ASSOCIATION OF CONSULTING ACTUARIES

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DB consultation
Private Pensions
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Caxton House
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London SW1H 9NA

Dear Sir / Madam

Security and Sustainability in Defined Benefit Pension Schemes

I am writing on behalf of the Association of Consulting Actuaries in response to the Green Paper of the above name issued on 20 February 2017.

Our comments on the consultation are set out in the six Appendices – one for each question set out in the Green Paper.

The tone of the Green Paper is largely accepting of the current regulatory regime. We have sympathy with this. However, we have identified in our response three key areas where we think that change is necessary:

1. A new facility to enable schemes that can no longer provide the promised benefits to be able to compromise them to a degree (and certainly no less than PPF compensation), subject to key safeguards and where so doing is in the members' best interests. This facility needs to be more flexible than the regulatory apportionment arrangement route and cheaper to implement;

2. The introduction of an employer option, exercised with trustee consent, to allow schemes to move from the Retail Prices Index to the Consumer Prices Index when determining pension increases and also (where necessary) revaluation; and

3. Subject to certification, DB schemes should be able to simplify legacy benefit structures so they can reduce scheme administration costs and facilitate hedging and buy-out options. This would also facilitate the introduction of the pension dashboards and help members to better understand the total value of their benefits. We also believe that this is an essential first-step if voluntary consolidation of schemes on any scale is to be successful.

If you have any questions on our response, please do not hesitate to contact me on 020 7432 6635 (david.everett@lcp.uk.com).

Yours faithfully

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On behalf of the Association of Consulting Actuaries Limited

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APPENDIX 1

Security and Sustainability in Defined Benefit Pension Schemes

Question 1 – Are the current valuation measures the right ones for the purposes for which they are used?

Yes – the four main approaches described in paragraph 147 are right for the purposes for which they are used. Turning to the Statutory Funding Objective this comprises:

- A "prudent" valuation of the scheme's accrued benefits (the "technical provisions").
- The "shortfall" (the difference between the technical provisions and the scheme's assets)
- The period over which the shortfall will be met (the length of the "recovery plan"); and
- The amount of payments made each year (the "contributions").

We consider it appropriate for trustees and employers to plan to finance their scheme using a prudent approach, since anything weaker seems likely to impose undue risk on members in the event of the employer's insolvency. Member security is provided via the employer's continuing solvency, including its ability to pay contributions, the scheme's current assets, and the trustees' future investment strategy. Consequently, it seems appropriate that these are taken into account when determining the "prudent" approach to the valuation.

Although we continue to support the Statutory Funding Objective, the reporting on valuations could place more emphasis on understanding risk in order to improve the likelihood of delivering pensions. We also have some concerns that the flexibilities inherent within this measure are not always used. We turn to this below.

a) Are the flexibilities in setting the Statutory Funding Objective discount rate being used appropriately?

- **If not, why, and in which way are they not being used appropriately?**
- **What evidence is there to support this view?**
- **How could sponsors and trustees be better encouraged to use them?**

Yes, in most cases. The flexibilities in the statutory funding regime relate to the calculation of the technical provisions and the length and content of the schedule of contributions. The Pensions Regulator's Scheme Funding Survey 2016[1] shows that:

- (Nominal) discount rates used to calculate technical provisions vary from about 3.5% to 5.5%, which is a material range.
- The majority of schemes have recovery plans of less than 10 years, although in 5% of schemes they are over 18 years. Provided the position of the scheme and the employer have been reflected in reaching this position that does not seem inappropriate.

[1] http://www.thepensionsregulator.gov.uk/docs/scheme-funding-appendix-2016.pdf

To the extent that trustees and employers do not take advantage of the full range of flexibility possible, we expect this is because:

- The Regulator is quick to react adversely to new ideas, and slow to retract its position when it is clear that the ideas, if adopted appropriately, are legitimate and can result in better outcomes for schemes and employers. This has been the case for liability management exercises and for certain special purpose vehicles. Trustees are therefore sometimes reluctant to consider employer or adviser proposals, because they do not wish to be the subject of increased scrutiny by the Regulator.

- Trustees of smaller schemes, particularly with small employers, are cost sensitive. Frequently, more "flexible" outcomes are facilitated by establishing company guarantees, in one shape or form, which might not be available from small employers or might seem too costly to implement.

b) Should we consider shorter valuation cycles for high risk schemes, and longer cycles for those that present a lower risk?

- **What should constitute a high or low risk?**

- **Or should a risk based reporting and monitoring regime be considered?**

No. We do not believe it would be practical to implement such a regime, or that there would be any benefits from doing so. In particular there is no evidence that the current, three year, cycle imposes undue cost or burden on trustees or employers and it does not seem possible to identify reliably what is high or low risk, to the extent that valuation cycles could be changed, since there are so many different factors that are relevant to the decision.

Our expectation has been that the Regulator uses risk criteria to "horizon scan" for relevant corporate and scheme-related information, as well as collecting comprehensive information annually using its scheme return process. It could request trustees to provide it with updates on progress, at intervals throughout the valuation process, to assist with this.

We expect also that it would be welcomed if some "low risk" schemes were identified that did not need to annually update their scheme returns, but since the sections most onerous to complete relate to the PPF we do not expect this could happen.

c) Should the time available to complete valuations be reduced from 15 months?

- **What would be an appropriate length of time to allow?**

There is no reason not to complete valuations more quickly and, indeed, technology means that results are available in much shorter timeframes than 15 months. However, it would require a change of mind-set from other parties (particularly employers) for a shorter deadline to be successful.

We suggest that the 15 month period should be viewed as a deadline after which the Regulator has full access to its powers to intervene in the valuation process. With this in mind, 15 months seems about the right period: some valuations require an extensive process, for example because they lead to a review of the scheme's structure, or because the employer covenant is complex and guarantees from overseas parents are being sought. Risk-sharing schemes which require employee consultation and multi-employer schemes generally may need the full 15 months. Mandating a shorter period before the Regulator can intervene could interfere with legitimate processes, and not necessarily result in better outcomes.

