Written evidence from Dr Steve Priddy (PPF0035)

Defined benefit pensions examined following BHS inquiry

“It should not be forgotten that these liabilities are promises of deferred pay to employees.”

Work and Pensions Committee, August 2016

1. Introduction

1.1 My name is Steve Priddy. I am 64 years old. My current job title is Academic Dean Grenoble Graduate School of Business London Programmes/Dean GISMA Business School Hannover. I am a chartered accountant and hold a PhD in Politics & Economics from Birkbeck College London. I worked for over 20 years at the consulting engineer Arup where, amongst other roles, I was accountant for the Arup Group Limited’s defined benefit pension scheme for a decade, as well as serving as an employer nominated pension fund trustee for three years, specialising in risk management and in evaluation of the employer’s covenant towards the scheme.

I write in a personal capacity.

1.2 In summary my argument is that there are fundamental faults in the regulation of defined benefit occupational pension provision in the UK, from a variety of stakeholder perspectives – pensioners, deferred pensioners, the role of trustees, sponsoring employers, accounting standard setters, politicians, regulators and others. These faults have been allowed to continue in part by a massive lack of evidence about the universe of post retirement and its provision, thereby allowing prejudice and ideology as well as regulatory arbitrage and rent seeking, to flourish on an industrial scale. While the current investigation by the Work and Pensions Committee is to be welcomed, the inquiry needs, in my view, to be deliberately patient and holistic in its approach. The time of post retirement provision is longer now than it has ever been and hasty ill informed decisions taken now will magnify the existing ‘wicked questions’ that have evolved over the decades since Robert Maxwell’s demise, as well as generating new ones that may be even more destructive to the laudable aim of providing a decent retirement to all UK citizens – an aim which must include a reasonable financial income through to the end of life.

1.3 In my opinion the appalling activities of those involved with the demise of BHS and its pension scheme should be addressed as a completely separate issue to the wider public interest and desire for a reasonable retirement provision. The Committee and its Chair have clearly exposed the unacceptable face of Sir Phillip Green’s approach to capitalism. A separate task should now be to get him to make good on his promise to ‘sort’ the BHS pension issue. At the very least this should entail the opening of an escrow bank account jointly controlled by Sir Phillip and the Committee, and the early deposit of a round sum of money – I would suggest £100 million – by him to demonstrate the tangibility of his commitment. As will become clear in the research streams I am proposing, the final amount due from Sir Phillip is not at all clear, and its calculation is extremely complex, but these
circumstances should not stop this first step. It is very likely anyway that the sorting of the BHS pension issue will take some years to resolve equitably.

What follows are several research directions underpinned in one example by research objectives and each with a rationale. In sum these point to an appreciation of the weight of the ‘known unknowns’ facing the regulator and other affected stakeholders in the world of defined benefit pension provision in the UK.

2. The urgent need for research into various aspects of occupational pension scheme provision in the UK – a proposal

2.1 Research Question 1 To what extent is the defined benefit/defined contribution classification helpful or an obstacle to innovation in occupational pension scheme provision in the UK?

Research objectives

2.1.1 To critically review the literature tracing the genesis of the binary DB, DC distinction;
2.1.2 To identify sources of innovation in occupational scheme design and the extent to which these have been taken up across the UK;
2.1.3 To consider international examples of best practice in occupational scheme design and the extent to which the DB-DC distinction has proved helpful or otherwise in their materialisation;
2.1.4 To critically evaluate the perceptions of involved stakeholders in occupational scheme as to how the DB-DC has enabled or disabled thinking about future scheme provision;
2.1.5 To propose ways to improve the classification of the pension scheme beyond the DB-DC distinction

