Tomorrows Pensions:

A Unions 21 Debate

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Debate

There are few areas of public policy which have been subject to so much change over so prolonged a period of time as that of pensions. Over the past several decades we have seen a seemingly constant stream of changes to the State pension, workplace and personal pensions, the services and products that financial institutions provide to pension schemes, and the choices individuals make to provide for their own retirement. These changes have reached into our personal and family lives, public finances, the commercial and legal worlds, as well as the world of industrial relations.

More changes are already on the statute books and will be introduced over the next several years. Future generations of workers will almost certainly be retiring much later than the pensioners who have retired in the last few decades, and for the first time employers will be obliged to make some contribution to a funded pension scheme for their employees through the new NEST savings scheme. And yet, as if we have an insatiable appetite for further change in this area of our lives, the subject of pensions and retirement continues to be an issue of political debate, and not infrequently industrial disputes.

One area of pension provision seemed to be exceptionally stable in the past, the large public service pension schemes which offered millions of public sector employees good pensions with a high level of security. However even those schemes are coming increasingly under scrutiny, and the traditional form of benefits abandoned or significantly modified. Although the papers in this discussion document do not examine the issue, it remains of key importance to those unions representing public service employees.

We have seen a steady decline in the coverage of funded defined benefit pension schemes in the private sector in recent years, and it is now rare to be offered membership of such a scheme on starting a new job. It is not that long ago that those schemes were held up as the foundation of a system of pension provision that was the envy of other economies. Now they are more likely to be depicted in popular commentary as black holes in company balance sheets, and it seems the only aspect of their operation which attracts attention is the size of their funding deficits. Perhaps the time has come to put forward a more balanced view of these schemes and the large funds which they invest.

Trades unions, employers and politicians are being forced to reassess conventional ideas about retirement and how we provide pensions. Fresh thinking on the problems of how we can best address the challenges of increasing life expectancies, volatile financial markets and changing work patterns is urgently needed. The papers that make up the rest of this Discussion Paper offer contributions to that fresh thinking, and I welcome the initiative taken by Unions 21 in publishing the Paper at this point in time.

Ed Sweeney,
External Reviewer for the
2007 Deregulatory Review of Private Pensions

Unions 21 exists to provide an 'open space' for discussion on the future of the trade union movement and help build tomorrow's unions in the UK.

We are mainly resourced by contributions from trade unions and others who work with trade unions that recognise we need to keep the movement evolving in an ever changing world. We encourage discussion on tomorrow's unions through publications, conferences, seminars and similar activities.

The Debate series of publications present opinions upon the challenges trade unions are facing, solutions they may consider and best practice they may adopt. These opinions are not endorsed by Unions 21, but are published by us to encourage the much needed, sensible and realistic debate that is required if the trade union movement is going to prosper.

Please read and consider this publication, forward it to others connected to the trade union movement and debate the content within your own organisation.

Sue Ferns
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The Authors

David Pitt-Watson

David Pitt-Watson has worked for many years in the pension world; as a trustee, an advisor and an investor.

Most recently he has lead the RSA "Tomorrow's Investor" project, an investigation into how we can best structure the long term savings and investment industry in the UK in the interests of pensioners. Its first major report, "Pensions for the People", is available from the RSA website.

David is the founder of Hermes Equity Ownership Services, and Chair of Hermes Focus Funds. Together these represent the largest, the largest "shareholder stewardship" programme of any investor in the world. These established Hermes as a leader in the field of responsible investment.

He has enjoyed a varied business career, both as a prominent City investor and as a senior strategic advisor.

Between 1997 and 1999 he was Finance Director of the Labour Party. He has advised leading politicians on issues of industrial policy and organization for over 20 years. He is a director of Oxford Analytica and a trustee of the Institute for Public Policy Research. He has been a member of several policy commissions, including work for the trade union and the co-operative movements.

Derek Benstead

Derek Benstead started in the pensions industry 21 years ago and has 11 years experience as a scheme actuary. He has always worked for pension consultancies in mostly trustee facing roles, but he also advises employers and, more recently, unions. He has been a member nominated trustee. Derek has a longstanding interest in the principles of pension scheme funding and benefit design. Down the years he has made many personal submissions to consultations on these topics. Derek works for First Actuarial LLP.

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Alan MacDougall is Managing Director of PIRC Limited. PIRC’s clients range from public and private sector pension funds to leading investment management firms, trade unions and churches. In common with his general managerial responsibilities within the company, Alan leads PIRC’s marketing, external relations and policy development and manages the company’s investment policy advice service.

Alan’s investment career started at the National Union of Mineworkers in 1979. He was responsible for monitoring the Mineworkers Pension Scheme for the union and also co-administered the NUM staff pension scheme. From 1982 he was a policy adviser at the London Borough of Hackney on housing, economic development and the Council’s pension fund. He worked for the Greater London Council from 1984 in the Financial Institutions Unit and was an adviser to the GLC pension fund, and he was appointed PIRC’s first Chief Executive at the company’s foundation in 1986.

Alan has a unique experience and track record on corporate governance and corporate social responsibility. His experience as an adviser to pension fund trustees, as the first chair of the UK Social Investment Forum and, through PIRC’s activities, being recognised as a leading shareholder advocate, has enabled him to make an active contribution to the development of corporate governance in the UK and Europe.