However, it might help the Regulator to have an early indication of valuations that are expected to exceed the deadline. Currently, its procedures do not seem to allow it to react to early warnings, but a check in 12 months, to see if trustees are on track or not, might help it to allocate its resource more efficiently.

d) Should other measures or valuation approaches, for example stochastic modelling, be mandated or encouraged?

- **If so, which ones and for what purpose?**
- **How would the information provided to the Regulator to explain the agreed recovery plan differ from that at present?**
- **What would the costs be, and would they outweigh the benefits?**
- **If not, why, and in which way are they not being used appropriately?**
- **What evidence is there to support this view?**
- **How could sponsors and trustees be better encouraged to use them?**
- **What would the costs be, and would they outweigh the benefits?**

There is nothing in the current regime that would prevent trustees from taking a stochastic approach to the valuation (indeed, many already do) or from considering different measures. In addition, risk analysis and stochastic modelling are much cheaper to do now and are more easily accessible than they were 10 years ago.

Regardless of the approach used, it should be straightforward to produce the technical provisions measure, the market value of the assets, and the schedule of contributions (including the recovery plan). Ultimately, the information these data points provide are useful summaries of the progress the trustees are making towards their objective of having sufficient assets to pay the benefits, taking their view of the employer covenant into account.

For the avoidance of doubt, the cost of mandating a stochastic approach would outweigh the benefits particularly since, for many schemes, there would be no benefit.

Whatever approach is adopted, the main point is that the trustees and employer understand the risks inherent in their funding and investment strategy – and this is the aim of the regulator's integrated risk management approach.

APPENDIX 2

Security and Sustainability in Defined Benefit Pension Schemes

Question 2 – Do members need to understand the funding position of their scheme, and if so what information would be helpful?

a) Should schemes do more to keep their members informed about the funding position of their schemes?

We agree that members need to be informed of the security available to their benefits, but we are not convinced that the current requirements achieve this. In particular, providing a range of different funding levels (technical provisions and solvency) does not seem helpful and many of the other information requirements for summary funding statements seem likely to confuse the issue even further.

We suggest that as a starting point, trustees should be required to state the technical provisions funding position, give broad information about how the technical provisions are financed, and explain how the employer's continuing solvency helps to ensure that benefits will continue to be paid. The commitments the employer has made to ensure the scheme becomes, or remains, fully funded should also be explained. Where a scheme is in deficit, it may then be appropriate to disclose the likelihood of the scheme reaching full funding on the technical provisions basis and by when this may happen.

It may also be useful to provide some generic information on the extent to which accrued benefits map across to PPF compensation given this is relevant for members' benefit security and could have a bearing on decisions around member options (and not just transfers out).

While we agree that it is appropriate to communicate financial information about the scheme to members, we do not feel this materially contributes to member protection. Members are very limited in how they can react to changes in the scheme's circumstances, and the appropriate decision for them will need to take into account far more information than the trustees have access to (such as members' personal circumstances). Consequently, we see the communication as assisting members develop some financial literacy, rather than being a useful risk management tool.

b) Do we need Government communications to provide information to the wider public and media about the degree of certainty and risk in the regime?

No.

- **What difference could this make?**

We need the Government to be clear about the degree of uncertainty inherent in all financial products. It is not only the defined benefit market that has suffered because it is politically uncomfortable for governments to accept that there will be circumstances where financial products will not deliver their expected outcomes. Personal pensions suffered from this in the early part of the 21st century, partly contributing to a loss of faith in retirement and other long-term products.

APPENDIX 3

Security and Sustainability in Defined Benefit Pension Schemes

Question 3 – Is there any evidence to support the view that current investment choices may be sub-optimal? If yes, what are the main drivers of these behaviours and how could they be changed?

a) Do trustees/funds have adequate and sufficient investment options on offer in the market?

Broadly, yes.

- **Is there anything Government could do to address any issues?**

Other than the absence of CPI-linked bonds, we believe that the range of investment options available to trustees is generally sufficient to meet any reasonable investment strategy requirements. However, for a number of years there has been an undersupply of gilts. Furthermore, the Government is the ideal broker to invest in infrastructure and raise money through gilts (to service the demand created by financial services regulation), rather than pushing institutional investors to invest directly in infrastructure.

Given the size of the institutional market, there are strong commercial incentives for asset managers to make potentially attractive asset classes and solutions available to pension schemes in a suitable form.

At the individual scheme level, governance budget constraints or minimum investment sizes may, at the margin, limit the range of options for some smaller schemes. In practice, the widespread availability of pooled funds means that such schemes can access most mainstream asset classes through a single or limited number of relationships with one or a small number of asset management firms.

b) Do members need to understand the investment decisions that are being made?

Not in a great level of detail.

- **If yes, are there any specific decisions that need articulating?**

Given the complexity of at least some of the investment decisions that pension scheme trustees need to make, we believe that it would be extremely challenging in practice to communicate these in a way that most members would find easy to understand. Members do not need to know how their scheme is being managed in this level of detail.

An appreciation of high level principles regarding the scheme's management and governance is more useful.

First, members should know / be reminded that their trustees have a responsibility to act in the best interests of the scheme's beneficiaries (which includes the employer).

Second, trustees can use member newsletters and similar communications to provide an overview of their scheme's objectives and how the investment strategy and choice of managers are designed to deliver these. As part of this communication strategy, we do believe it may potentially be helpful for members to understand somewhat more about the investment risks their scheme faces, as well as the options the trustees have in managing these, and the trade-offs they have chosen to make. This may help develop or reinforce member appreciation that defined benefit pensions are not guaranteed.

To the extent that members do wish to know more about their scheme's investment arrangements, a number of relevant documents are typically available to members on request, such as the Statement of Investment Principles, and the Trustee Report & Accounts.

c) Would it be appropriate for the Regulator to take a lead in influencing or determining an acceptable overall level of risk for a scheme in a more open and transparent way?

No. If the Regulator were to intervene in this manner it would likely lead to a reduction in flexibility in the system as well as a material increase in the level of resources needed by the Regulator.

We believe that the most difficult part in setting an investment strategy is the trustees' determining the appropriate amount of risk that could or should be taken, since this needs to take account of not only a number of general but also scheme- and employer-specific issues. Current guidance is high level, which appears appropriate for what is a difficult and somewhat subjective area.

