Written evidence from the Association of Consulting Actuaries (PPF0039)

This paper sets out some thoughts from the Association of Consulting Actuaries (ACA) to assist the Work and Pensions Select Committee in its deliberations following its request for written submissions dated 8 August 2016.

We respond to each question in turn.

In summary we think that you should:

• Consider the role of all regulators that could possibly have authority over actions that might affect pension scheme outcomes, and how they could use their powers to influence good governance in relation to decisions and advice affecting workplace pension provision.

• Review the regulations that apply to how different types of companies operate, to ensure they meet the objectives of good corporate governance, recognising this could be interpreted differently for different corporate structures.

• Encourage closer working practices between different regulators, in particular those that can directly influence corporate actions that could affect pension scheme outcomes, to ensure that appropriate regard is given to the security of scheme members.

On matters relating just to the regulation of pension schemes, we have suggested that, 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 defined contribution schemes. This would aid inter-generational fairness.

We also suggest that to introduce a mechanism whereby DB schemes could convert their benefits to a uniform scale would potentially simplify and improve the quality of administration, make it easier and more cost-effective for schemes to buy out their benefits, and facilitate consolidation of smaller DB schemes as well.

We hope that you will find our submission of assistance and would be happy to discuss further if that is helpful.

1. Defined benefit (DB) pensions regulation by the Pensions Regulator (TPR)

1.1. The adequacy of regulatory powers, including anti-avoidance provisions

The Pensions Act 2004, which established TPR, gives it certain functions. These are largely to do with how schemes are operated, to ensure effective and compliant decision making on the part of trustees, and to protect schemes from any actions by employers intended to adversely affect member security. In carrying out its functions, TPR must have regard to the security of members’ benefits and act to reduce the risk of calls on the PPF and to improve the understanding of good administration. When it carries out its functions in relation to the funding of DB schemes, TPR must also have regard to the sustainability of the sponsoring employer.
However, TPR’s ability to direct trustee decisions where there has not been a proven failing is limited. For example, to use its powers to direct scheme funding outcomes, TPR has to wait for the valuation to be completed (or the deadline for delivery to be passed without completion); it then has to establish that the outcome was flawed in some way, according to expert advice, and only then can it make directions. This is a lengthy and expensive process for all involved, and is little used: perhaps if TPR had easier access to its powers, it would have more influence over outcomes.

TPR also has little power to regulate the companies that sponsor pension schemes, apart from being able to intervene retrospectively when company behaviour is deliberately intended to harm the security of pension scheme members. By contrast, other regulators do have powers in this regard. For example, the FRC sets standards of corporate governance and can influence incentive structures in ways that should reduce the risk that senior company employees are motivated to act against the interests of the scheme. Although the extent of these powers differs according to a company’s status (for example, more control is possible over a listed plc than over a private equity company), our view is that more attention should be being paid in that direction, rather than expecting a single issue regulator like TPR to be able to proactively control employers’ responsibilities towards their pension schemes.

It is also worth considering the credentials of the individuals with senior roles in companies and the organisations and individuals from whom they take advice. Often, the individuals are members of professional bodies, which should have codes of conduct that can be used to discourage poor behaviour. Many of the advisory organisations companies use when considering, for example, corporate restructuring, are regulated by the FCA, the FRC or the PRA (banks and accounting firms, for example), which should also be able to foster cultures within those firms that recognise how a client’s immediate interests can affect a wide range of other parties, thereby enhancing the quality of the advice being given (noting that advice given does not need to be followed). In particular, trustees of pension schemes are required to have sufficient “knowledge and understanding” of their scheme and the environment in which it operates, to run it effectively. It would seem appropriate that, collectively, the senior leadership of firms with material pension scheme liabilities should have sufficient awareness of the risks the scheme poses to be able to take appropriate actions in relation to either sales or purchases so that the interests of pension scheme members are not ignored.

Steps are being taken in this direction. For example:

- From 2013, the Takeover Code has required publicly listed companies to inform trustees of any scheme they sponsor if they have become the target of an offer. Although this has limited scope, this seems an appropriate “home” for company related control.

