1 billion in2011, the Climate Bonds Initiative expects a total of USD $40 billion in 2014, with USD $100 billion in 2015. Features of the market include the following:

- Proceeds are earmarked to specific projects
- 95 per cent is investment grade [Note: BlackRock define an investment grade bond as: "A bond with a credit rating of at least BBB- (Fitch), Baa3 (Moody's) or BBB- (S&P)"]
- Over subscription for bond issues is normal
- There is a pattern of classic bond market evolution: starting with high ratings, then falling back closer to average figures
- The market is asset focused, rather than equity focused

Expert groups have been set up to keep a watch on individual sub sectors: renewable energy, energy efficient industry, and so on. Kidney predicts that we shall see an increase of trust in the sector. Further debate will ensue on whether, or how, the sector adds value to the portfolio of a pension fund.

5.8. "Investing in ancient books, letters and manuscripts": Aristophil; Institute of Ancient Letters and Manuscripts (Conference session 7)

Aristophil noted that the art market is booming. They asked why this is the case, and noted some likely contributors:

- Rising number, globally, in the number of high net worth individuals: defined as individuals with USD $1 million available for investment (say £625k in GBP)
- Maslow's pyramid, with its hierarchy of needs, applies to the art market. In ascending order, five layers from the more elementary needs at the base of the pyramid are: physiological; safety; love/belonging; esteem; self actualisation.
- Art is an asset; the market is a steady one, albeit different segments behave differently at different times
- Thus, there is importance in pinpointing niches. To be desirable, assets need to combine both rarity and also significance

One niche that meets the dual criteria of rarity and significance is the material that is prepared by an artist or an author at development stage of a masterpiece. Sketches or manuscripts could be examples.

Aristophil asked: "What makes the market for manuscripts soar?" The company had published a book:"L'Or des manuscrits" in which they addressed this question. They described there some exhibits that had commanded top prices. Among these:

- Le Codex Leicester de Leonerd de Vinci: bought for USD $75 million in 2012
- Le manuscript Einstein-Besso: bought for USD $28.4 million in 2012

- La Magna Carta, la Grande Charte des libertes anglaises: bought for USD $21.3 million in 2007
- The Tales of Beedle the Bard by JK Rowling: manuscript of 160 pages: bought for USD $3.9 million in 2007.

The average annual rise in prices for manuscripts over the past 30 years had been between 8.3 per cent and 10.3 per cent.

Those present at the conference asked questions:

- Q: A pension fund needs an income stream from which to pay out pensions: how does investment in art create an income stream rather than a, potential, capital gain?
  A: Art assets can be rented out to exhibitions, which people will pay to attend. Also, Aristophil "pool" art collectors, in order to allow them to rent art that would otherwise be unaffordable.
- Q: Can you quantify changes in taste in order to reduce unpredictability in gains?
  A: Definitely not!
- Q: How does the tax regime in France treat investment in art?
  A: The Daily Telegraph answered the question after the conference, on 26 November 2014: "In French, ISF means 'solidarity tax on fortunes'...first introduced by the Mitterand government in 1981...The wheezes used to avoid paying the tax are, of course, manifold. If you've ever wondered why French people have so many works of art in their homes, the reason is not just Gallic good taste. Assets over 100 years old, or created by hand, do not count towards the ISF."
- Q: What is the influence of the UK's leading investor in art, Charles Saatchi?
  A: Who is Charles Saatchi?

6. GOVERNANCE ISSUES

6.1. "Keynote address: Engagement and employee participation": Pauline Vamos: Chief Executive Officer: Association of Superannuation Funds of Australia (25)

Vamos described the background to the work of the Association of Superannuation Funds of Australia: ASFA. She listed some of the features of its operation:

- The Australian pension industry has a broad membership. Members have choices about products and investments. Pension schemes need, therefore, to be accountable and transparent. Member activism has caused some pension schemes to move out of investments in tobacco and coal.
- ASFA has regard for three goals: (1) engage the community; (2) manage the political risk; and (3) adjust asset allocation accordingly.
- Large numbers of people are moving into the drawdown segment of the pensions market, yet staying with the system itself. This represents the largest part of their retirement income. People are staying out of annuities. There is a decline in state pensions.
- Phased drawdown on retirement is the route of choice for many, because they want a reliable income stream. One of the first questions that they ask is: "which companies can I rely upon to give best value?" Providers of advice offer a range of services, through a spectrum from general communication to personalised guidance.
- Generally speaking, pension scheme members tend to prefer personalised methods of communication, such as email. Some financial providers now offer interactive methods of communication
- A questioner asked Vamos if the move from defined benefit schemes to defined contribution schemes had made it more difficult for pension funds to invest in infrastructure. She

responded that 10 per cent of assets thus invested is often thought to be an appropriate target.