Moreover, IRM already provides a useful framework for scheme trustees to consider risk in the round.

d) Would asset pooling or scheme consolidation help schemes to access better investment opportunities?

It seems reasonable to conclude that scheme consolidation could help smaller schemes access a wider investment opportunity set, through reducing barriers such as governance and cost as well as minimum investment sizes. However, to be effective, this would also result in some – potentially material – loss of control over the choice of investments, and also possibly in other areas, which may reduce the attractiveness to many scheme trustees.

For all but the smallest schemes, the widespread availability of pooled funds means that investment opportunities once seen as the preserve of large schemes only (eg Liability Driven Investment) are now generally available to most trustees.

e) Is regulation (including liability measurement requirements) incentivising overly risk-averse behaviours/decisions that result in sub-optimal investment strategies?

- **If yes, which regulations and how do they impact on these decisions?**

Risk is typically considered in the context of: meeting benefit outflows; maintaining and improving funding levels; controlling funding level volatility; and managing the potential contribution requirements resulting from triennial actuarial valuations, in which liabilities are often measured with some reference to gilt yields and assets are valued at market value. As a result, pension schemes typically maintain material allocations to relatively secure investments such as gilts and bonds which will match or "hedge" (a proportion of the) movements in this liability measure, thereby reducing the volatility of both the funding position and future contributions. In one sense, this could arguably be considered inefficient, since the long-term returns on these types of investments are expected to be lower than those available on other assets, such as equities and property.

However, in the context of the objectives outlined above, we do not believe this is inappropriate. The trustees of most schemes, which are closed to future benefit accrual, are in practice ultimately aiming to secure those benefits with an insurance company, and the cost of doing so typically also has some link to gilt / bond yields – so a strategy that invests (an increasing amount) in these or similar instruments over time is appropriate. Similarly, if a sponsor was to become insolvent, the level of benefits that could be secured at that time would be linked to gilt / bond yields; hence these low-risk investments increase the security of members' benefits in the short-term. However, it should be noted for schemes which are immature and / or have potentially strong employer covenants, the use of a gilt-based discount rate and the associated investment in bonds may lead to a potentially overly conservative investment strategy.

Further, we do not believe that targeting the objectives described above necessarily gives rise to overly risk-averse or sub-optimal investment strategies. Pension scheme trustees can meet such objectives (of managing funding levels and their volatility) by investing in leveraged liability-driven investment funds. These have bond-like investment characteristics but their leverage means that £1 invested provides more than £1 worth of hedging. As a result, for a given level of hedging, more of a scheme's assets are available for investment in asset classes which are expected to deliver higher long-term returns.

f) Are you aware of evidence of herding or poor advice from the intermediaries and advisors?

No; not in general.

Trustees will often have similar objectives (as described in the response to e) above) and will adopt similar, commonly accepted principles – matching and diversification – in setting and attaining those objectives.

As a result, scheme trustees may end up doing broadly the same thing but that of itself is not evidence of herding.

The detail of each pension scheme's investment strategy will be specific to that scheme's situation, governance budget, the trustees' investment beliefs, and their attitude to risk. To repeat, whilst broad similarities in strategy will exist, we believe that this is more likely to arise as a result of commonly held objectives and broad principles, rather than poor advice or "herding".

g) Are measures needed to improve trustee decision making: skills such as enhanced training, more Regulator guidance, or the professionalisation of trustees?

We think that you first need to gather further information and insights on the nature and quality of trustee decision-making before proposing measures to address any shortcomings. The Pensions Regulator's work on 21st Century Trusteeship is a useful start in this area. It should progress with its initiative and put in place appropriate actions to deal with its findings.

APPENDIX 4

Security and Sustainability in Defined Benefit Pension Schemes

Question 4 – Is there a case for making special arrangements for schemes and sponsors in certain circumstances such as a different regime for employers who can afford to pay more, and/or new or enhanced flexibilities for stressed sponsors and schemes?

We do not think there should be special arrangements for employers who could afford to pay more than the contribution agreed under the current scheme funding regime. The current system works reasonably well for most employers and scheme members. However, one change that we would endorse for all schemes is a statutory override to allow a move to a CPI-based inflation measure.

There is a strong case for changes to help stressed sponsors and their schemes' members. The situation at the moment is almost binary – if it is determined that a pension scheme is unviable as a result of the employer not being strong enough to support it, the only option (unless a Regulated Apportionment Arrangement can be agreed, which is far from straightforward) is for the employer to become insolvent and for the scheme to drop into the Pension Protection Fund or otherwise secure reduced benefits with an insurance company. Members receive reduced benefits, there is often a strain on the PPF (and hence other DB schemes) and employees lose jobs. In both scenarios the scheme and the employer have failed.

Our view is that there should be an intermediate solution available. It will sometimes be the case that if the trustees of the pension scheme had been able to reduce members' benefits (but not below the level that would be secured on employer insolvency) then they may still be able to find a viable solution for the pension scheme and scheme sponsor. This would have the following advantages relative to the above:

- Members would be expected to receive benefits in excess of those that they would receive on employer insolvency;
- The employer remains in operation and there is no destruction of sponsor value;
- The pension scheme would not fall into the PPF and therefore not adversely affect the PPF funding; and
- Employees are less likely to lose their jobs.

Separately, we note that there was no question on expanding the Pensions Regulator's winding-up powers although this was listed as a potential change and discussed in paragraphs 242 to 245. It is not clear to us that further changes to the Regulator's powers should be made in this area. If changes were to be made, the Government should consider the potential accounting implications on sponsoring employers – these might mean that a much wider group of schemes and sponsors would be affected than anticipated, and could discourage employers from making deficit contributions if ultimately there is no power for the employer to reduce contributions or obtain a refund if a surplus were then to arise in the future.

a) Do you have any evidence that Deficit Repair Contributions are currently unaffordable?

We do not have evidence of a systemic problem but we are not sure that this is the correct question to ask. Employers would not agree to pay deficit repair contributions that are unaffordable. Generally, the position is more likely to be uncomfortable than impossible.