- From 2015, international accounting standards have required published accounts to detail the material risks the company is exposed to, including pensions risks, and the actions the company is taking to mitigate those risks.

These actions have limited scope: in particular, whilst the target of a takeover (in scope of the code) must make limited disclosures to trustees, it is not required to help the purchaser understand its pension scheme liabilities. In that case the onus could sit with the purchaser’s advisers, many of whom will be professionally regulated, and should in any case be expected to provide appropriate advice: to the extent that information is not available to
advisers, in which case they cannot form a considered opinion, they could be expected to observe the risks associated with the absence of information. The limitation here is that, in the end, clients take decisions and they can choose to ignore their advisers’ advice. It seems likely that the entities already responsible for regulating those acting in these situations are better positioned than TPR to influence any required changes of behaviour in the corporate sphere.

Ultimately, though, it is impossible (and would probably be undesirable) for all schemes to be funded at all times to the degree that, were the employer to fail, it would be possible for all the benefits to be secured with an insurance company, and it is also impossible (and would probably be undesirable) to remove the risk of corporate failure altogether.

1.2. The application of those powers, including in specific cases other than BHS

Regulators are limited by the resources available to them, as well as by their powers. It is possible that TPR does not always direct its powers at the right targets, but it is unlikely to be unique in this regard since it is difficult to identify the right targets without the benefit of hindsight.

TPR’s conflicting objectives (see below) are likely to be unhelpful in this regard. There could be some advantage in reviewing how TPR allocates regulatory resource, but also in considering whether the requirements it has to satisfy before it can use its powers are too limiting.

1.3. The level and prioritisation of resources

We interpret this question as though it were referring to prioritising TPR’s resources.

TPR’s costs are met by levies paid by its regulated community, which largely consists of trustees and employers trying to do the right thing. The levy paid is calculated as an amount per scheme member, with the amount per member being lower for larger schemes: the amount paid does not necessarily reflect the risk the scheme poses to TPR. A balance has to be struck between the resources available to TPR and the cost to levy payers. TPR also has to balance the interests of the different communities it regulates, in particular those providing money purchase schemes (which includes trust based schemes and those operated by firms regulated by the FCA and PRA) as well as those providing DB schemes.

However, TPR’s actions often have resource implications on trustees and, in our view, these are not always proportionate. In particular, TPR collects a lot of information from trustees on an annual basis: better targeted requests for information would likely help both trustees and TPR to operate more efficiently.

On the other hand, TPR has limited powers to collect information from employers. Instead, it might be more appropriate to seek greater clarity about the purpose and effectiveness of existing company regulation, which might result in changes, for example in relation to information shared with parties involved in company takeovers or mergers, including in relation to pension risks. If this were combined with better co-ordination between existing regulators, it could help TPR to prioritise its existing resources better, without the need for yet another regulatory regime.
1.4. **Whether a greater emphasis on supervision and pro-active regulation would be appropriate**

It is not clear what is meant by “supervision” and “pro-active regulation”. TPR has no explicit function enabling it to intervene on its own initiative in how trustees carry out their functions. For example, it cannot direct trustees to take a particular path, unless it can demonstrate independently that the path they have chosen is contrary to their statutory duties; it has no powers to intervene in company decisions and can only react after the event if it can demonstrate that the decisions were taken with intent to harm the scheme.

Its supervisory or “pro-active” powers are therefore limited to providing guidance and education: TPR can only act within its powers and therefore should not seek to intervene in a scheme’s operation, unless the statutory tests for it doing so are met.

It is possible that the Select Committee is considering whether TPR’s statutory powers should be changed to give it the authority to be more pro-active. Our view is that:

- The situations where TPR would be able to access any pro-active powers would need to be carefully drawn up, to be confident that the powers are used to reduce the risks faced by pension scheme members without imposing excessive additional costs on trustees and employers. For example, although it is possible to establish criteria that identify a company as having a weak covenant, many companies so categorised will continue to operate long enough, in one form or another, for most members to receive all their pension benefits. That is, it is not possible to identify reliably those companies that will fail sufficiently in advance to make a difference, so giving TPR extra powers might not reduce the risk of such failure.

