The Regulation of Long-Term Savings

Professor Avinash Persaud

29 January 2004

Introduction

We have talked a lot in this lecture series about banks, their behaviour and their regulation. We have talked about the inadequate emphasis in financial theory and regulation, on behaviour of market participants and in particular the impact of herding. We have talked about the need for diversity in behaviour for financial markets to function correctly. Liquidity needs buyers and sellers; it needs diversity of opinion and strategy. We have spoken about the pressures for less diversity in the behaviour of banks and markets - some technological and therefore immovable, some regulatory and avoidable.

The consequences of this homogenisation of banking, of a smaller number of large players with similar processes and behaviour, are markets and financial systems that are getting bigger and yet thinner: larger in turnover and capitalisation, but more volatile. This is important. Volatile markets are not just a nuisance but often lead to a costly misallocation of savings and investment as the dot-com saga showed us recently. Volatile markets also breed fatter margins for bankers and traders, which may be good for the London property market and will be recorded as GDP growth, but ultimately does not add to any economic welfare. I say this as a banker and trader myself.

Throughout these lectures we have found that there are many instances of unintended consequences, where the outcome of a regulation is the opposite of the intention. The path to financial hell is paved with good intentions. Modern day bank risk management creates risks. Some will conclude that we should have less regulation as a result and I think there is often, though not always, some sense to that. However, my principal contention is that these unintended consequences, emphasise the importance of getting regulation right.

The process of doing that is through considerate, open and constructive critique. Regulators are often at the sharp end of these lectures. But I do not envy their task and I compliment their commitment to it. That said, the unintended consequences of regulation in the pension and insurance markets, the focus of tonight's lecture, are potentially very dangerous for pensioners and the economy.

Transferring risks to pensioners

There are three trends I would like to focus on. The first is the shift from defined benefit pension plans to defined contribution plans. [Defined benefit plans are fading into the memory for most people. They are those plans where the company defines your benefit at the start of your employment – often some proportion of your final salary. Defined contribution plans, define your regular contribution into the fund, but not the eventual pay-out which will depend on the investment performance of your contributions.] This shift started some time ago, but defined benefit plans were dealt the knock out blow by the now infamous FRS17 which reflected the sensible wish of regulators to put the net financial obligations of a company's pension funds on to its balance sheet. This regulation followed directly from the dominant school of thought that says a risk disclosed is a risk better managed - which sounds sensible, but may not be.

Many companies concluded that once disclosed, it was better not to have this risk at all, especially as the frequent recording of the financial position of the pension fund would add to the pro-cyclicality of their underlying business. They would make more money when the markets were prospering and less when

they were not. Consequently, they dropped their defined benefit pension plans and choose defined contribution pension plans instead.

Of course the risk that the company previously had, did not disappear, they just shifted it to the employee. Employees will augment those risks further. Your average company is less liquidity constrained than your average employee. If you are a young employee with many years before you retire, you may expect your income to rise over time. As a result you will want to borrow from future income. But your average employee cannot go into a bank and borrow next year's salary without putting down substantial collateral, like an equity stake in his home. She is liquidity constrained. But the one way she can borrow from the future is borrowing from her pension fund, and they way she does that, is by trying to achieve her pension objectives by choosing a lower contribution, but by buying riskier assets.

This is an important conclusion because it means the excessive equity holdings of the average pensioner is not to do with poor or inadequate advice, though that may well exist, but the individual choice of liquidity constrained people. Giving people the opportunity to make informed choices sounds like apple pie and ice-cream - how could you argue against it - but this choice, not through chance, or miss-selling, but just inevitably, will be the wrong choice. It would appear that the government and our regulators do not appreciate this in finance, though they appreciate this behaviour with the national lottery, where liquidity constrained people are happy to play a bad gamble in the hope of changing their lives.

The authorities believe they are making the financial system safer through FRS17 and more financial education, but they are not. Of course who ultimately carries the risk of the financial system; the risk that the next generation of pensioners and should I add, voters, are poorer than they hoped and expected? It is the tax payer. Private, defined contribution pension schemes, reduces the liability of the tax payer on paper, but perhaps not in the end.

We need to consider ways in which the private sector can offer portable defined benefit pension schemes, and ways in which the government can make these schemes attractive to liquidity constrained employees. In essence a defined benefit plan is an insurance product; someone is taking the bet that they can invest over the years sufficiently well to produce a pot that would deliver the pension that was defined in the beginning. If like other insurance products the proceeds were untaxed, even the liquidity constrained may go for it.