6.2. "A holistic approach to social protection: gauging pension liabilities in conjunction with healthcare requirements": Francesco Briganti: Director: European Association of Paritarian Institutions (AEIP): Brussels based European lobbying organisation (Conference session 9)

AEIP, the European Association of Paritarian Institutions, represents the social protection agencies that are jointly managed by social partners, the paritarian institutions. AEIP seeks to promote the paritarian management of social protection at European Union level. This has been its key objective since foundation in 1996. "Ultimately, its aim is the recognition of the status of the European Institution of Social Protection as a structure enabling joint negotiations and joint management of cross border collective agreements on pensions, health and providence schemes."

Briganti sought a comprehensive approach to social protection. He noted as key trends:

- An increasingly ageing population;
- A change in the economic dependency ratio, with an increase in the proportion of non workers
- He saw that current trends in occupational pension schemes include concerns for solvency, sustainability, transparency, and supervision through EIOPA: European Insurance and Occupational Pensions Authority. There is a trend from defined benefit to defined contribution schemes.
- Funding for all schemes is rendered more difficult by a climate of low interest rates.

Spending on healthcare had seen rapid growth in the 1960s and 1970s. By 2009, the average spend on healthcare across the European Union rose to 10.2 per cent of GDP. Life expectancy has also risen. Longer life does not, however, mean that people will remain healthy. It just means that they will live longer. Increased longevity will need to be accompanied by promotion of healthy lifestyles in order to cap healthcare costs.

The route ahead requires a combination of adequate pensions and accessible healthcare. AEIP has set up a working party to explore "integrated welfare", and how it might best be organised. The Netherlands, for example, has shown how housing policies can be arranged to provide residences for the elderly that are funded by "reverse mortgages". "The integrated welfare debate has finally started", said Briganti. The traditional welfare state model is disappearing.

6.3. "A holistic approach to risk supervision": Arnaud Claudon: Global Head of Depositary and Fiduciary Services: BNP Paribas Securities Services (Conference session 10)

Claudon considered investment risk in the current regulated environment. The shadow banking system was sometimes quoted as a source of problems. It was: "a term for the collection of non bank financial intermediaries that provided services similar to those of traditional commercial banks." Shadow banking was widely held to be a prime factor in the sub prime mortgage crisis of 2007-08 and in the global recession that ensued. Former Federal Reserve Bank Chairman Ben Bernanke said in 2012: "Shadow banking, as usually defined, comprises a diverse set of institutions and markets that, collectively, carry out traditional banking functions – but do so outside, or in ways only linked to, the traditional system of regulated depositary institutions. Examples of important components of the shadow banking system include securitization vehicles, asset backed commercial paper (ABCP) conduits, money market mutual funds, markets for repurchase agreements ("repos"), investment banks, and mortgage companies."

Other concepts related to risk supervision that have acquired traction in present times include the following: market infrastructure, investor protection, banking regulation and risk assessment. Can best practices for pension schemes be transplanted worldwide, Claudon mused? If so, then would the same apply to worst practices, too? In any case, can oversight ever catch up with innovation?

6.4. "Corporate sustainability reporting: why firms, institutional investors and society at large will profit from solid metrics": Robin Edme: Coordinator, Responsible Finance: French Ministry of Ecology; President: Group of Friends of Paragraph 47 (the Inter Governmental Sustainable Development, supported by the UN Environment Programme) (Conference session 8)

Edme recapped on the history in recent years of reporting environmental, social and governance issues (ESG). He outlined the concepts of fiduciary duty, sustainable ventures and reporting on sustainability. He quoted examples from Denmark, France and Netherlands. He drew attention to the work of the International Corporate Governance Network: ICGN. ICGN is: "an investor led organisation of governance professionals, ICGN's mission is to inspire and promote effective standards of corporate governance to advance efficient markets and economies worldwide." ICGN is based in London. It works through three core activities: (1) influencing policy; (2) connecting peers and cross border communication; and (3) informing dialogue amongst corporate governance professionals. Board members include three from UK: Frank Curtis of RPMI Railpen Investments, David Pitt-Watson of London Business School, and Geoff Stapledon of BHP Billiton PLC.