We note in passing that in the decade to March 2015 UK companies paid some £120 billion in deficit repair contributions to their DB schemes, whilst at the same time seeing deterioration in their scheme funding positions.[2]

There are schemes that have relatively long recovery periods, because the employer is unable to afford the contributions necessary to make good the deficit over a more reasonable period. Many of these schemes will also be relying on anticipated additional returns from assets such as equities in order to make the recovery plan 'add up'. These 'stressed schemes' could end up in the PPF if their employers are forced into insolvency and the required returns have not materialised. A relatively small proportion of schemes are in significant difficulties.

There is also the question of schemes being affordable, but at the expense of current employees' benefits. The cost of financing historic defined benefits may lead to low levels of defined contribution benefits for the workforce. A successful system would be one where the relationship between funding the past and funding the future was less skewed.

b) Should we consider measures to encourage employers who have significant resources as well as significant DB deficits to repair those deficits more quickly?

- **If so, in what circumstances, and what might those measures be?**

We think the current system/mechanism for this is happening 'sufficiently well'.

c) If measures are needed for stressed sponsors and schemes, how could "stressed" be defined?

- **Should a general metric be used, or should this be decided on a case by case basis?**

We suggest that this should be decided on a case by case basis with input from both the trustees and the Regulator. We suggest an intermediate solution should only be possible if:

- the trustees decide that it is in the members' best interests, and
- the Regulator gives its consent. The Regulator's role here would be to satisfy itself that the trustees were acting in the members' best interests and that the change was not likely to materially disadvantage the PPF.

It would be important for the Regulator to provide guidance for trustees. This should include guidance on how trustees should interpret "members' best interests" and how to review and manage conflicts of interest that might arise in these circumstances.

[2] Page 12 of the 2015 edition of the Purple Book

If the Regulator is unable to provide the necessary guidance or carry out the role envisaged above, an alternative would be to use an independent third party – perhaps a judge or court, to assess and agree the compromise.

In order to address governance concerns it may be necessary for independent/professional trustees to be put in place.

d) Are there any circumstances where stressed employers should be able to separate from their schemes without having to demonstrate that they are likely to become insolvent in the near future?

The existing Regulated Apportionment Arrangement framework can be used to achieve separation. However, consistent with our general comment above under (c), we think the test should be based on the members' best interests rather than explicitly requiring insolvency in the near future. In practice, we suspect the tests outlined above are most likely to be met in circumstances where there is significant uncertainty over whether the 'guaranteed' benefits will be paid in full. In this scenario an intermediate solution may be attractive to both members and the employer.

e) How would it be possible to avoid the moral hazard of employers manipulating such a system in order to off load their DB liabilities?

- **Would some sort of 'quid pro quo' be appropriate to ensure the scheme is not disadvantaged relative to other creditors of the employer/stakeholders?**
- **What could this look like?**

The approach we have outlined above under c) should minimise the risk of employers manipulating the system. For schemes which are not underfunded or where the employer is expected to be strong enough to finance the deficit, it is unlikely to be in members' best interests to adopt an intermediate solution. However, where there is significant uncertainty over whether the 'guaranteed' benefits will be paid in full, then an intermediate solution may be attractive for both members and the employer. Other creditors are already able to renegotiate debt – these changes would put pension schemes in a similar position, being able to negotiate suitable safeguards as part of the renegotiation.

f) Are there any circumstances where employers should be able to renegotiate DB pensions and reduce accrued benefits?

- **If so, in what circumstances?**

Yes. See c) above.

g) Is there any evidence to suggest that there is an affordability crisis that would warrant permitting schemes to reduce indexation to the statutory minimum?

Such an approach would seem to be extremely badly targeted from both a member and sponsor perspective. It could allow significant reductions in benefits for some schemes with strong sponsors where reduction is not really necessary, while other schemes that are in difficulties might already be paying increases at the statutory minimum and therefore have no scope for such a reduction in benefits. In addition, within a scheme, some members would be much more significantly impacted by the change than others.

h) **Should the Government consider a statutory over-ride to allow schemes to move to a different index, provided that protection against inflation is maintained?**

- **Should this also be for revaluation as well as indexation?**

Yes. The ACA believes that there is a case to rationalise indexation arrangements because of the official and general lack of confidence in RPI as an appropriate measure of price inflation and also to remove the "lottery" that has applied since the government changed its statutory measure of inflation from RPI to CPI in 2010.

This should be an employer option, exercised with trustee consent, and should not be limited to schemes in stressed circumstances. Whilst we accept that this may put some trustee boards into potentially difficult positions, trading off differing impacts on different members and presumably benefit security, we feel that it is not appropriate for the employer to have sole power to deliver a benefit compromise.

Given that the RPI is no longer an official national statistic all DB schemes should have the right to be able to switch to the CPI. They would also no longer be held hostage by what for many could well be an unintended consequence of the drafting approach taken by those responsible for constructing the Trust documents many decades ago, in combination with subsequent legislative changes. Two schemes which were originally similar could end up with very different provisions now, just by chance. Whilst it is true that such a move will deliver a lower overall retirement income over the course of an individual's retirement, it does seem to be an entirely reasonable compromise.

As well as helping those companies whose pension schemes are becoming unmanageable, the introduction of a statutory override that enabled schemes to switch pension indexation from RPI to CPI would potentially free up resources to enable companies to make increased contributions to their DC schemes. This would aid inter-generational fairness. Alternatively, freed-up resources could provide additional security for accrued benefits.

Our Small Firms Pensions Survey of 2016 indicated that over 90% of firms support legal reforms that would allow defined benefit schemes to move to CPI indexation of benefits.

Similar considerations apply to both revaluation and indexation, although our understanding is that RPI-linked revaluation is less common than RPI indexation.

i) **Should the Government consider allowing schemes to suspend indexation in some circumstances?**

- **If so, in what circumstances?**

Yes, a move to conditional indexation for past service could be part of a proposal put to the trustees for consideration in the test we outline in (c) above. The ACA supports moves towards conditional indexation, with appropriate safeguards. This is an approach the ACA has advocated, for future service, for many years.

j) **How would you prevent a sponsoring employer from only funding a scheme to a lower level in order to take advantage of such an easement?**

The existing framework for funding will already act to prevent this. In addition, the test we outline in (c) above is not based on the funding level but on whether the change would be in the members' best interests. In our view, if a scheme has a strong employer standing behind the benefit promise, it is unlikely to be in the members' best interests to reduce benefits, irrespective of the current funding position.

k) Should Government consider allowing or requiring longer, deferred or back loaded recovery plans?

