The 2008 global financial crisis had many profound effects, including a meltdown in asset values and the subsequent establishment of new regulatory structures. In the world of pensions, the financial crisis also created two complementary paradigms: it made the pensions landscape more complex and it established trends in the industry that are increasingly global in scope.

Some effects are still unfolding. The full requirements and timing of new regulations, for example, are shrouded in the mist and may continue so for the foreseeable future.

What is clear now is that there are certain key challenges that require attention from across all levels of the stakeholder community, including:

- the difficulty of finding trustees in an increasingly complex world
- the movement globally to raise the retirement age
- the impact of new regulations, particularly with regard to derivatives
Better governance remains top of the agenda for most pension sponsors. In a recent survey conducted by Towers Watson, a sizable number of respondents voiced the need to focus more energy in the area of governance, particularly in light of evolving regulatory demands. In addition, the survey results identified two of the greatest perceivable risks facing pensions in the next two years – regulatory compliance and investment volatility.¹

Board structures, managing conflicts of interest and training are key areas of focus for all levels of the industry, including trustees, sponsors, supervisors and lawmakers. But nowhere is the new pensions landscape more observable than at the trustee level where the minefield of regulations and lawsuits makes retaining a good talent pool an increasingly challenging business. Recent studies confirm the direct influence of competency at the trustee level as a measurable factor toward improving overall fund performance, making governance all the more critical.²

With new regulations have come requirements for less but better trained trustees, the ability to develop a core of independent chairs of trustees with strong outside business acumen and, last but not least, better purchasing power for the fund in terms of underlying costs. The level of skills alone required to manage the range of fund regulations makes finding the right trustees a challenge. Above all, a huge focus for regulators is to improve trustee knowledge and awareness. Accreditations, self-assessments, formal training programs within the annual trustee cycle are all becoming the norm.

Education is the watch word. Are there different standards of governance protocol being applied globally? Of course.

From the U.S. to Canada, the UK, Australia and The Netherlands, change is in the air. Across these major markets, debates are being conducted on the resource impact of new regulations, plan consolidation and improving professional standards.

In all of this, no one has lost sight of the point of pensions: providing an adequate income in retirement; but what perhaps could be called extraordinary is how trustee groups around the world are beginning to share their experiences in order to establish new levels of best practice.

It is increasingly a possibility that some of the world’s largest public funds will second trustees to boards of like-minded public funds in other national jurisdictions to foment a consortium of ideas in much the same way as they make media headlines with partnerships to back large infrastructure projects.

Might we then see a proliferation of international standards for pension trustees? Perhaps. There is, of course, a lot of wood to chop before then.

Within the United States, government bodies have sought answers to resolve the widespread underfunding of state and local pension systems, of which 78% participate in defined benefit plans. Proposals range from incorporating a defined contribution element to reducing post-retirement benefits to raising the retirement age for future participants.3

The latter has led to quite a bit of controversy when offered as a remedy for inadequate public finances. Regularly the media promote stories of passionate public hearings and large-scale demonstrations both for and against the idea. In the U.S., where fierce debate focuses on budgetary shortfalls, 90% of state retirement systems reporting actuarial data in 2011 were designated as underfunded.4 Raising the retirement age might provide some relief to state budgets, even as the ranks of retirees increase, without resorting to the most dreaded option of all – raising taxes.
A successful recent effort to raise the retirement age for members of the third-largest U.S. public pension, managed by the State of New York, required the careful negotiation of multiple parties, including several powerful unions that represent state and local workers who strongly objected to the original measures.

In spite of the controversy and in the long run, raising retirement ages could save taxpayer dollars. A benefit embraced by many in the political spectrum, it also may serve to keep plans sustainable and might impact investment strategies, as plans see the potential for reduced liabilities.

However, the case remains that increasing longevity is a cross-generational, global concern. Taken against falling birth rates, a hard question awaits: who should pay? Ideally, all generations will have to harmoniously agree to changes in living standards – including the probability that the retirement age will continue to rise.

One Non-U.S. Trend

Today’s buzz word is “super-size.”

Outside the U.S., every indicator suggests that if all stakeholders can agree, the super-sizing (or consolidation) of plan arrangements particularly in the public fund arena will gather pace. Nowhere has this become clearer than in Australia where reforms were made to super-size twenty years ago. In The Netherlands, consolidation of the existing defined benefit plan market is being encouraged by local regulators. In the UK, a serious debate has commenced on super-sizing the marketplace for both the public and corporate fund space as it pertains to closed defined benefit plans and the fast-growing defined contribution arrangements. Globally, scale looks increasingly desirable as has proved in the Danish, Canadian, Dutch and Australian models. Scale brings a more transparent supervisory model and a more even-handed relationship with big government in terms of being a ready resource to tap for long term investment projects.

