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The capital markets as a neural network – should pension funds align with companies?

A core function of the capital markets is to create and allocate capital efficiently, both across society and over time. But this is not a linear process and what this project has identified is that it operates in a sense like a neural network, with the actions of each player affecting its neighbour, with knock-on effects over time through the system.

Conflicting incentives and misalignments of interest distort the strength of these effects across the capital markets. Conflicts of interest between different players in the capital markets rightly receive attention, but one of the important outcomes of this project has been the attention it has paid to calibrating *alignments* of interest – and rightly so, for this is where careful calibration of incentives can promote value.

We see this calibration across the system, an important example being that between ownership and control: when founders or generations of founding families exercise control of a company (say through dual voting rights shares) despite only owning a relatively small proportion of the company's share capital, there is a risk that they will favour their own interests over those of external minority shareholders. Nonetheless such companies are attractive to many investors precisely because they see an alignment of interests in sharing economically in a founder's vision for the company or a managerial approach taken over several generations. So, in practice, governance and disclosure mechanisms are used to address the type of conflicts of interest and calibrate alignment of economic interests arising here through equity capital.

Capital flows in different directions. Many large companies not only support pension schemes but are owned, ultimately, by pension schemes. The relationship between companies and their defined benefit pension schemes is an important example of the need to re-calibrate the balance of incentives.

The pensions regulatory regime has been built around the conflicting interests between a company and its pension scheme(s), with the scheme positioned as a quasi-creditor of its sponsor, limited in its ability to invest in it and with a separate governance structure.

However, although pension schemes are in one sense competing with their company's shareholders for funding, they fundamentally depend on the long-term health and cash flows generated by the company. So in the wider sense there is an alignment of interests. This is now being recognised. Two regulatory developments stand out: the introduction of a new statutory objective to take into account the 'sustainable growth' of the sponsor, and the shift of pensions regulatory emphasis on collaboration and integrated risk assessment.

A few leading pension funds and sponsors are now working together to articulate their long-term objectives, investment beliefs and risk appetites, building on this shift of regulatory emphasis. In some cases this is causing them to challenge the current orthodoxy that pension schemes with very long liabilities, even those supported by very strong sponsors, should inevitably be on a de-risking path. This is to the good, for long-term value creation ultimately needs an equity risk culture. Nonetheless, this will require a shift in the professional consensus of opinion within the consulting industry. Further academic and professional work in this area would therefore be valuable.