- **If so, in what circumstances?**
- **Should other changes be considered, such as the valuation method of Technical Provisions?**

These options do not appear to be prohibited by legislation. The Regulator can influence behaviour and set expectations in these areas via its Code of Practice of scheme funding and via other guidance and statements.

l) Should it be easier to take small pots as a lump sum through trivial commutation?

The Green Paper states that it has been suggested that members might be allowed to trivially commute before the age of 55 and that the limit might be increased from £30,000.

We believe that, in general, individuals should not be able to access retirement savings in full before age 55 other than in very limited personal circumstances, such as serious ill-health. There are two exceptions to this – the winding up lump sum on which we comment at the end of this response, and (to a limited extent) to help fund house deposits and/or to meet a short and specific list of other eventualities.

However, once members have reached normal minimum pension age, we can see a good argument for allowing more flexibility over how members take their benefits. Allowing DB benefits to be commuted for a lump sum within the scheme rather than the member having to go through a transfer process (but still subject to various conditions) is one additional flexibility that we would welcome – and this is consistent with the flexibilities available for DC pension pots (so would be subject to tax in the normal way).

If the Government is not prepared to go to full flexibility direct from DB schemes then it would be desirable to make cash out of smaller benefits more straightforward and aligned. This is particularly true given the direction in which the capital value of DB benefits is heading. The Government should give serious consideration to having one "small benefit" measure (rather than the two different measures – the "TCLS" and the 2009 regulations' "small lump sum" rule). For example, tax rules could abandon the complex TCLS rules and instead just have the "small lump sum" limit for occupational pension schemes – ie the test allowing cash out focussed solely on one scheme in isolation – with the maximum amount rising from £10,000 to £30,000. If this "simple" change is unacceptable for any reason, we would not suggest other tinkering.

Security and Sustainability in Defined Benefit Pension Schemes

Question 5 – Do members need further protection, and should this be delivered by a stronger and more proactive Regulator, and/or trustees with enhanced powers?

No, we do not believe that there is any significant evidence that members need additional protection or that substantial new powers are needed for the Pensions Regulator. Whilst several recent high-profile cases have raised the question of whether members have adequate protection, the outcome of these cases has seen members generally receiving (or expecting to receive) benefits above PPF minimum levels, which should be regarded as a qualified success for the current regulatory regime.

It now often seems to be forgotten that, when the PPF was originally established, it was set up to provide a level of compensation that Parliament deemed to represent an appropriate level of protection, far beyond the very limited protections that applied before the introduction of the PPF. The concept of a protection scheme providing a level of benefits at a slight discount to the benefits that would have been provided under the scheme still seems to strike an acceptable balance between PPF levy payers and the recipients of PPF compensation. We are concerned that recent comments, by the Work and Pensions Select Committee amongst others, give the impression that the PPF is in some way an inadequate form of protection for members, which could lead to members (and the general public) ceasing to value the very real protection provided by the PPF and funded at considerable cost to levy payers. The fact that members of a failed scheme receive PPF compensation which corresponds to the vast majority of the benefits they would have received under the scheme should be seen as a success of the overall regulatory regime (although, as we set out in our answer to Question 4, we think that there is a case for an intermediate solution between the levels of PPF compensation and full scheme benefits being made available in a limited set of circumstances).

Having said this, it is clear that there are anomalies in the calculation of PPF compensation which were highlighted in the Tata Steel consultation, such as the treatment of bridging pensions. Such anomalies could usefully be addressed to ensure that members do not receive a 'windfall' from entering the PPF.

We also do not believe that recent events have demonstrated any significant failings on the part of the Pensions Regulator. In fact, it is arguable that the failures seen in recent cases such as BHS have been failures of corporate governance rather than of pension regulation. It might be helpful for the Government to consider how all regulators can use their existing powers to influence good corporate governance in relation to decisions and advice affecting workplace pension provision, and to encourage closer working practices between different regulators.

We note that the Pensions Regulator already has significant powers, some of which it has used only sparingly (the moral hazard powers) and others of which it has never used at all (the scheme funding powers). The Pensions Regulator's powers to wind up a scheme under section 11 of the Pensions Act 1995 have also only been rarely, if ever, used. This would suggest that the focus should rather be on whether the Pensions Regulator is using its existing powers as effectively as it should, rather than on whether it should have any major new powers (although, as we note below – see d), e), f) and i) – we think there could be a case for some minor additional powers). In particular, it might be worth considering whether the process that the Pensions Regulator has to go through before deciding whether or not to use its powers is overly laborious and whether it could be made easier for it to embark on regulatory intervention using its existing powers.

We also note that the Pensions Regulator (like all regulators) is resource-constrained and any significant increase in regulatory powers would be likely to add to the General Levy. It would need to be clear from a cost-benefit analysis that any such additional cost payable by pension schemes would be outweighed by the benefits of the additional regulation being proposed. In particular, we are not convinced by the argument for 'paid-for' regulatory services as we discuss under (g) below.

Finally, any new powers granted to the Regulator are only as good as their operational capacity to implement them effectively. The highly regulated professional community has a role here too, so it is not solely the Regulator's job.

a) Would greater clarity over the requirements for scheme funding be helpful to members and to sponsors?

- **If so, would this be better set out in detail in legislation or through increased guidance and standards from the Regulator?**

No, our experience as advisers to pension schemes and to the employers who sponsor them is that the scheme funding regime is generally well understood by trustees and employers, although sometimes the scheme-specific funding regime does require particular explanation for non-UK companies based in countries in which the local pension funding regime is prescribed.

In the UK, the Minimum Funding Requirement could be argued to have led to a race to the bottom in which a funding level originally established as a minimum soon became a maximum with many schemes operating at a deficit to that 'minimum'. We think therefore that the setting out of new funding requirements in legislation or in binding regulatory standards would be a retrograde step. We believe that the flexibilities available in the scheme funding regime to take account of the particular circumstances of a scheme and its sponsoring employer(s) largely work as intended, are increasingly well understood by all parties involved, and allow trustees and employers to agree on outcomes which are in the interests of both parties. Any move away from a flexible scheme-specific funding regime to a prescribed regime (whether through legislation or guidance) would also be likely to conflict with the Pensions Regulator's sustainable growth objective, since it would require the imposition of a funding regime that would override any such employer-specific considerations.