Paul Moloney

Paul Moloney is the Assistant General Secretary of Nautilus International, the union that represents maritime professionals in both the UK and the Netherlands. Paul has a long history in the trade union movement. His current responsibilities include leading the union's Industrial Department and as such, he oversees the union's involvement with many of the big employers in the shipping industry. Paul is also a Member Nominated Trustee of the industry wide Merchant Navy Officers Pension Fund and also the defined contribution Merchant Navy Officers Pension Plan. Paul is also Vice Chair of the Unions 21 Steering Committee.

Chapter 1

Why a collective approach to investment could be the key to solving the pensions crisis

David Pitt-Watson

Let me start this debate with a statement which will, I hope, surprise and challenge you. Most trade unions in the private sector could increase the retirement income their members will receive form a lifetime of pension savings by 50% or more. This can be done without costing their members or the employers who pay into the pension, a penny more than it does today.

I hope that does surprise you. In part because it is good news; there is a huge opportunity for trade unionists to improve their member's standard of income in retirement. In part because it is bad news; if unions do not begin to campaign for a different sort of pension provision they will leave their members in a level of retirement poverty which is entirely unnecessary.

So why can pensions be so enormously improved? To understand why, let's have a look at the recent history of pensions in Britain. 20 years ago Britain had a system of occupational pension provision which was dominated by large, collective pensions. Each pension fund received a contribution from the employer, and from the employee, and, over time, the employer guaranteed that this would provide a certain level of pension. These were known as "defined benefit" or DB pension schemes, because the pensioner knew the benefit they would receive.

However, bit by bit DB schemes have been dismantled. Today our pensions, particularly those in the private sector are provided in smaller, individual accounts, with no employer guarantee. Again, the employer and employee both contribute to the scheme, but the benefit is unknown. So they are known as "defined contribution", or DC schemes. Trade Unionist have been active and vocal in opposing this change. They have wanted to preserve the employer guarantee. In the private sector this has proved a losing battle. In the public sector the war will doubtless begin after the election.

However, here is the key point. The focus on the employer guarantee, however understandable, has meant that unions have tended to overlook other aspects of the change in pension provision; from the large collective schemes which characterised DB, to small individual pots which characterise DC.

This change is of huge importance for two reasons. First, because large schemes have much lower costs. Second because collective schemes can sustain an investment philosophy which can weather short term poor performance, and can therefore generate higher returns in the long term. This has a huge effect on the level of pensions which are ultimately paid.

Let me give one example, from a study done in the USA. It was written by Beth Almeida, a former trade unionist who now runs America's National Institute for Retirement Security, and William Fornia, who is a consulting actuary with qualifications and experience as long as my arm. The study started out by asking a very basic question. "How much of an employee's income will they need to set aside in order to have an adequate income in their retirement?"

They imagined the situation as it would be for high school teachers. They reckoned that, at today's prices a retired teacher might need a retirement income of around $2,000 per month, with appropriate benefits for their dependants, should they die young. They factored in the number of years of employment, likely salary and salary progression, and the number of years of retirement.

Then they came to the big choice. What sort of retirement plan should the teacher choose? Never mind whether or not the employer agrees to underwrite it.
The employee themselves can have the choice between a large collective pension,

where everyone contributes to a big savings pot, and receives a "fair share" of that pot when they retire. Alternatively, they can invest in an individual savings account, where the pension they take out will be determined precisely by the money that they have put in, and the return it has made.

That's where things become interesting, for three reasons. First, because the costs of each approach are different. Typically a large collective scheme has lower costs.

Second because the investment philosophy of the funds will also be different. As they reach retirement, the person who saves individually will need to be very conservative in their investment, ideally buying a very safe, but very costly annuity which will guarantee their income. The person who saves collectively can take a higher risk because they take it with thousands of others. So the collective pool can be safely invested in a way which gives a higher return while still being able to guarantee a pension.

Third, because the nature of collective pension is different to that of an individual one. A collective pension is just that; you will get a payment for as long as you or your dependents are alive. In a sense those who die young "subsidise" those who live longer. In an individual pension you have to save more because there is no such subsidy; you have an individual savings account, and if you die young, it could go to your beneficiaries; if you live too long, you may end up in poverty. More likely you will buy an annuity, which will provide you a guaranteed income, but will be expensive, hence you will have a lesser pension. The insurance company who sold you the annuity will make the profit by taking the premium for insuring your life expectancy.

So how much are all these three factors worth? Well of course it's difficult to pin this down precisely because each element interacts with the other. For example annuities cost a lot and give low returns in part because they are safe investments. If you are an individual saver you could get higher returns, but you would have to save more because of the risk.

So how much does this all add up to? Well let's start by looking at this in principle, and then we can look at an actual example. Let's start with costs. Below is a simple example:-

> *Imagine a wise young person who decides, at the age of 25, that they will save for a pension, so that they can retire at 65 and enjoy a pension for the next 20 years. They set aside £1000 each year, and raise that sum to cover inflation, which is 3%. They receive a 6% return on their money. That means that, by they age of 65 they will have a pension pot of £248,170. This in turn will create an inflation protected pension of £16,080 for the next 20 years. For those of you who are interested in the maths, a fuller explanation can be found in a report for the RSA Pensions for the People, on page 41.*
>
> *http://www.thersa.org/_data/assets/pdf_file/0010/220141/Tomorrows_Investor_Pensions-for-the-people.pdf*
>
> *Now imagine that this person has to pay a fee of 1.5% per annum on their savings. Guess how much that will reduce the pension that will be earned. The answer is that it will be reduces to £9,900. In other words, someone who pays no fees gets a 60% higher pension than someone who pays 1.5%, because £16,080 is about 60% more than £9,900.*

This happens because costs compound over time. The "average life" of a pension, that is the average time over which a pound stays in the pension pot is about 25 years. So a 1% per annum charge will take about 25% off the value of your pension.