Rationale

The vast majority of those planning for or living in retirement expect or receive their income from a variety of sources. In the sense that 30 years of my working life has been with 3 principal employers I am a rarity. Yet even in that rare sense I can expect post retirement income from at least five sources. And the degree to which these sources can be pigeon holed into DB or DC does not seem particularly helpful from the perspective of the beneficiary. For a short time in the long world of pensions there was the promise of innovation through ‘hybrid’ schemes such as career averaging or reclassifying benefits. However it seems that DB/DC as a binary opposition has forced the hand of most sponsoring employers who have for a variety of reasons seen fit to close apparent DB schemes to future accrual, often replacing them with far inferior provision. This research question would probe the extent to which this has been the case across the UK’s corporate sector of over 3 million businesses.
2.2 Research Question 2 To what extent is the provision of occupational pension provision in the UK public and private sectors proving to be an engine for reducing inequality across UK households as a whole?

Rationale

One of the most startling facts to emerge from the Office of National Statistics is the narrowing of median household income between those in work and those in retirement. From a figure of over 30% a decade ago this is now below 10%. From one perspective this could be seen as a source of congratulation in terms of reducing pensioner household inequality as compared to households living on employment income. A conjecture might be that this narrowing is being driven by defined benefit promises crystallising for a generation living and working through the latter part of the last century. This research proposal would seek to test that conjecture. It might lead on to a debate about whether a gap should exist between households of adults and dependents and those in post retirement - and the sustainable size of such a gap.

2.3 Research Question 3 To what extent is the above provision an engine for increasing inequality across UK generations?

Rationale

A more popular notion in the UK today is that pension provision, and particularly so called DB provision is leading to an unprecedented inter generational transfer of wealth between young and old households across the country. To some commentators this is leading to the idea that for the first time in living memory – say the half century to 2016 – younger generations are not as well off as their parents’. This is a strong assertion which needs an evidence base. Related questions might be, how long has this reversal of fortunes been in place, what is the trend, and of course for regulators and policy makers, does it require attention? The research would need to pay attention to factors such as the possible pervasive impact of the global financial crisis and the attendant unorthodox fiscal responses from the Bank of England, as well as the growing anxiety about continuing poor productivity in the UK.

2.4 Research Question 4 To what extent are pension scheme ‘buy out’ providers regulated in their public pronouncements on the cost of transferring deficits from the corporate sponsor to the buy out provider?

Rationale

When I was an employer nominated fund trustee, from 2004 to 2007, a repeated message from our actuarial advisors was that the measurement of the surplus or deficit of a scheme was no simple thing and that there was no commonly accepted methodology or calculation. Indeed I can remember being told, half in jest, half seriously, that we would only know whether the scheme was adequately funded when the last pensioner had died. And without stretching comparisons too greatly one might point to London’s livery companies as
pension schemes whose surpluses far outlived their pensioners’ needs and now seek worthy causes to promote their aims in order to disburse these historic surpluses.

During my three year period of trustee-ship two figures were repeatedly held up to quantify the value of the deficit. The first of these was the accounting standard setters’ as prescribed in FRS 17 and later IAS 19. This figure effectively assumed the scheme to be a going concern in the sense that the employer sponsor was both willing and able to support the scheme for the foreseeable future. A far more pessimistic assessment, either reducing a surplus or magnifying a deficit, was based on the shadowy world of the ‘buy out’. Our advisors typically asked us to ignore this figure since it assumed a ‘fire sale’ of the scheme – the sponsor is effectively forced to pass the scheme on to a provider who in calculating how much the transfer would be, managed longevity risk, put relative insurance policies in place and of course sought a fair return in terms of a profit on the transaction.

What appears to have happened since my trustee term is a proliferation of headline grabbing items which in the absence of any regulation and control may be made with impunity by anyone who wishes. Thus, for example, a recent discussion of the Tata Steel scheme on Radio 4’s “Today” programme referred to a current deficit of £1.5 billion, however the ‘true’ figure taking into account a buyer of the Tata Steel pension assets and liabilities represented a figure nearer £5.0 billion.