The Pensions Regulator already provides considerable guidance on scheme funding to trustees and employers. Whilst Code of Practice 3 is not binding or part of a 'comply or explain' regime, the fact that a court must take any relevant provisions of a code of practice into account when determining whether the relevant legal requirements have been met does give the code a status above other regulatory guidance. In addition, the Pensions Regulator also publishes other guidance and analysis. For example, its recent Tranche 9 analysis[3] provides some practical case studies of how trustees and employees have used the flexibilities in the system

[3] http://www.thepensionsregulator.gov.uk/docs/db-tranche-nine-overview.pdf

to achieve the best outcome from their funding valuation. Such guidance aims to encourage best practice outcomes in a range of different situations, rather than to impose one-size-fits-all outcomes. We would support the Pensions Regulator in producing similar good practice case studies in future.

We therefore do not believe that greater clarity over the requirements for scheme funding is needed for sponsors (although the publication of additional guidance and case studies that focus on the principles at issue could be helpful). The consultation document also asks whether greater clarity over scheme funding requirements would be helpful to members. As we set out in our answer to Question 2 a), we are doubtful whether the existing summary funding statement provides the information that is most helpful to members.

b) Is it possible to design a system of compulsory proactive clearance by the Regulator of certain corporate transactions, without significant detriment to legitimate business activity?

- **If so how?**
- **What are the risks of giving the Regulator the power to do this?**

No, we do not believe that it is either desirable or practical to introduce compulsory clearance for certain corporate transactions. It is unlikely that it would be possible to devise a definition of the circumstances in which such a system could apply, without unnecessarily impacting on legitimate transactions.

One possibility is that the Pensions Regulator could find itself buried under unnecessary clearance applications and would therefore act as a barrier to legitimate corporate activity which would get bogged down in the clearance process. Whilst a possible solution to this would be to increase the Pensions Regulator's resources, this would lead to increased costs either for schemes via the General Levy or for employers if charging is introduced for clearance.

Alternatively, the existence of a mandatory clearance regime could mean that employers simply seek to avoid any kind of transaction at all where a DB scheme is involved, which could potentially lead to employers failing because they are no longer able to restructure their businesses appropriately.

c) Should the Regulator be able to impose punitive fines for corporate transactions that are detrimental to schemes? If so, in what circumstances?

No, we do not believe that a case has been made for the Pensions Regulator to be able to impose punitive fines in relation to corporate transactions. Powers already exist for the Pensions Regulator to require a sponsor to pay an amount up to the section 75 debt, i.e. the maximum extent of an employer's legal obligation to the scheme. This seems a proportionate power for the Pensions Regulator to have in the event that corporate activity has led to material detriment to the scheme. However, it is not clear what would be achieved by the threat of punitive fines, other than acting as a deterrent to <u>any</u> corporate activity where a DB pension scheme is involved. It is also not clear what would happen to such a fine since the Pensions Regulator already has the power to ensure that the scheme is fully funded to the extent of the section 75 obligation. It does not seem appropriate that the Pensions Regulator itself should be able to profit from such disproportionately large fines.

d) What safeguards could ensure that any additional powers given to the Regulator do not impact on the competitiveness of the UK business or the attractiveness of the UK market?

As noted above, we do not believe that it would be easy to provide the Pensions Regulator with new powers to intervene in corporate activity without also impacting on the competitiveness of UK business or the attractiveness of the UK market. What could be done is to ensure that the Pensions Regulator can exercise its existing powers as easily as possible, and that the process is as straightforward and streamlined as it is possible to be. To a large extent, the Pensions Regulator controls its own decision-making processes, and therefore the onus lies with it to determine whether and how to change the way in which it exercises its powers, whilst still ensuring that there are checks and balances in place to prevent completely unfettered use of its powers.

We also think it would be helpful for the Government to consider how all regulators can use their existing powers to influence good corporate governance in relation to decisions and advice affecting workplace pension provision, and to encourage closer working practices between different regulators.

e) Should the Regulator have new information gathering powers?

The Pensions Regulator already has quite significant information-gathering powers under section 72 of the Pensions Act 2004, so a clear case would need to be made that these powers are inadequate and that additional powers are needed. The Pensions Regulator has only recently started to flex its muscles in relation to its existing information-gathering powers, as witnessed by its recent successful prosecutions for failure to provide required information. These cases on their own might act as a sufficient encouragement for all parties to co-operate with the Pensions Regulator without the need for any additional powers. However, we agree that effective information-gathering is an essential part of the Pensions Regulator's role and would therefore support further measures in this area if there is clear evidence that the Pensions Regulator is currently prevented from accessing information that would be helpful in the exercise of its functions.

f) Should civil penalties be available for non-compliance?

Yes, we agree that it seems appropriate that the Pensions Regulator should be able to impose civil penalties in relation to non-compliance with both existing and any new information-gathering powers, in addition to the existing criminal sanctions under section 77 of the Pensions Act 2004. However, we would note that the absence of civil penalties has not in fact prevented the Pensions Regulator from taking strong (and very public) action against parties who failed to comply.

g) Should levy payers be asked to fund additional resources for the Regulator?

Broadly, we think that it is right that the Pensions Regulator should take a risk-based approach in order to achieve a proportionate regulatory system. Whilst for most schemes, the General Levy is a much lower expense than the Pension Protection Levy, it remains important to ensure that the costs of funding the regulatory system do not become excessive and increase the levy to the extent that more schemes are potentially put at risk of failure. Whilst it may be appropriate for the Pensions Regulator to get some small additional powers, and therefore for there to be small incremental increases to the levy, we think that broadly the balance between levy and regulation is correct.

We are also not attracted to the idea of 'hard charging' for services such as clearance. If clearance remains voluntary, then any such charge will make businesses even less likely than at present to access clearance; whilst, if it becomes mandatory in certain circumstances, an upfront charge would be viewed as an additional tax on businesses that may already be in difficult circumstances.

h) Should trustees be given extra powers such as powers to demand timely information from sponsors, to strengthen their position?