What is true for costs is also true for investment returns. A 1% lower return will give a 25% lower pension. So someone who expected £100 a week as a pension will get £75 if the return is 1% lower. Putting it the other way around, someone who expected a £75 pension will get £100 if returns are 1% higher - a 33% uplift in their pension. So costs and returns matter, and matter a lot.

So does the nature of the pension you buy. Imagine that you wish to provide for your retirement, but you don't know how long you are going to live. You know how much you will need each year, but you don't know how many years you will need it for. To be on the safe side, you either need to save too much, or you need to buy an insurance policy which will work like a life insurance in reverse; that is that it will pay out if you live for longer than might be expected. That is essentially the principle of buying an annuity, but annuities are very expensive.

An alternative is to save for your pension collectively. If all save together, then provided we know on average how long people will live, then, in the event you need a pension for many years, you will benefit from the savings of those who did not.

So Almeida and Fornia put all these sort of features together. By the way, there are many different ways to deal with pensions, so the researchers would have used slightly different figures had they looked at the circumstances of any particular individual. But the overall picture they present won't change very much.

Here was the bottom line of their research.
It cost 12.5% of the teacher's salary every year to provide the collective pension; it cost 22.9% if they took the individual pension. In other words it cost 83% more to provide a decent retirement income using an individual DC scheme, than it did using a collective scheme.

In other words, over the lifetime of the scheme, retirement incomes for those using individual DC schemes could be increased by 83% at no additional cost to those funding them.

So what is the lesson here for the Trade Union movement? Well that should be pretty clear. To secure proper benefits for their members, they should campaign for the creation of large collective investment pots, with low costs, and able to extract higher returns. There are two groups who need to be influenced. First the policy makers. Right now, the structure of British pensions is rather restrictive. Either you have a defined benefit pension, where it is known who has to pay if things go wrong, or you can have a defined contribution, where it is all down to the saver. What is more difficult is to establish a pension where a group of people save collectively.

The legislation (Pension Schemes Act 1993 s1) treats anything which is not pure DC as DB - and then applies the full rigour of DB rules and regulation, which is expensive and inappropriate. Indeed, a well known law case (KPMG) treated what has been thought by the employer to be a DC scheme, to be a DB scheme, and the employer ended up with a big bill.

But it would be perfectly possible to change the law. If we did, we could create in the UK a pensions framework which might look like that in Holland; a country generally acknowledged to have the best occupational pensions in the world.

After that, it seems unlikely that employers would object, in principle, to the new regime. It would allow them to give much better benefits to their staff, and cost them not a penny more.

Indeed, one leading pensions expert, Robin Ellison of Pinsent Masons, reckons you don't even need a change in the law. Writing for Unions 21, he has concluded that

> *research it is now clear that provided the scheme is carefully drafted (and in particular does not offer any annuity arrangements within the scheme) collective DC might be offered within the UK. Alternatively, and unfortunately preferably, it would be possible to offer a non-UK-based scheme (perhaps domiciled in Ireland, Gibraltar, Austria or Belgium) with the full advantage of UK tax relief under the European Pensions Directive, and cross-border recognition, but avoiding the excessive UK regulation and accounting rules which have made such schemes hard to offer.*

But the danger is that Unions have been so focussed on trying to preserve the employer guarantee for a defined benefit pension, that they may have overlooked the structure of the new pensions systems which are being adopted.

The prize is huge. It could easily lead, at no cost, to a 50% or greater uplift in pensions for members at no extra cost.

So that's the challenge. What's stopping us?

The author would like to thank Beth Almeida, William Fornia, Robin Ellison, and many others who have given generously of their time and expertise, to help promote a better framework for pensions, in the UK and across the world.

Chapter 2

Pension Design: is it time to think outside of the box?

Derek Benstead FIA
First Actuarial LLP

Pensions involve risk
Nothing set up by human beings is without risk. You can do everything you can think of to eliminate risk, and still fail disastrously. The Titanic sank on its maiden voyage. You can try so hard to eliminate risk that the activity is regulated out of existence. A balance must be struck between the benefits of reducing a risk and the costs of doing so.

A pension scheme is a very long term project. A member contributing to a pension aged 20 is likely to be still drawing a pension aged 90. Business managements draw up 5 year business plans and regard those as very uncertain. What certainty can there be in a 70 year business plan for a pension scheme? The task is not to model with certainty the payment of benefits in 70 years time, but to manage change as we go. Within the last 70 years we have had any number of market crashes, the 1973 oil crisis, sustained low inflation, sustained high inflation and a world war. Our pension system needs to be able to adapt to any or all of these kinds of events occurring in the next 70 years. A system that cannot adapt to change will either break itself, or break its sponsors. Our present system of rigid defined benefit pensions is arguably unmanageable.