7. ROUND TABLE DISCUSSIONS

"Listed equity at the crossroads of governance: corporate and asset owner" (Conference session 5)

Barry Parr is co chair of the UK's Association of Member Nominated Trustees (of pension funds): AMNT. Parr described a new initiative that AMNT has started, in order to increase the control that pension funds, as asset owners, exercise over the companies in which they invest. The aim is for trustees to increase their stewardship over their investments. The initiative goes under the title "Red lining".

AMNT has studied and compared the voting and engagement policies of several large pension funds (with a total of over £100 billion of assets under management), particularly in relation to how they implement in practice the UK Corporate Governance Code. AMNT found that there was substantial consensus about issues of governance. They use these consensus positions as the starting point in producing a series of red lines: specific instructions to fund managers on a range of environmental, social and governance issues. For each red line, there will be proposed voting action (short of disinvestment) in relation to a company that oversteps. Trustee bodies will be invited to sign up to all the red lines, or to select a subset from them. Trustees would instruct those to whom they had delegated asset management to take the appropriate red line action, or at the very least to explain why they felt that this would be out of place on a particular occasion.

Parr also highlighted the problem of short termism in investment. The average asset ownership period in recent times had declined from seven years to seven months. This placed a premium on short term gains. A pension fund investor, by contrast, had an investment perspective that endured for much longer. There is, thus, a mismatch.

Nick Sherry of Australia saw an increasing pressure on issues of governance for pension funds since the 1980s. He thought that most, if not all, national governments were ever ready to turn matters that were no more than worthy of consideration into requirements that were mandatory. He

reckoned that national governments inevitably increased obligations on pension scheme trustees when they came to note the proportion of GDP for which pension funds accounted.

Risk supervision (Conference session 11)

Anton van Nunen of Syntrus Achmea is the author of: "Fiduciary Management: Blueprint for Pension Fund Excellence". He claims that he is: "the founder of the fiduciary concept. He is an acknowledged authority in the discipline, and has received several international awards for this work". He is on record as giving his answer to the question: "What kind of pension do you wish for your child?" He said then: "I wish for my daughter an acceptable measure of uncertainty in the build up of her pension. Absolute certainty is not attainable, so she will need to accept some measure of uncertainty that fits in with her circumstances and future plans. Within that margin of uncertainty, I obviously wish for her the highest possible pension."

Van Nunen presented to the conference round table on risk supervision. He said that the extreme low interest rates that prevailed currently resulted in the necessity of risk taking in order to achieve decent returns. Capital allocation differed from risk allocation. Diversification over assets produced returns that were disappointing in stress times. Those returns became even more disappointing during times of financial crisis and its aftermath. Actual results differed hugely from expectations, as always. Expected returns remained the most important driver of asset allocation.

Optimisation procedures, based on expected returns, always led to extreme solutions. If those expectations proved to be wrong, then resulting disappointments could be huge. This uncertainty was unlikely to diminish in the future. Given this situation, van Nunen judged that it was: "better to be roughly right than to optimise". He outlined his requirements for an adequate response: (1) model the risk factors; and (2) allocate actively, because expectations would never be correct.

Van Nunen set out his recommendations:

- Design the portfolio based on risk factors. The risk budget should be allocated amongst four sources of risk: (1) Beta (market risk); (2) Currency; (3) Alpha (acive management risk); and (4) Cash (which was risk free, except for inflation)
- Betas should be allocated according to: (1) Type of specific market risk; (2) Sensitivity toward economic developments and inflation; and (3) Role in portfolio
- See to it that the governance structure is adequate. In specific terms: (1) Ensure that risk is measured correctly and punctually; (2) Take an overall view of the risk in the balance sheet; (3) Know the instruments that can make an impact; and (4) Implement the agreed plan, using specialists, but having them act in accordance with oversight

Overall, judged van Nunen: "Fiduciary management can deliver oversight, [but only] with adequate expertise".

Panel members were asked for their opinions about hedge funds. They expressed a scatter of views, among which were the following. (1) The asset owner did not usually know how the returns were being achieved. (2) Returns that were quoted had been risk adjusted. (3) "Money weighted returns on hedge funds are not good." (4) Huge fees could be "crippling". (5) One positive feature about hedge funds was that they were not tied to benchmarks.

DAVID WEEKS: 02 NOVEMBER 2014 – 11 DECEMBER 2014
DAVID WEEKS: 11 DECEMBER 2014