- **If so, what extra powers might be helpful?**

Legislation already includes a requirement for employers to 'disclose on request to the trustees or managers such information as is reasonably required for the performance of the duties of trustees or managers or professional advisers'[4].

In general, sponsors providing more information to their trustees should lead to a better assessment by the trustees and their advisers of the employer covenant, and therefore to more effective decision-making. We therefore think that sponsors should be encouraged to share information in a timely fashion with their trustees, as indeed the Pensions Regulator's code of practice and guidance on 'Assessing and Monitoring the Employer Covenant' already does. It should normally be in the interests of the employer to ensure that the trustees and employer have a shared perspective on the strength and future plans of the employer.

Some employers may, however, have legitimate concerns that some trustees may use any new requirement to demand information from the employers as a negotiating tactic within funding or other negotiations, or indeed for reasons outside the scope of the pension scheme altogether (for example where employees are concerned about the future viability of their employer). Whilst confidentiality agreements between the trustees and employers can be used to mitigate such risks, it is likely that some employers would still be concerned about being required to share all information with trustees.

It is also hard to see what information such a new power would cover, given that legislation already entitles trustees to ask for information that is reasonably required for the performance of their duties. In practice, whether under the existing powers or an extended version, the trustees may not know what information they are lacking, and so what to ask for, or when to ask for it. It would not be straightforward to specify a list of information to cover all circumstances; equally it would be impractical if employers were required to provide information to the trustees about anything at all that might be of interest in their assessment of the employer covenant.

One possibility might be for the Pensions Regulator to have the power to require the employer to provide information to the trustees (with suitable confidentiality agreements in place) in circumstances where the relationship between the trustees and employer has broken down, but without trustees being given an automatic right to require the employer to

[4] Regulation 6(1) of the Occupational Pension Schemes (Scheme Administration) Regulations 1996 (SI 1996/1715).

provide information in all cases. Voluntary information-sharing between trustees and employers is likely to be more effective in the majority of cases.

Even if such a power to demand information is given to trustees, it will not necessarily help in circumstances where the information that would be most helpful to the trustees concerns a non-UK sponsor or parent company, where the demand for information could be very difficult to enforce.

i) Should trustees be consulted when the employer plans to pay dividends if the scheme is underfunded – and if so, at what level of funding?

We think that the proposed power as expressed would have the potential to impact on legitimate corporate activity. However, we would be sympathetic to a regime under which employers could be required to consult where they are proposing material changes to their existing dividend policy. So, where a routine annual dividend payment is made to shareholders in the normal course of business, there would be no requirement to consult trustees. However, if the employer is proposing a much larger dividend than usual, or if the employer had not paid a dividend for a number of years and then proposes to do so, then it might be appropriate to introduce a requirement for the employer to consult the trustees or at least to provide advance warning of the payment. This could align any new requirement with the guidance produced in relation to the existing 'material detriment' test under Code of Practice 12 which indicates that routine annual dividend payments would not normally be grounds for concern.

If such a requirement is introduced, then the underfunding test could potentially be aligned with that for notifiable events, i.e. the employer is not required to consult/notify the trustees where there is a material change to dividend policy where the scheme is fully funded on a section 179 basis and payments are being made in line with the schedule of contributions.

j) Is action needed to ensure that members are aware of the value of and risks to their DB pensions?

As set out above under Question 2 a), we have some concerns that the current content of the summary funding statement does not necessarily provide members with the optimal information for understanding the risks to the DB pension.

APPENDIX 6

Security and Sustainability in Defined Benefit Pension Schemes

Question 6 – Should Government act to encourage, incentivise, or in some circumstances mandate the consolidation of smaller schemes into vehicles with greater scale and better governance in order to reduce the risk to members in future from the running down of closed, especially smaller, DB schemes?

Given that DB schemes in the private sector are almost entirely in some form of run-off, we can see the rationale for taking measures to facilitate the consolidation of smaller DB schemes. Many may be sub-optimal in terms of governance and quite possibly investment performance. Regulatory oversight for this sector of the DB landscape is also limited.

The sponsors of smaller schemes are also unlikely to want to devote the necessary time and resource to the management of what is increasingly becoming a legacy issue for them.

The issue is how to go about it which the Green Paper starts to explore.

a) Is there anything in the existing legislative or regulatory system preventing schemes from consolidating?

- **How might such barriers be overcome?**

The system has been built to regulate pension promises entered into by employers in respect of their own workforces without any recognition that it may be desirable for schemes to be consolidated many years later. The working assumption has always been that an employer will always be there to ensure that the pension promises are delivered. Therefore it is inevitable that there will be barriers to consolidation, depending on what type of consolidation is intended.

The trust model inevitably acts as a barrier to consolidation. For example, whilst it may technically be feasible for the scheme actuary to certify a proposed bulk transfer without consent to a consolidating vehicle, the trustees may well conclude, assisted by advice received from the scheme actuary, that it is not in members' interests to proceed with it. The current rules on transfers of contracted-out benefits to schemes that were not previously contracted-out also act as a barrier.

The variety of benefit designs, in part caused by changing regulatory requirements, is also a barrier. This could be overcome by implementing a variation to Section 67, essentially requiring an actuary to certify that the benefits after simplification are of no less value than immediately before simplification on a prescribed basis. Government should define a simplified model design that schemes could move to and benefits post simplification would be expressed in that format.

This would be easier for members to understand than their present complex benefit structure. It would be simpler to administer, easier to hedge benefits and ultimately less expensive to buy out.

It would then be simpler to consolidate such schemes, although this would likely be done on a segregated employer basis and so involve just harmonisation of trustee, administration and investment.

As a secondary benefit it would make introduction of the pensions dashboard easier to implement for DB schemes.

b) What other barriers are there which are preventing schemes from consolidating?

- **How might they be overcome?**

There are numerous other barriers which the Green Paper touches on. These include fragmented administration systems, different funding levels and objectives, different attitudes to investment risk, the scheme sponsor losing control and the potentially adverse consequences of risk pooling.