Ideally, the three parties of state, employers and employees will each take a share of pension risk. The state and employers do so by providing defined benefit pension schemes. Employees do so not only through money purchase pensions, but also in the risks of defined benefit provision.

The employee's pension risks
A defined benefit pension scheme is not without risk for its members. Members' contribution rates may be increased, or future benefit accrual cut or removed, in response to the need to pay off a deficit that may have risen mainly in respect of previous members. A pension scheme will inevitably outlast its sponsoring employer. If an employer becomes insolvent, members of its pension scheme almost certainly have their pensions reduced. Happily, since the creation of the Pensions Protection Fund, there is a limit to the amount of benefits lost.

Most important though, is the severe risk placed on the individual in a money purchase pension scheme. If sponsoring a defined benefit scheme is problematic for employers, who can spread changing contribution requirements over a number of years, how much more problematic is a money purchase pension scheme to the individual, whose account is converted to a pension on a single day, with no opportunity for spreading risk over time? Two money purchase scheme members, identical in every respect save that they started making their identical contributions years apart, may receive very different pensions, one pension being less than a third of the other.

The employer's share of the risk
The traditional 1/60 accrual final salary pension scheme is several times more expensive to provide now than in the 60s and 70s when the concept developed. Projections show that a 1/60ths scheme with retirement at 65, sponsored by an employer of constant size may grow until its liabilities are over 10 times the annual salaries of the employees. If the funding of the scheme is controlled only by changing the contribution rate, a contribution towards deficit alone of over 20% of salaries is likely to arise from time to time, as a normal event, never mind another 20% of salaries to pay for the cost of accrual. That is simply not possible for employers to cope with. If we are to continue to have rigidly defined benefits, the employer's share needs to be an order of magnitude smaller than we are used to. Or, we can define benefits more flexibly and create levers of funding control in addition to varying the contribution rate. This latter option also enables a scheme to adapt to change over the coming decades.

An employer with a payroll of	£10m
May build up a 1/60ths pension scheme with liabilities of	£100m
Which may sometimes have a deficit of	£20m
Which needs an annual contribution to pay off the deficit of	£2m
Plus the annual cost of benefit accrual of	£2m
Making a total pension contribution of	£4m or 40% of payroll

No wonder then that the number of people in the private sector accruing a 1/60 defined benefit pension is a fraction of what it used to be. To a large extent, the rising cost of a 1/60 pension has been handled by providing it to fewer and fewer people, a trend that started with the abolition of compulsory membership in the late 80s. It would be much better to provide a small defined benefit pension to most of the employed population than to provide a large one to a minority. Or perhaps better still, provide a larger pension to the majority from a risk sharing, adaptable scheme.

Models for risk sharing pension provision

One simple model could be for each party of the state, employers and employees to take its share of pension risk. Presently, employers are typically sponsoring contracted-out schemes to which members contribute. The funding risk of providing a defined benefit in respect of National Insurance rebates and members' contributions is being shouldered by the employer. This burden has grown too large for the employer to bear and has contributed to a withdrawal from providing defined benefits, and indeed from providing any scheme of reasonable quality while the funding problems of a legacy scheme are sorted out.

Instead, employers could sponsor a defined benefit scheme of manageable size, which is contracted in and non-contributory for members. Such a scheme might be 1/120ths accrual or less. The state provides both the basic state pension and the state second pension. Members' contributions go into a money purchase scheme, so members take the risk in respect of the contributions they pay. In this way, part of the risk formerly shouldered by the employer is passed back to the state and part to members. Each party takes its share of pension risk.

This model involves nothing new, and does not necessarily involve a change of contribution for any party, it is just a redistribution of the risk each party takes. It is presently perfectly possible within the current regulatory framework. A problem might soon be created by the proposed rules for opting out of the National Employment Savings Trust (NEST, the new name for the Government scheme starting in 2012, formerly known as Personal Accounts), which might not cope with a part final salary/part money purchase scheme.

More interestingly, consider a scheme which has a core of defined benefits, which are the guaranteed benefits should the scheme ever wind up, with a plan for paying discretionary benefits on top for as long as the scheme is ongoing. For the members' protection, the scheme rules can define a minimum employer's contribution rate and ban any refunds from the scheme to the employer. In this way, the scheme would have a demonstrable value to members, despite the discretionary element, because all the contributions going in must be spent on the provision of benefits. Instead of changing the employer's contribution rate to provide a rigid set of benefits (a model that

employers are increasingly reluctant to sponsor), the discretionary benefits can be varied to match what can be afforded from the accumulated assets and the contributions coming in. Employers may be more willing to sponsor a scheme if its contributions are not wildly variable. Members have more benefit outcome risk through the discretionary increase policy, but the grave uncertainty of money purchase pensions is avoided. The possibility of the re-establishment of widespread employer sponsored pension provision that is not money purchase is created.

Such a scheme could have its guaranteed benefits calculated on a "career average earnings" basis. In a career average earnings scheme, the pension earned each year is a fraction (1/80th, say) of the member's earnings in that year. The discretionary benefit could be an annual increase on the accumulated pension, to be awarded both before and after retirement. The trustees of the scheme would use regular actuarial valuations to decide what the rate of discretionary increases on pensions should be, to spend the assets and contributions on their members. Members will see how their scheme is doing from the trustees' discretionary increase policy.