Pension plan consultants

Another trend that interests me is for commentators to blame analysts, salesmen, or pension fund trustees for bad decision by pension funds, but to forget the consultants. The dirty little secret of the pension world is that the pension fund consultant market is rather like the market for auditors. The consultants drive pension fund decisions – there is some upside, but substantial downside for a trustee that chooses to ignore the advice of the consultants, and that is a risk-return trade-off that trustees are not paid to take. Besides commissioning the consultants, trustees do very little and are paid very little - these two aspects reinforcing each other.

There are only a handful of consultants and they tend to have the same view about what pension funds should do. In the late 1990s it was to hold more equities, today it is to hold more bonds. The problem is that as long as trustees follow the consultants and the consultants follow each other, it will inevitably be the wrong advice for everyone, except the first. Well done Boots. Imagine defined benefit pension funds all switched out of equities into bonds on the words of the five major consultants. Because they own the single largest share of UK equities, they would end up selling an under-valued equity market with limited downside and buy and over-valued bond market with limited upside.

Plausible you say, but why has this not already happened? Pension fund trustees will follow the latest consultant fad and buy more bonds, but rather like Saint Augustine's advice on celibacy, not yet. If pension funds were to make the trade now, they will lock-in their pension fund short-falls, requiring a further injection of funds which cash-strapped companies do not want to do. So the pension funds will wait and pray that the equity market will recover and close the funding short-fall. Once that has happened, they will sell.

Of course the reasons why we have consultants in the first place is the hope that external, objective advice will avoid fad like herd behaviour, not create it. We need some more contra-cyclical thinking and more diversity from the consultant community. Some of the ideas around for creating more independence by

auditors may be well applied to consultants. A rotation of consultants or a list of approved consultants held and monitored by the regulators would create incentives for the consultants to focus more on the specific liability of the pension funds they work with and less on the latest investment fad.

Insurance and Pension fund regulation

A third trend I want to look at is regulation itself. Regulation in the UK is becoming expensive, cumbersome and not particularly successful. This is because, and I say this with the deepest of respect, financial regulation in the UK is being driven by law and not economics. The legal approach to regulation focuses on equality of treatment. It means if you fine a big international bank for certain behaviour you must do the same for the local mutual building society or the foreign insurance company. The legal approach is blind to location and type of institution. It is a fine principle in its own right and is another one of those apple pie and ice cream examples. How can you argue against that? The problem is that it is wrong.

The economic approach to regulation is to begin by asking, not what precisely have you just fined someone for, and could you be sued by them for treating them differently than others, but what are you trying to regulate? This question leads to a very different regulation. For example, we should regulate banks because we are worried about the impact on the economy of a bank run. Banks are systemic, they lend to each other and as we saw with the Parmalat scandal a deposit at one bank can represent collateral for a loan from another. Bank regulation should therefore be focused on how good or bad systemic banks are at estimating their risks.

Insurance companies are not systemic. They do not lend to each other. The focus of insurance regulation should therefore be consumer protection, not short-term risk assessment. The economic approach to regulation leads to different institutions being regulated differently depending on which risks they pose and to whom, with some institutions being regulated intensely and others not. The legal approach is about ensuring equality and so brings a high water mark level of regulation everywhere, even where it may not be necessary. This will prove extremely expensive.

Moreover, as we have argued before, if regulation forces diverse institutions to behave in the same way, for insurance companies and pension funds to act like banks with daily mark to market and VaR limits, then the lack of diversity will make the financial markets more volatile. There will be no one to buy when the short-term players want to sell because everyone has become a short-term player. Our regulators are not mandated to worry about volatility directly, but as we said at the beginning, volatility brings a wider economic cost, as it makes it more likely that there will be a miss-allocation of savings and investment. In other words, they should worry about it.

Conclusion

In an attempt to reduce pension fund risks through better disclosure, and more informed choices, we have ended up increasing pension fund risks and transferring these risks from companies to employees and perhaps ultimately to the tax payer. The driver of this development is not miss-selling but mistaking the value of choice when the choosers are all liquidity constrained.

By outsourcing advice on pension funds to a handful of consultants, pension funds are in danger of becoming more herd like and harming themselves in the process. It is a reminder of a point we have made in a different context before, which is that consultants measure risk as if it is independent of what we do, but it is not, in a world of herding it is strategic; the observation of safety in the bond market, will make it risky, if we all go there at the same time, and the observation of risk in the equity market will ultimately make it safer as we all leave it.

Finally, we appear to have adopted the legal approach to financial regulation based, not on why we are regulating an institution, but on making sure that we regulate all institutions in the same way. The result will be expensive regulation that could remove the markets natural stabilisers by forcing different institutions to behave in the same way, increase volatility and as a result, distort the allocation of resources. Our regulators are conscientiously preparing their regulation of long-term savings institutions now; it is not too late to change the course of this Titanic.

© Professor Avinash Persaud, 2004