If you consolidate, but keep employer segregation, then different funding levels and objectives become a non-issue. It is essential that benefit simplification is part of the process, but that requires tax barriers to be excluded. If benefit simplification is achieved then administration is massively more straightforward. That then changes completely the cost/benefit analysis of consolidation.

c) Should Government define a simplified benefit model to encourage consolidation?

Yes – we believe that consolidation is most likely to happen if schemes simplify their accrued benefits. The Government will need to define a simplified model with some limited optionality in it that schemes are encouraged to convert to. Employers and trustees can then decide on a scheme by scheme basis whether to move to the simplified basis. Any members not wanting to have their benefits reshaped could have the option of transferring to a personal pension.

For those schemes that were contracted out, one clear barrier to conversion is the GMP inequality issue. Until there is a clear way forward on this, sponsors will be reluctant to address it through the GMP conversion legislation, which is likely to be necessary before a broader simplification can occur.

Other barriers include statutory restrictions on the revaluation and indexation of various benefit tranches. These would need to be dealt with by the Government simplified model.

A further barrier is the complex tax regime. This currently creates inappropriate tax outcomes for sensible reshapes or transfers; or else leads to the need to explore and use artificial structures to overcome the anomalies if possible. In either case, this results in extra cost of advice and administration. The simplification process that we put forward would need to be transparent for annual allowance and potentially lifetime allowance purposes.

d) Should rules be changed to allow the reshaping of benefits without member consent?

- **In what circumstances?**
- **Should there be prescribed restrictions to the types or limits of such reshaping?**

Yes – as outlined above. Rules already exist that constrain the reshaping of benefits – the GMP conversion legislation and Section 67 of the Pensions Act 1995. Both need to be revisited, the first as part of the GMP inequalities resolution project, on which we understand that work is continuing following the recent consultation and the second as it was not designed with wholesale conversion in mind.

e) Are costs and charges too high in DB schemes?

We are not aware of any evidence supporting the contention that costs and charges are too high in DB schemes in the context of the necessary work that is required for their effective running, including compliance with ever-changing legislation.

However, that is not to say that costs and charges might rightly be perceived as being too high in comparison with other savings products.

We note that some of that necessary work is to deal with a very complex tax regime. The burden falling on schemes to comply, and effectively to explain (given the way the regime impacts options) is extraordinary and increasing – and applies not just in relation to those currently active, but also to deferred members.

f) Should schemes be required to be more transparent about their costs or justify why they do not consolidate?

- **In what circumstances?**

As we do not support mandatory consolidation for schemes with solvent employers, we do not see the imperative for requiring greater transparency generally about scheme costs (which will mean further costs).

However, we can see a case for greater transparency when it comes to risk sharing schemes and also perhaps schemes where costs are not being explicitly met by the employer.

g) Is there a case for mandatory consolidation?

- **In what circumstances?**

Whist we support the case for mandatory consolidation following business failure (which is what happens in effect through the Pension Protection Fund) we do not believe that the case has been made for mandatory consolidation in the DB market more generally. This also seems to be the view of the Green Paper.

h) Should the Government encourage the use of consolidation vehicles, including DB master trusts?

- **If so how might it do so?**

We are happy for the Government to indirectly encourage DB consolidation vehicles to enter the market, through such measures as facilitating schemes to simplify their benefit structures. But it must first ensure that its DB regulatory regime is fit for purpose to deal with such vehicles and so not repeat its past mistake in relation to DC master trusts.

i) Are further changes needed to the employer debt regime in multi-employer schemes to encourage further consolidation?

Not necessarily. Consolidation can be achieved without a pooling of liability risk via multi-employer but segregated schemes.

j) Is there a case for consolidation as a cheaper, but more efficient form of buy-out, with the employer and trustees discharged?

- **If so, (a) what should be the requirements for a scheme to enter such a consolidator, especially the level of funding; and**
- **(b), should the residual risk be borne by the member, or by the PPF?**

We are not convinced with this superfund concept. We think it better to focus on the ring-fenced consolidation model. We also have doubts about the full consolidation model.

k) Should Government encourage creation of consolidation vehicles for stressed schemes?

No. The fact that a scheme (or rather its sponsor) is stressed, does not mean that its benefits should be consolidated with other schemes whose sponsors are also stressed (or were). Each situation will be different and each solution will be unique.

l) Should employer debt legislation for multi-employer schemes require full buy-out and for the actuary to assess liabilities for an employer debt by estimating the cost of purchasing annuities?

We see no reason to depart from this principle which has been established for many years and which is an essential element of the protections necessary to ensure that a promise made is a promise delivered.

The issue is whether this principle gives rise to anomalies and unfairnesses. We will respond separately to your deferred debt arrangement proposals published on 21 April 2017.

m) How else could historic orphan liabilities be met if they were not shared between employers?

We agree that they need to be shared between the remaining employers, but we acknowledge the unfairness that has been created in relation to the orphans of already departed employers when the employer debt measure of cessation was moved from MFR to buyout in 2005.

n) Are new measures needed to help those trustees of an association or employers who could be held individually liable for an employer debt?

Yes. We will respond separately to your deferred debt arrangement proposals published on 21 April 2017.

You also asked (in paragraph 371) whether the rules for winding up lump sums (WULS) could be widened, for example, allowing schemes to partially wind-up simply to allow them to pay WULS. You suggested that the rules for WULS should be considered alongside those for trivial commutation and transfer values to ensure policy objectives are met and the rules are not open to abuse or considered too confusing so that people are put off from considering the options.

Abuse does have to be guarded against, but a WULS is a useful mechanism to avoid disproportionate fixed costs in buying out small DB benefits and to enable trustees to make more efficient use of scheme funds. So there should not be complex barriers to this facility.

There are various easements in tax law that apply to full wind ups, but not for a partial wind-up, and this can add costs or blocks to sensible restructuring. We agree that WULS should be available to deal with small benefits within a partial wind-up exercise that is a genuine exercise to secure benefits.

We also note that the current £18,000 limit for WULS was set some time ago. Raising the WULS limit to £30,000 would create a more coherent set of tax rules (rather than having the complexity of three different limits on small benefit cash out) and recognise that the cost of securing benefits has continued to rise because of low yields.

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