Social obstacles
The lack of trust in pensions is a potential obstacle to schemes that include a discretionary benefit. "I wouldn't trust the employer/ trustees/ actuary to give me fair value" is an obvious fear. Where this fear is the dominant factor for an employee, a money purchase pension is the employee's logical choice.

The more tightly defined benefit schemes are tied down in legislation and regulation to control their risks, the less able and the less willing an employer is likely to be to sponsor it. Its logical reaction is to choose to sponsor a money purchase scheme.

The herd instinct is strong. Many employers have adopted money purchase schemes simply because others have done so before them, and it is seen to be "the thing to do". Non-executive directors propagate the solutions they have seen at one employer at other employers whose boards they sit on.

More recently, a momentum to convert to career average revalued earnings schemes has built up among those employers who have so far persisted with defined benefit schemes. Where some high profile names lead, others feel encouraged to follow. But these schemes typically contain no risk sharing element, they are just cheaper defined benefit schemes.

Some ideas have not gained any momentum. The "cash balance" scheme has not become popular, despite being adopted by Barclays.

The kinds of schemes described in this article will take time to take hold. But the logic is inexorable. The traditionally sized defined benefit scheme is unmanageable. Either we adapt and develop new models for collective pension provision or, if we cannot overcome the fear factor, we will all in due course have money purchase pensions.

Legal obstacles
Although it is possible to envisage constructive scheme designs, it is an unfortunate fact that obstacles to innovation are written into the law. We need to create scope for innovative schemes in UK legislation, not by writing into the law a definition of a new kind of scheme, which would only be creating a new straitjacket, but by removing from the law the obstacles that prevent innovation.

For example, the requirement to provide RPI up to 2.5% increases on pensions in payment is an obstacle to the risk sharing career average earnings scheme described

earlier, which envisages discretionary pension increases in payment. This needs to go. If the risk sharing career average earnings scheme were to be allowed to have negative discretionary "increases", it could be a defined contribution scheme that is not money purchase. The employer could have a contribution rate that is fixed. Yet the law defines all schemes that are not money purchase as defined benefit, and the law further disallows defined benefit schemes from reducing pensions. So a defined contribution scheme that is not money purchase (the phrase "collective defined contribution" is becoming the term in common use) has been inadvertently outlawed. Creating scope in law for collective defined contribution schemes to exist will probably be a difficult drafting task, but it needs to be done, without prescribing what such a scheme should look like.

It has already been observed that the proposed rules for opting out of NEST might not allow opt outs by innovative schemes that are nevertheless demonstrably better value than it. It would be better if the opt out rule for NEST were simply that a scheme can opt out if it is worth more than the minimum contributions to NEST, a rule that could apply irrespective of whether the scheme is defined benefit, risk sharing, collective defined contribution or money purchase. This would not place any constraints on the scheme's design. An actuary can work out easily enough whether a defined benefit scheme passes.

Summary

The shrinking of employer sponsored pension provision in the private sector is a grave concern. The traditional final salary scheme is too expensive, too rigid and too variable in cost for an employer to be able to sponsor, if it is to be provided to all of its employees. Innovative pension scheme designs that spread the risks around, that are more risky for the member than a traditional final salary scheme but less risky than money purchase, can be envisaged. A scheme with a substantial discretionary benefit included is adaptable to change. Variation of the discretionary benefit gives another lever of funding control in addition to varying the contribution rate.

Flexible, adaptable schemes may be what we need if we are to reinvigorate employer interest in occupational pension provision. The social obstacles are large, but the prize is good occupational pension provision for the many, not just for the few. If we do not accept the risk sharing principles and organise adaptable collective pensions, money purchase pensions will be all we have in years to come.

There are some obstacles in law to their implementation. As a matter of principle, our legislators need to avoid prescribing in law the detail of scheme design, and the prescriptions that already exist need to be removed. Scope in law needs to be created for collective defined contribution schemes to exist.

Chapter 3

Responsible Investment: An Essential Trade Union Tool

Alan MacDougall
Managing Director, PIRC

The role of investors as 'owners' of companies has emerged as a distinct theme in the ongoing analysis of causes of the financial crisis. According to critics, such as City minister Lord Myners, many institutional investors failed to provide proper oversight of the companies in which they invested beneficiaries' capital. Worse than that, some argue that some investors actively encouraged banks and other financial institutions into excessively risky behaviour.

Unfortunately, there seem to breakages in the investment 'chain' that links the real owners - pension scheme members and other savers - with the companies in which their money is invested. Whilst pensions are paid out over decades, the investments that fund them are often approached with a very short-term perspective. The pressure that this puts on companies can lead them to take action that is very damaging to the ultimate owners, those millions of ordinary employees saving for retirement.

Similarly, whilst those saving into a pension no doubt want to work for a company that adheres to high standards of social and environmental responsibility, this message often is not transmitted by those who invest employees' savings.

Even before the financial crisis there had been an increase in the interest amongst some investors in ensuring that their ownership rights were being used effectively. There has been a steady increase in shareholder voting, for example. In addition, more investors have sought to give proper weight to social and environmental factors in their investment policies. As a result there has been a growth in so-called responsible investment.

