Written evidence from Philip Coggan (PPF0005)

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Work and pensions committee investigation into the PPF and DB scheme regulation

KEY TAKEAWAY: The economics of pension provision are deteriorating. This is as true for the Pensions Regulator and the PPF as it is for the companies they insure. In the circumstances, regulation must be cautious, emphasising stronger pension funding now, rather than relying on longer recovery periods. But the Regulator has moved in the opposite direction. The Regulator should have powers to intervene when the funding level falls below a defined threshold, including limiting dividends and bonuses and warning workers so they can transfer assets. We should not end up in a position where a company can fall into the PPF with £435m of assets and a £571m deficit.

The current system of pensions regulation was set up to protect workers in defined benefit pension schemes from the danger that their employer might go bust, or in some way walk away from their pensions commitment. In my view, before considering the detailed regulation of the scheme, the Committee needs to understand the fundamental factors that are driving the problem.

First, there is a timing mismatch. Take on a worker today and the employer might be paying them a pension in 70 years’ time. But very few companies will survive for that period without being split up, taken over or going bust. The original FT index of leading companies, set up in 1935, included Bolsover Colliery, Callenders Cables, Fine Spinners and Doublers, International Tea company, Murex, Patons and Baldwins, Pinchin Johnson and United Steel – all long gone.

Second, the pension scheme system designed to deal with that mismatch has a conflict of interest at heart. Trustees must safeguard the interest of their members, which fall into three categories - current workers, deferred members (those who used to be employed and will be paid a pension in future) and retirees. But those trustees tend to be drawn largely from the company staff (even when they are outsiders, they will be paid by the employer).

Trustees must balance the interests of the company (which will want to limit current contributions) with the interests of deferred members and retirees (which will want to ensure the trust is fully funded at all times). Current workers have a divided loyalty. If the pension fund’s demands are too high, that may be a risk to their jobs or to pay increases (it seems likely that workers value current pay much more highly than future pay, in the form of pensions). Indeed, many workforces are divided between long-term workers (still on defined benefit, or final salary promises) and newer workers (in defined contribution, or DC schemes). When it comes to pension scheme funding, there is a conflict of interest between the former and the latter.

Third, the cost of funding a pension has risen dramatically – thanks to improved longevity, disappointing investment returns and falling interest rates. Some might say
that those low interest rates should be ignored because they are temporary, or simply a
function of accounting. But the Bank of England’s official rate has been at 0.25% for
seven years, far longer than anyone would have envisaged in 2009. The Bank of Japan
has had 15 years of low official rates and bond yields without any sign of a change.
And this is NOT just a matter of accounting. The cost of pensions has objectively
risen – as will be discovered by any company wants to offload its pension scheme via
the buyout markets.

Regulation

All these problems dog both the Pensions Regulator and the PPF. They too must
balance conflicting interests. They need to protect workers, whose benefits will be
reduced if they end up in the arms of the PPF. They must protect responsible
employers against “free riders” – those companies that contribute the minimum
pension funding they can get away with, in the knowledge that the PPF will pick up
the slack (the moral hazard problem). And they must balance the desire to safeguard
the future of the PPF (higher levies and stricter funding requirements for member
schemes) against the danger that higher upfront costs will damage the financial health
of the companies covered by the scheme.

In addition, the economic fundamentals are working against the Regulator and the
PPF. It is not just that, as already noted, the cost of pension provision has risen. It is
that the corporate sector has been shifting away from DB provision to DC schemes.

That change is important because of the timing mismatch. The mismatch means that
all pension provision is a form of pyramid scheme. State schemes are run on a pay-as-
you-go basis; benefits for today’s retirees are paid by current workers. This is still true
if the scheme is funded, as with corporate pensions. The scheme may buy equities,
property and government bonds. But equities are a claim on the profits generated by
future workers, property a claim on the rent paid by such workers, government bonds
a claim on future taxes. Without future workers, pensions cannot be paid.

The PPF is funded by levies on companies offering DB schemes. Some of these
schemes will be run by employers whose business model is struggling (BHS and Tata
Steel being two examples). Slowly and surely, they are dropping out of the PPF,
leaving their liabilities behind them. That would be OK, if new companies were
joining the scheme to provide future funding. But new companies don’t set up DB
plans.

In other words, the PPF is a pyramid scheme with a dwindling number of
members.

As far as this writer can see, the PPF is well-run. Still given the deteriorating
economics of pensions, the Regulator should act cautiously to safeguard the long-term
interests of the fund. The PPF has a surplus of £3.6 billion but it is worth noting the
combined deficit of the schemes it covers was £302 billion at the end of March.
Obviously all those companies will not go bust overnight. But the deficit is up from
£70 billion two years ago.
Getting companies to reduce their deficit now is not just prudent for the PPF. It is “fair” to prudent companies that have managed their pensions liabilities well (and who risk paying higher levies to bail out the imprudent) and to employees. But in 2013, the Regulator headed in the other direction, allowing more flexibility for companies to reduce their deficit.

It would appear that this “flexibility” may explain why BHS was part-way through a 23-year recovery plan. (I write “appear” because the Regulator’s decisions are not transparent; something I urge the committee to consider redressing.) BHS went into administration only 10% of the way through this plan. In retrospect, the recovery plan looks absurdly optimistic. The cash payments it was making to close the deficit were not covering the cash outlays to pensioners.

This is where “flexibility” contains its own paradox. The weaker the company, the more likely it is to need flexibility in closing its deficit. But the weaker the company, the more likely it is to go bust before the end of an extended recovery plan.

The Regulator has to choose one or the other; allow more flexibility (in the hope that the company will survive) or demand more funding (to protect the PPF). As argued above, it has veered too far in the former direction.

A further problem is that the actuarial deficit calculated when a company is a going concern is a lot smaller than the crystallised deficit when the scheme goes into the PPF (because different discount rates are used). The stated BHS deficit in 2014 was just £208m and on that basis the scheme was 65% funded. In PPF terms, however, it was less than half-funded. So when the PPF gets the bill, it is usually a big one.

Of course, the Regulator has the powers to pursue past business owners to make up the shortfall. But there is no guarantee that such owners will have big enough pockets. Early intervention by the Regulator is thus needed; if a scheme falls below, say, 80% funding (on an actuarial basis).

And that intervention should be public, with the Regulator empowered to stop the payment of dividends or executive bonuses. Employees should also be notified so they can transfer their assets into DC schemes and avoid the potential cuts that might occur under the PPF. BHS employees might have saved money if they had been aware of the dire nature of the scheme’s finances. The committee should consider whether future employees of other failing companies could be saved from the same fate.

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