- Our understanding is that TPR’s “pro-active” interventions in scheme funding, for example, have not always been well targeted and have sometimes resulted in poorer outcomes being reached following a less than satisfactory process. TPR is not a scheme or employer adviser: its objectives in any case are internally inconsistent, and also conflict with those of the employer and the trustees.

Consequently, if TPR were to be more interventionist, in our view this would not guarantee better outcomes.

1.5. **Whether specific additional measures for private companies or companies with complex and multi-national group structures are required**

TPR does not regulate companies, and companies have to balance the actions they take in relation to their DB pension schemes with their other responsibilities, for example, towards any other creditors they might have and towards their employees, who might only have access to money purchase pension provision. If company law permits complex corporate structures, or non-disclosure of important financial information, then that does not seem a matter for TPR to address. The fact that it makes it more difficult for DB trustees to assess the value of the “covenant” available to them will be reflected in the discussions they have with the employer about how the scheme should be financed, and TPR can already intervene if it feels these discussions have not led to appropriate outcomes. Apart from that, corporate responsibility for balancing the security of company pension schemes with their other priorities seems a matter for other regulators, such as the FRC or PRA, with responsibility for good corporate management and governance.
1.6. The pre-clearance system, including whether it is adequate for particular transactions including the disposal of companies with DB schemes

Clearance is a voluntary process operated by TPR, to give companies with DB schemes that are involved in corporate restructuring comfort that their actions will not be found wanting at some point in the future. Sometimes companies have to pay a “fee” (that is, provide additional security to the scheme) for the privilege.

Companies often choose not seek clearance because they feel the “fee” can be penal and there is no statutory basis for the protection it provides. As a result, very few companies now seek clearance; so the voluntary clearance process is effectively redundant. Initially, the concept of clearance was welcomed, as it was perceived as helpful to companies to understand how their actions might be viewed: if TPR treated it in this way – helping companies navigate their sometimes conflicting priorities – rather than as a process for increasing member security, we expect it would be more used.

Statutory protection for the scheme is achieved via the Occupational Pension Schemes (Employer Debt) Regulations 2005, which apply (broadly) when events occur that could sever the relationship an “employer in relation to the scheme” has with the scheme. These will not impact on transactions or other events affecting employers that are not directly associated with the scheme, even if they are part of the same group. Our view is that this is correct, since there is no reason why those employers should have any responsibility toward the scheme, unless they have deliberately chosen to do so, for example, by providing a guarantee of some sort. In that case, ideally, the legal document that establishes the guarantee should provide adequate protection.

1.7. Powers relating to scheme recovery plans

It would be more appropriate to consider TPR’s powers in relation to all aspects of the statutory funding regime, rather than only recovery plans. This is because, if the trustees fail to carry out their responsibilities in relation to any part of the regime, TPR has powers to intervene in all its aspects. This is significant since just the failure to reach a conclusion (that is, a valuation not being completed with the statutory timetable) would enable TPR to intervene – this means that, if trustees cannot agree one aspect of the valuation process with the employer then, in theory, the door is left open for TPR to impose a particular valuation outcome.

However, in practice, TPR has not used these powers, which potentially undermines their usefulness as a deterrent.

1.8. The impact of the TPR’s regulatory approach on commercial decision-making and the operation of employers

TPR has no authority to intervene directly in how employers operate their companies, but (as discussed above) there are by-products of its role in relation to the scheme that can affect companies’ decision making. In particular:

- By using pre-clearance, it can influence the cost of particular transactions or other corporate decisions that potentially affect the scheme’s security;
o If companies fail to reach agreement with trustees over valuation outcomes, it can impose an outcome, including a recovery plan, that could impinge on other company decisions;

o If companies take actions with the intention of undermining the security of the pension scheme, TPR can use its “moral hazard” powers to impose financial and other penalties, including providing additional resource to the scheme.