One of the major initiatives in this field has been the development of the UN Principles for Responsible Investment (UNPRI). At its simplest, investors sign up to the principles and report on their implementation. However the UNPRI also provides an online resource through which investors can exchange ideas and collaborate on proposed engagements with companies. Notably in 2009 there were various engagements with companies in both the US and the UK over the Employee Free Choice Act, which aims to make it easier for employees to choose to be represented by a trade union.

Given these developments, this is an area where arguably trade unions ought to be involved. If investors are already engaging with companies over employment-related issues this is a relationship that unions would presumably wish to be involved in. There are also a number of issues of company policy such as merger and acquisition activity and remuneration, over which shareholders have some degree of influence and which are clearly of direct interest to unions employed by those companies.

The labour movement in North America has a long history of this kind of activity. In the US, trade unions are amongst the most active filers of shareholder resolutions. These resolutions target both corporate governance issues, like the combination of chair and chief executive positions, and social issues, like the company's involvement in countries with poor human rights. US unions have also been involved in economically-targeted investments, driving up standards in the private equity industry, and, most recently, in trying to bring accountability to the boards of the giant financial institutions.

There have been notable attempts by the UK's trade union movement to have more of an influence in this field. Unison has sought to organise and train its members who are member-nominated representatives on local authority pension funds. Unite last year filed a shareholder resolution at Tesco's AGM seeking to focus attention on the treatment of agency workers in the UK meat-packing industry. The TGWU had also previously been involved in filing a shareholder resolution at FirstGroup, to address anti-union activity in its US operations. And the TUC has carried out research into the

voting behaviour of asset managers, pushed for greater transparency and accountability in the private equity industry, and maintained an annual conference for trustees.

Nonetheless there remain significant opportunities for unions to increase their activities in this field. A fact that is often overlooked, especially by those seeking to portray unions as implacable opponents of reform of pensions, is that actually union members are one of the core constituencies in pension fund governance. Many union members are pension fund trustees who devote their time to seeking to ensure that pension schemes are well-run and sustainable. Day after day in hundreds of schemes up and down the country union members have to make pragmatic decisions about how the schemes will go forward.

Trustees also have a direct influence over the investment arrangements of those schemes, and within this falls the approach to the exercise of responsible ownership. There are a number of regulatory interventions that have affected how schemes address such questions. For instance, since 2000 pension schemes have had to state their policy on both the exercise of shareholder voting rights and the extent to which (if at all) they take social and environmental factors into account in their investment policy. In addition schemes are expected to adhere to the Myners Principles on investment decision-making on a ‘comply or explain’ basis. One of the Principles directly addresses ‘responsible ownership’.

In reality practice at schemes varies dramatically. Some schemes have well-developed policies on responsible investment which can influence voting and actual allocation of assets. To date these have tended to be public sector schemes or those of a similar kind of orientation, although some private sector schemes have shown more interest of late. On the other hand many schemes have not taken much interest. This is understandable since many funds have been under extreme funding pressure, but it may represent something of a missed opportunity.

For those schemes which do not have a well-developed policy, the standard approach is for trustees to delegate responsibility for responsible investment to their existing asset managers. Such a situation is perhaps not surprising. Pension funds are primarily interested in picking an asset manager who is best placed to manage a given mandate most effectively. Having picked the best manager for the job, funds then also give them responsibility for responsible investment. The problem is that these managers may not have a strength in this area, because they do not consider it core to their business. Indeed some fund managers appear to believe responsible investment activity is simply a box that needs to be ticked in order to appear on client shortlists.

Recent experience demonstrates that many asset managers may not provide much challenge to investee companies, even over core governance issues like remuneration. PIRC’s own preliminary analysis of shareholder voting at financial institutions has suggested that the banks have been put under very little pressure to reform their pay policies by most shareholders. The only UK-listed bank to have lost the vote on its remuneration was RBS in 2009, as a result of the Fred Goodwin pension scandal. And this defeat was in effect inflicted by UK Financial Investments, the body which manages the state’s majority shareholding in the bank.

For many asset managers the RBS remuneration report in 2009 appears to be one of the only resolutions, if not the only one, that they have opposed at UK-listed banks in recent years. What is more, there is evidence that the message that asset managers are sending to banks even today is that they must promise high rewards to staff in order to win the supposed “war for talent”. Giving evidence to the Treasury select committee recently, RBS chief executive Stephen Hester said that institutional investors had

“raised concerns about our ability to keep and motivate good people.”

An obvious question is why asset managers don’t take a more challenging position in respect of remuneration, or other governance. Part of the explanation might be a conflict of interest - a number of asset managers are themselves part of listed financial institutions, even banks in some cases. In addition cultural factors might be at play. Fund management staff work in the City, and as such may not have found the bonus culture at the banks they monitored unusual.

Whatever the explanation, it may not be an approach that is acceptable to union members who are pension fund trustees. Therefore an obvious step to take is to review the arrangements for voting and other aspects of responsible investment. This might include reviewing the voting decisions taken by the appointed asset managers in respect of the banks both pre- and post-crisis. If the picture that emerges isn’t good, trustees could consider working with a voting and engagement provider to develop a better approach. The added benefit of this is that a policy could be applied across the fund’s entire assets. Because another flaw of simply delegating responsibility to existing asset managers is that they will inevitably take different approaches.