The clear danger here is twofold. Firstly such magnified figures serve to instil fear into pension fund trustees, deferred and pensioners in payment, and corporate sponsors. Secondly they allow rent seeking by the buy out provider who may put these figures into the public domain without any fear of being held accountable for them.

This research stream seeks to address this apparent lack of transparency and accountability.

2.5 Research Question 5 To what extent are buy out advisors regulated in their individual valuations of specific defined benefit assets?

Rationale

The combination of the former Chancellor’s ‘liberation’ of pension sums, a lifetime limit on the size of these sums before they are taxed, and uncertainty about future intentions of the UK tax authorities have led to increasing focus on what a DB promise is actually worth. While the current consensus is a figure representing 20 times the annual pension promised under a DB arrangement this appears to be challenged by a range of players in the financial services sector. The multiple of 20 is presumably related in some way to actuarial tables assuming a retirement at 65 with a likelihood of 20 years before death in the mid to late 80’s of a human life. However anecdotal evidence points to individual buy out providers placing far higher values on these sums. For example, a recent Weekend Financial Times edition carried a full page advertisement directed at those with DB promises talking to multiples as high as 35 times the annual pension. A charitable view on quotes such as these might be buy out providers’ superior insights into human mortality figures. A more cynical view might be that buy out providers are seeking to seize such sums on the basis that a DB
promise is transformed into a significant asset that can be invested to achieve superior returns over the medium and long term.

This research stream would seek to critically evaluate the regulation of buy out providers in their individual dealings with pensioners and particularly deferred pensioners, both in terms of regulatory design, but also in its effective implementation.

2.6 Research Question 6 How often, and when do pension fund trustees consult with the deferred pensioner class on proposed major changes to the schemes of which this class is a major beneficiary?

Rationale

The DB pension fund trustee has an unenviable and complex task. She is usually unpaid, usually time poor, and lacks little regulatory backing and support. Yet her central role is to ensure the highest quality of stewardship of the scheme assets while taking into account the three major beneficiaries of the scheme, namely currently contributing members, deferred pensioners (those who have previously contributed but are now working for another employer), and the current pensioner community. She has to balance the competing needs of these three classes while being acutely aware of the sponsoring employer and their ongoing willingness and ability to support the scheme. It goes without saying that the assets of many pension schemes dwarf those of the net current assets of the sponsoring employer.

In the current limited UK regulatory regime the deferred pensioner class is particularly vulnerable to erosion of their pension promise. Currently there is no requirement for deferred pension representation on the trustee board, and indeed many corporate sponsors strongly resist such representation on the grounds of commercial confidentiality. In ‘ordinary’ times this lack of oversight may (just) be justified, but when the corporate sponsor is thrown into major transactional anxiety, for example take over, merger, acquisition, restructuring, this can never be the case.

This research therefore seeks to discover the extent to which lack of representation is a cause of concern for the deferred pensioner class, and where examples of best practise exist to address this lack of representation and to mitigate the risks that such a lack might represent.

2.7 Research Question 7 How effective are Scheme actuaries in engaging with a) corporate sponsors of schemes, b) fund trustees, on the relative health of their specific scheme?

Rationale

Thinking on the health of an occupational pension scheme is still in its infancy. We know that a reasonable time span to think through pension issues is 40 to 50 years. This puts decision making about such schemes and their future on a par with the great infrastructure projects of the UK from a new generation of hospitals through offshore wind generation and investment in Trident. And, as with these examples considerable professional specialisation
and expertise is needed, and considerable imbalances of information exist between relevant stakeholders. My experience is that actuaries and the actuarial profession have had to go through a steep learning curve in issues such as communicating complex ideas to non-specialists, resolving conflicts of interest between corporate sponsor and board of trustee, never minding the really complex issues associated with human mortality rates, inequalities impacting on those rates, and the ever hungry rent seekers associated with financial services trying to penetrate the veil of the scheme.

This research stream would explore the degree to which actuaries are discharging their professional and ethical responsibilities, and how things might be improved.

*September 2016*