Editorial

Quantum of blame

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The financial crisis, as foreign television stations call it, has caused a rethink in many areas of activity – and in the area of pensions in particular. Stock markets have been volatile, and generally equities have fallen considerably. Bonds of all description are either wildly over-priced or curiously under-priced, depending on their status, and whether they are corporate or sovereign, flat or indexed. Pension funds struggle to understand whether they are solvent or not, and if they are short of a few readies, by how much they are in deficit. And in the meantime, in the United Kingdom at least, the regulator has issued a ‘don’t panic’ notice, saying that pension funds should think very hard.

It might be better, of course, if they didn’t think at all. It is virtually impossible over the short term to decide what to do: should we change the portfolio, sue for a class action dividend or hit the employer for a massive additional contribution?

Changing portfolios is expensive, and the timing seems inopportune when equities are on the floor. Brave pension funds, rather like Clare College Cambridge, might borrow (if they can) to go long on the stock market. Chances are they will make a lot of money – and if they are wrong, then capitalism has bigger problems than the insolvency of pension funds. Less brave pension funds should perhaps wait until the smoke has cleared, and try and peer into the future as best they can. But doing nothing seems sensible.

Option 2 is to sue someone. US law firms have been touring the United Kingdom and other European Union jurisdictions for some years doing their best to persuade the rest of us that a dabble into the litigation morass would produce riskless returns and satisfy fiduciary

obligations. They may be right. But the thought begs the question: who can we sue?

There is no shortage of possible malefactors. We could, as the Pensions Regulator indicated in October 2008, have a crack at the accountants. There is no doubt that the accountants (or most of them – there are still backwoodsmen, who demonstrated their affection for spurious accuracy at the expense of real business in a letter to the FT also in October 2008) have rather recently been ruing their determination to measure everything – even Sir David Tweedie, the high priest of the accountancy standards religion, has said publicly that perhaps the pensions disclosure requirements are doing more harm than good. No serious observer would object to disclosure of contingent pension liabilities in the reports of a company; but insisting that they be included in the balance sheet when the assets (and oddly the liabilities) are measured in an arbitrary and volatile way, which is only relevant in a corporate meltdown, has been, is now and always will be absurd. The obsession with measuring everything in sight has not only led to inappropriate investing by pension funds and heart attacks by finance directors but also to the indirect destruction of perfectly good and sustainable pension arrangements. There is also no doubt that the determination to mark to market when it is inappropriate has led to accentuating difficulties unnecessarily. The accountant standards setters are also being blamed for adopting analogues (such as double AA rated bonds), which with hindsight also make bad problems worse. They stand accused, and it is hard though not impossible to find much in the way of defence. Mind you, their sins have been noticed and criticised for years (especially by, for example,

the National Association of Pension Funds in the United Kingdom) but not remedied.

They are, of course, not alone in the dock. How about the rating agencies? They are now accused of conflicts of interest, failure to practice due diligence, incompetence, and slowness to respond. They are probably guilty of all these, and it is hard to see how the rating industry can survive the recent mayhem. If we cannot trust them to have a look under the bonnet like an AA engineer opining on the roadworthiness of a second-hand car what is the point, of them, especially as they are so expensive? Their use was sanctioned and in many cases (eg the UK Pensions Regulator) their use was made obligatory in the assessment of risk. There is no doubt they have been a major instrument in the collapse of structured instruments and mortgages, but it is hard to maintain a hatred of something that seems destined to evaporate into obsolescence. But a writ or two might be worth pursuing.

Now how about the investment banks? They also are no more. Lehmans is bust. Bear Sterns is bust/taken-over. Merrill Lynch has been bought by a bank and the two remaining investment banks have converted to ordinary banks. They made huge sums by devising and selling what are in the quaint phrase toxic assets – and also persuading gullible pension funds (and their investment advisers) into the acquisition of derived assets such as swaps, whose counterparties seem not as quite as strong as appeared at first, and whose benefits now seem not to have been worth the risk. The insistence by the investment banks that derivatives could be part of the solution to the risk problems of pension funds was opportunistic (fair enough), expensive (well, that's market forces) and probably wrong (they have simply sacrificed the trust of future generations of trustees). It is hard to hate dead institutions, even though some of them live on in other incarnations. Nonetheless the salaries that they receive should continue to warn off pension fund investors in future. If they are making who is losing? No prizes for guessing.

There is no need to forget some other potential defendants, the most obvious of which

seem to be the investment consultants on whom trustees rely – by law, lest it be forgotten, because trustees are nowadays not allowed to do much unless they have obtained professional expertise. Investment consultants have also been swayed by the winds of fashion, into exotic instruments designed to 'match' liabilities with assets, as though it needed doing. The dream of LDI investments was always rather spurious and has now been shown to be an expensive aberration – yet regulators in particular remain addicted to the notion. They confuse matching assets and liabilities with the need to bear in mind future cash flow demands, which is not quite the same thing. Investment consultants are very much now in the front line, and are somewhat exposed unless they can demonstrate that they properly explained the risks (as against the rewards) of some of the more interesting products they have been instrumental in advising on.

Who else? Well the obvious culprits are the regulators. They have driven pension trustees insane with incessant requirements to improve their investment process, devise investment plans and negotiate investment strategies. While they have concentrated on the minutiae, they have of course missed the big picture and are squirming to devise a response to market turmoil. As pension funds asset values fall, it is clearly not only impractical but also impossible for most pension funds to impose cash requests on their plan sponsors (who even if they were minded to divvy up would find resistance from their banks who simply do not have the cash). The liquidity problems make it virtually impossible to meet the fall in market values with increased injections, which means that regulators are going to have to accept that repayment schedules and recovery plans are going to have to stretch over 20 or even more years if they are going to be met at all. Although the regulator will probably understand this intellectually, it has found it embarrassing to state this publicly. But until reality checks overwhelm regulators, they are vulnerable to criticism.

Anyone else in the blame game? How about the legislators? Responsible for around 40 000 pages of regulatory stuff much of it without scrutiny, responding to every passing whim,

blaming all around while washing their hands of responsibility, the legislators are a sorry sight. But on they go, with proposals for yet more controls – while again missing the elephant in the room, namely the ponzi game that was the bankers' round-about.

It's a bit of a failure all round. The people as ever who will suffer will be the scheme members. And it is far from clear whether any of the perpetrators who got us into this state of affairs will, or will ever be able to, indemnify the schemes for their behaviour. To do so they first of all need to say they are sorry, and there is little sight of that happening any time soon.

So in the meantime, pension plans should be consulting their lawyers. One massive writ (nowadays called a complaint) against everyone should get the ball rolling, and we can leave it to

the judges to apportion the quantum of blame. The lawyers might prove to be the ultimate saviours of the system, but in the interim we all need to reflect on the cycles of human nature that no regulator however efficient or well-intentioned can control or should try to. The big question is, as we mop up after this most recent perfect storm, when is the next hurricane due and whom can we blame then? Rather like real sailors in a real storm, we should take down the sails, batten down the hatches and go to sleep. In other words, maybe the best solution of all would be for all of us, pension funds and regulators, to sit tight, stop thinking and do nothing until the skies clear.

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