No doubt member trustees will face some opposition to suggesting this course of action. Some opponents may seek to portray it as playing politics. In reality, of course, the dangers of shareholders not providing proper oversight of their investments is only too clear. Therefore trustees might wish to take a look at the amount of money lost in banks and other financial institutions as part of any review.

Closer to home, another area where unions perhaps ought to devote more attention is to their own financial assets. It has been estimated that unions have assets of upwards of £1bn through staff pension funds, general funds and other investments. Yet in most cases the ownership rights attached to the shares held by unions are again delegated to appointed asset managers. Quite aside from the fact that many asset managers have not used these rights effectively in recent history, the possibility exists that they may vote against union initiatives.

If unions are part of the growing trend to file shareholder resolutions to address environmental, social and governance (ESG) issues then this will become increasingly important. Once again it is instructive to note that the position asset managers take on such resolutions, if not directed by clients, may well be one of opposition. PIRC has recently reviewed asset manager voting on six shareholder resolutions filed at UK companies from 2006 to 2009 which sought to address ESG issues. With some notable exceptions, such as Co-operative Asset Management, the picture is not encouraging. A number of asset managers voted against every resolution, despite the variety of issues they sought to address.

Again the obvious solution would be for trade unions to review their existing arrangements and revise them as appropriate. Some steps have been made in this direction, with some union pension funds developing voting and responsible investment strategies. Nonetheless they seem to be in a minority. In addition, the real prize for unions is to develop a co-ordinated strategy, to have the most impact with their ownership power. If, for example, unions sought to develop a common voting strategy, perhaps allied with the occasional use of shareholder resolutions, they could become a unique new force in shareholder engagement in the UK.

At present this may seem like an ambitious, if not idealistic, strategy. But it is worth remembering that this is the route that the unions in North America have taken. Having decided a number if years ago to use the clout they had as shareholders to seek

to influence companies, they have gradually built up activity. They are now one of the key groups in corporate governance reform in the US.

Unions in the UK have some initiatives in place which could be built upon. They also have the added advantages that the regulatory environment is favourable, and in the wake of the crisis it is much easier to make the case that shareholders should be challenging companies over issues relating to ownership. Clearly this type of activity will never replace unions' industrial influence, but it does provide an extra option. And arguably there has never been a better time to seek to use it.

Chapter 4

Engaged Investment: is there power in the union?

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The primary purpose of pension funds is to provide an income in retirement for scheme members and also an income for the dependents of members should they die. The level and extent of these benefits increasingly relies on investment performance. This is clear in defined contribution schemes where the link between investment performance and benefits is stark. Today, however a less obvious but very real link also exists for members of defined benefit schemes as reduced benefits and small or non-existent pension increases becomes an increasing reality for many as one of the consequences of fund deficits and the increase in the cost of providing such benefits.

Clearly, this is not the ideal environment for member nominated trustees to develop policies in relation to socially responsible or engaged investment. As a result the debate about whether pension fund money can be used to bring about change in society has stalled and the trade union movement and others have not fully exploited the huge potential that a coherent, focused strategy for engaged or socially responsible investment could deliver. A policy that would enable the democratic intervention in the market place in a way that can benefit the both workforce, and good quality businesses, whilst also delivering long term sustainable investment returns.

Yet it is in the post credit crunch environment, that the need for a co-ordinated strategy to use pension fund money positively, and also a strategy for using the power that share ownership brings to make change, has never been so urgent.

Of course the debate about how to do this has been raging for many years both within and beyond the trade union movement. Certainly since the early 1990s and the McGarry judgement against the NUM opinion has been divided as to whether pension fund trustees could or indeed should take into account issues other than pure investment decisions when investing other peoples money.

Unfortunately this debate has often been less than sophisticated. Many in the pensions industry have a very clear interest in preventing this debate taking place. Some employers and many investment managers argue that any socially responsible or engaged investment by its very nature compromises the obligation of trustees to achieve the best returns they can for the members of their funds. The McGarry judgement is quoted adnauseum and the debate often has focused only on the limited point of whether or not investment return and therefore member's benefits are adversely affected by any attempt by trustees to use pension fund money for positive change. Despite the existent of very little hard evidence it is taken for granted by many that any investment that tries to alter the decision taken by a company must by definition deliver a lower return.

There is also a particularly strong lobby among investment mangers and the pensions industry generally against any form of engaged investment. Engaged investment can be defined as the active involvement by investors, using their voting power, to influence company decisions. The Pensions industry however has ensured that trustees have very little say in the decisions taken by investment mangers in relation to individual companies. Although there is some good work being done to influence board room decisions on, for example, remuneration policy it is very rare, if at all, for there to have been a coordinated approach to ensure real change within boardrooms.

This in turn means that the response of those advocating socially responsible or engaged investment has been defensive and limited to defending the right to have basic objectives and basic objections, such as no tobacco, no weapons, no emerging economy debt and no use of child labour in the production of goods. These are of course vitally important aims and there is no doubt that there has been some success in these areas. Maybe however it is time for the debate to start focusing also on more

specific proactive objectives as well.

The post credit crunch environment, in some ways paradoxically, provides exactly the right environment to start a more detailed debate within the trade union movement, the pensions industry and among the business community on developing this approach. Whilst there will no doubt be those who will argue that now is the worst possible time to start injecting considerations other than pure return into investment decisions, it maybe that such an approach by pensions fund trustees is precisely what is needed to protect working people from the continuing fall out of the credit crunch.