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The portent of regulatory impact
In most countries, it is where politics meets pensions that the landscape gets rocky. Post the financial crisis of 2008, regulation of derivatives (a key area of managing liabilities and general risk for pension assets) has increasingly become a concern for sponsors and trustees. Multiple global regulatory initiatives in process are expected to have a significant transformational impact on the financial services industry – with the common objective of instilling greater discipline and governance to protect the public interest, manage systemic risk and foster general economic welfare.

To a large extent, this rule-making was preceded by periods of industry engagement and consultation on the part of regulators. Given the potential pace and sheer volume of rules, how industry participants engage and feed into this process will be instrumental in addressing uncertainty and determining the overall success for that delicate balance of markets, government, supervisors and those ultimately expecting an adequate income in retirement.

In fact, the breadth of reform is so sweeping that it is challenging for fund sponsors and other market participants to anticipate how these rules will be implemented and to understand their effects on business practices. Daily valuation standards and financial reporting disclosure are just two areas where J.P. Morgan expects significant pensions impact.
Today, fund sponsors must manage not only the increasing regulatory requirements for disclosure and transparency but also improve the standards for valuation. Gone are the days when firms could rely on the brokerage community to provide daily pricing of derivatives. Over a short period of time, independent pricing vendors have largely replaced broker or investment manager-supplied valuations for derivatives, setting the standard with the same scrutiny, data scrubbing and second-sourcing previously only typical for equities and bonds.

In the U.S., the Securities Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) have recently amplified their scrutiny on registrants’ use of fair valuation information obtained from third-party pricing services. Specifically, there is increased interest in the prices of instruments for which observable market quotes are available for similar, but not identical, instruments.
These instruments are often classified in Level 2 of the fair value hierarchy. The SEC staff has reminded registrants of their obligations to:

- Comply with U.S. GAAP, including disclosure requirements
- Maintain appropriate internal controls to prevent or detect material misstatements
- Assess the effectiveness of internal control over financial reporting

At issue is how fund sponsors may respond to the SEC’s focus on vendor-supplied prices. While the SEC has not prescribed any specific actions for registrants, audit firms have already begun to increase the level of their review of fair value measurement and valuation procedures. How management should take responsibility for vendor-supplied prices is a developing matter and reactions from respondents may vary. It is clear, however, that firms should be proactive even if they have not themselves received direction from the SEC. Plan sponsors should ask themselves if they are comfortable with their knowledge of valuation methodologies and inputs used by their pricing sources and with their level of oversight for pricing services.

Another type of disclosure requirement will also demand considerable attention. In this year-end financial reporting cycle, plan sponsors will be challenged to comply with the Fair Value Measurement (Topic 820) guidelines issued under Accounting Standards Update (ASU) 2011-04. For any instruments reported in the fair value hierarchy as Level 3, reporting entities must produce quantitative disclosures about the significant unobservable inputs used in the valuation process. ASU 2011-04 also requires a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement.
Finding the right trustees, managing investment strategies and sustainability, and coping with regulatory change are all challenging pension sponsors in different ways. New regulations, in particular, have created additional burden and complexity.

As a global partner to the pensions industry, J.P. Morgan is actively involved in industry trade associations and meetings with regulators to further our understanding of the evolving regulatory environment. These meetings allow us to monitor the latest developments and provide clients with feedback on the impact of changes that they may not have contemplated.

To assist pension funds with meeting their goals in this complex environment, J.P. Morgan also offers a transparent, integrated pension servicing platform to help balance investment and regulatory requirements. We leverage global, firm-wide resources to offer pension clients a broad range of strategic solutions and insight to help anticipate market trends.

For example, in keeping with the rapid pace of development and increasing complexity in the derivatives market, J.P. Morgan continues to enhance its centralized pricing unit by supporting multiple external vendors and offering an in-house valuation service to provide derivatives pricing coverage. Many of our clients now use a combination of vendors for both primary and second-sourced prices, which integrates independence and robustness into the valuation process to the benefit of investment fund boards, management companies and their pricing committees. Clients may also leverage J.P. Morgan’s customized reporting – which provides information such as price movement exceptions – to help better manage risk and to support valuation oversight committees.

J.P. Morgan’s unique ability to access the depth of skills and expertise within our firm ensures we keep pace with changes in the marketplace. This specialist approach, combined with the global strength and capability in our fund servicing locations, provides clients with comprehensive solutions.

In today’s world, navigating the pensions landscape is a collective effort. Sponsors and trustees are typically at the limit of their resources. They can look to J.P. Morgan for the necessary solutions to manage a global environment undergoing enormous change.
For more information, please contact your J.P. Morgan representative or:

J.P. Morgan Worldwide Securities Services
Benjie H. Fraser
Managing Director
+44 207 742 0214
benjie.h.fraser@jpmorgan.com

Brian S. Hyde
Managing Director
+1 212 552 5356
brian.hyde@jpmorgan.com

You may also visit us at
www.jpmorgan.com/visit/wss