TPR has seldom used those of its powers that would directly impact company decisions, which has perhaps led many to view that its powers are illusory (for example, because the hurdles to cross before they can be used are too onerous). It is possible that the threat of using them has always proved sufficient, but that is not obvious to many in the industry. TPR has to produce reports about when it does use its powers; some clarification around situations where it chooses not to might also be helpful.

1. The Pension Protection Fund (PPF), including the sustainability of the Pension Protection Fund and the fairness of the PPF levy system and its impact on businesses and scheme members

The PPF is the insurer of last resort. One of TPR’s objectives is to reduce claims against the PPF. Since one way of achieving this is to ensure that schemes are strongly funded, this conflicts with TPR’s other objectives, particularly in relation to minimising any adverse impact on employers’ sustainable growth. We expect also that it skews TPR’s view of its risk profile, and therefore the way it prioritises its regulatory spend, since its duty to the PPF encourages it to concentrate resources on larger schemes, which would be harder for the PPF to absorb than individual small schemes.

Currently, the PPF seems to be strongly funded and legislation permits it to reduce levels of compensation in certain circumstances. It is funded by a risk based levy, and by the assets of the schemes where it pays compensation to members. The levy for schemes with large deficits (using the PPF calculation) and weak employers can be large and employers and scheme members need to understand what value it provides. In particular, although our understanding is that the PPF is unlikely to reduce compensation, legislation does permit it to do so and it would seem reasonable for it to be clear about its policy in this regard. We expect this would contribute to its sustainability in the event that it did have to cut benefits: a contributing factor to the downfall of DB provision was that members had an expectation that DB pensions were “guaranteed” when they were not, and legislators felt that the “guarantee” had to be strengthened.

We also have concerns about inequities in the compensation paid by the PPF, with some members (eg those with temporary bridging pensions) getting windfall gains compared to their scheme benefits while others see benefit cuts. This has been defended by the PPF because of rules relating to how compensation is calculated and because of its desire for compensation to be simple. We believe that it is time to review this position, since it was clear from the consultation on British Steel that the PPF’s approach could lead to unintended consequences.

However, the general direction seems to be to increase levels of PPF compensation, in particular to make the “cap”, which is applied to the compensation paid to members of DB schemes that fall into the PPF when the member is aged less than the scheme’s normal pension age, service related. The cap is currently around £37,420 for someone retiring at 65 (before allowing for the 10% discount applied to the same group).
Few people are affected by the cap: in a “typical” private sector scheme with 1/60ths accrual, only people with complete or close to complete working histories in the scheme (i.e. 40 years) and earnings in (or just below) the upper decile of the earnings distribution are likely to be affected. We have no strong view on whether that results in a fair balance; we do consider that it is fair to apply a cap.

2. The role and powers of pension scheme trustees

TPR is currently considering how effectively trustees carry out their responsibilities. In our experience, many trustee bodies are extremely effective, but in some cases they are less so. However, in the first decade of this century, legislation gave more responsibility to trustees by transferring to them some decisions that were previously made by their advisers. Our view is that this was correct, since it is the trustees who are ultimately in control, but in doing so the role was considerably altered.

Trustee advisers now take pains to understand the needs of their clients and seek to be “trusted” by them, with the expectation that trustees can accept and act on the advice given. Provided trustees are able to, and do, appropriately question their advisers, and understand and accept the reasons for the actions they take as a result, this seems sufficient. Since trustees cannot be experts in all aspects of the running of their scheme, for the relationship to remain functional, advisers need to act professionally, in their client’s interests and with awareness of the wider consequences of their activities. As mentioned above, many advisers are members of professional bodies or otherwise regulated. Again, it seems to us that there are adequate controls in place to ensure the system works well – it just requires everyone to properly understand and act on the responsibilities their regulatory framework provides for.