At its heart this debate must challenge the notion that engaged investment is a particular type of investment. This is not the case. Every investment decision is a decision to engage to one degree or another. All investment decisions have consequences for the pension fund, the employees of a company and the business itself. Engaged investment therefore can be socially responsible or irresponsible. It can produce excellent returns or poor returns. But it is entirely wrong to link the term engaged investment with a particular form of investment that puts concern above return. Some of the most socially responsible investment has delivered some of the best returns and it is vitally important that those who advocate engaged investment also recognise this.

The debate therefore must recognise that any investment decision, whether taken actively or passively has a consequence that can be positive or negative for an individual company, the employees of that company, the industry that company operates in and wider society.

The question therefore should not be whether engaged investment is desirable or not. Instead it is time to concentrate on the effects of any investment decision and recognise that all investment decisions are a form of engagement.

If this is recognised then the discussion about how trustees, and in particular member nominated trustees can develop strategies changes significantly. Instead of there being a broad set of principles that are designed to attract widespread support, member trustees can start adopting specific policies that have a direct benefit for the members of their scheme, and also of their trade union. With this approach the ability working people have of influencing the economy they work in will increase immensely and through their pension funds they will be able to make changes that are very relevant to their own working experiences.

For example, alongside a set of broad principles like the objectives listed above could sit industry specific objectives. These will of course vary from industry to industry and union to union but one obvious example would be objectives relating to improving and maintaining safety standards .This represents a particularly good potential objective because almost without exception the membership of the trade union movement benefits where employers are prepared to invest in skills. At the same time, without fail, investment in companies in any industry with a good safety record produces long term sustainable investment returns, provided such companies are not vulnerable to competition from others who cut corners and compromise safety.

My own union represents maritime professionals in both the UK and the Netherlands. Our member's interests are best served by a maritime industry that is required to apply the highest safety standards by enforcing the very best training standards. It goes without saying that passengers also share this interest.

Unfortunately the maritime authorities in the UK, in a desire to ensure the UK ship

registry remains “flexible and competitive”, allow an environment where companies with lower standards are able to compete against those who are committed to having the highest skilled workforce. In addition the EU appears more interested in allowing unfettered competition than enforcing standards. As consequence we see a downward spiral of standards as those who do operate at the highest level are undercut by those who do not.

However, a co-ordinated approach by pension fund trustees could also help enforce standards. By engaging with companies and demanding the highest safety regimes, and disinvesting when necessary, pension funds can be used to bring about change that is in the interests of skilled workers and passengers and, unequivocally in this example, the pension fund members who will receive a better long term return on the money invested. And change for the better can be made.

Exactly the same approach would have a similar effect in many other industries, particularly in transport where a wide ranging consensus could be built involving passengers, employees and pension fund members.

So there is clearly scope for individual unions, coordinated by the TUC, and others interested in the debate to start working on a set of objectives to assist member nominated trustees. There is no reason why these objectives should not also continue to have some global aims, such as the eradication of child labour but much more can be delivered by also having more focused, industry objectives.

In the maritime industry there would be two main objectives.

The first would be to influence those companies that do not apply the highest safety standards. This could be through disinvestment, engagement or by channelling investment to assist those who wish to adopt high standards on training sea staff, for example.

The second would be to create a pension fund investment vehicle to assist companies replace their ships, but in doing so place requirements upon them to ensure high standards are employed onboard these ships. Pension funds could become ship owners leasing ships to companies but dictating that certain employment and training standards must be applied on board. This may sound like engaged investment gone mad to some in the pensions industry but such arrangements that are in place in other countries, including the Netherlands and Germany and are considered a normal investment opportunity for pension funds there.

Unions in other industries would of course have their own objectives which may focus on safety but for many trade union recognition may be the objective they wish to pursue.

The point is that each union or group of unions could produce their own short list of priorities that are then pursued by member nominated trustees throughout the UK. The emphasis should be on a short list of achievable objectives and not a long agenda which could be amended as progress is made.

For this to work a few things need to happen. First we need to see someone take up the challenge to move the debate forward and bring people together to focus on industry objectives. The TUC already runs a trustee network and is launching a campaign to increase their involvement in engaged investment. Unions themselves must also engage with their members who are trustees.

There is also a political dimension to this. Local authority and some other public sector schemes are controlled democratically and it is vitally important that sympathetic local government councillors are brought together to pursue the same objectives. And of course we should not forget the role unions as investors and as the sponsors of pensions funds can play themselves.

We also need trustees to stop focusing on short term return. Too many investment mangers are assessed quarterly and therefore take decisions designed to protect themselves in the short term rather than to produce a long term sustainable return on their investments. Member nominated trustees must be prepared to assess investment managers over a longer term and this must be clearly defined in the statement of investment principles.

Clearly it is a huge challenge to bring about change through using the money we all invest in our pension schemes. Limited success has been achieved but the idealistic view that capitalism would be democratised as workers recognise the power they have collectively through their pension funds remains as far off as ever. That does not mean however that it is not possible to have an influence that helps working people. To do so however we need to focus on achievable objectives on an industry by industry basis to sit alongside the well documented global objectives. If we can do that then the trade union movement will be able to demonstrate how influential an alliance of member trustees could be by providing some concrete examples of just how powerful it actually can be.

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