3. Relationships between TPR, PPF, trustees and sponsoring employers

The balance between meeting pension obligations and ensuring the ongoing viability of sponsoring employers, including:

4.1. TPR’s objective to "minimise any adverse impact on the sustainable growth of an employer"

This objective only applies to how TPR carries out its functions in relation to the statutory funding regime. Our view is that TPR has addressed this in a reasonably balanced way. For example, it says that trustees can, when carrying out funding negotiations with employers, take account of the employer’s plans to invest in its future growth but that, to the extent this results in a weaker approach, trustees should seek agreement to share in any positive outcomes expected as a result of the investment.

Since, to a large degree, the security of most pension schemes rests on the continuing security of the sponsoring employer this seems a good balance to strike.

4.2. Whether the current framework is generating inter-generationally fair outcomes

The pension regime it itself does not result in inter-generationally fair outcomes. It is because of the risks and costs of financing DB schemes that younger generations of employees only have access to money purchase provision.

The contributions employers pay to money purchase schemes are materially less than they would need to pay for ongoing accrual in their DB scheme (and, in many cases considerably lower than even the contributions they would have expected to pay when the DB scheme
was first established), and considerably less than some employers have to pay to address funding shortfalls. It seems likely that the cash calls required by schemes in deficit (or the risk of such calls) constrain the level of contribution employers make to the money purchase schemes offered to new entrants, and also are likely to depress salaries and other forms of remuneration.

In our view, providing a statutory override to scheme rules that would enable trustees and employers with schemes that link increases and revaluation to the RPI to move to the statutory rates (currently linked to CPI) would help address this unfairness. Indeed, by freeing up company resources, this could result in better outcomes for money purchase members. We do not make this suggestion lightly, but it is unlikely that scheme rules were ever intended to tie trustees to an index the National Statistician has described as flawed. It is also worth noting that compulsory indexation of pensions was introduced by the Pensions Act 1995 – many schemes provided increases on a discretionary basis prior to then – and so, we suggest that it would be appropriate for the Government to legislate to help address an issue that is largely due to the impact of previous legislation.

The current regime means that current employees with no access to DB schemes (nearly all younger employees in the private sector) take all of the risk of pension provision, and on average will receive considerably lower pensions than previous generations of employees. In addition, the tax system makes it difficult for them to contribute sufficiently to match the benefits DB schemes provided, particularly where they succeed in their careers, or they have career breaks.

That said, the majority of DB schemes have or will soon close to future accrual. As companies have endeavoured both to keep up with changing pensions and tax legislation and to make their DB scheme affordable, many schemes have complex benefit structures with different accrual rates, retirement ages and pensions increases applying to different periods of service. This leads to more expensive administration (which are more prone to error) and more confusion amongst members. Complex benefit scales are also unattractive to insurers.

It would therefore be helpful for the Government to introduce a facility whereby schemes could convert historic benefit scales to a single simplified benefit structure – on the basis of fair value. Once schemes had converted in this way, it would be open for smaller schemes to merge with each other. Such consolidation would also lead to greater efficiency and cost savings.

4.3. Whether the current wider environment, including very low interest rates, warrants an exceptional approach

Unfortunately, it is not possible to tell if the current environment is exceptional, and so difficult to say whether it warrants an exceptional approach. However, we assume that the question is asked in the context of creating a regime that would result in lower contributions to pension schemes than, perhaps, might emerge from valuations that comply with the current legislation.

Our view is that the purpose of a valuation is to impose some controls over the future expected cost of providing the scheme. The statutory funding regime achieves exactly that. If a non-market related approach were introduced, the results might be different, but it also seems likely that they would have no context, be virtually meaningless (for example, they
would not give appropriate signals to inform investment strategy), and inevitably short lived. In particular, if the current environment turns out not to be exceptional, the difficulties it creates will be exacerbated and transferred on to subsequent generations.

The overall cost of pension provision is not really changed by the method chosen: instead, different approaches just share the cost differently, for example, passing it to future generations of employee or to the PPF. In practice, costs (and therefore the risk of the entity responsible for provision) can only be reduced by reducing benefits.

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