Dear Sir/Madam

*Defined benefit pensions examined following BHS inquiry*

I am writing on behalf of Lane Clark & Peacock LLP in response to the above named inquiry for which submissions were requested on 8 August 2016.

Lane Clark & Peacock LLP ("LCP") is a firm of financial, actuarial and business consultants, specialising in the areas of pensions, investment, insurance and business analytics. LCP is regulated by the Institute and Faculty of Actuaries in respect of a range of investment business activities. LCP has offices in London and Winchester in the UK. In Europe, the LCP group includes offices in Ireland and the Netherlands.

LCP welcomes the Committee’s decision to raise these important issues separately from the results of its joint inquiry into BHS.

1. **Introductory comments**

   UK businesses have historically made significant DB promises to employees, and many individuals are relying on these promises for their retirement security.

   As has been widely discussed over many years, significant improvements in life expectancy, lower future expected investment returns (particularly on government bonds) and multiple enhancements to member benefits required by legislation (e.g., index-linking) have made these promises much more expensive than originally expected by UK businesses.

   A significant minority of businesses are now expected to not be able to afford these promises and will fail to fund them, often going bust in the process with a resultant loss in jobs and inefficiencies for the UK economy. Many other businesses will manage to fund their promises, but will do so but at the expense of investment in the business and long-term growth.

   In our view there are no simple solutions to these challenges that can address everyone’s concerns. There will need to be political decisions taken on the priorities, which may mean painful change now, in return for the long-term security of pensions and for the overall economic well-being of the UK.

   Individual cases like BHS and Tata Steel are helpful for creating a focus on the issues and generating momentum to address problems. However, any solutions should be those that seek to address the wider challenges, and should not in our view be knee-jerk reactions to particular cases.
2. The importance of looking at the bigger picture

The finances of the UK’s pension schemes are at a critical juncture following the vote for Brexit, and the Bank of England’s most recent monetary policy intervention. New record lows in long-term yields available on government and corporate bonds are putting very significant pressure on pension scheme deficits. In the absence of a material change to the current environment in which pension schemes operate, the likely outcomes will include:

- Businesses being unable to pay dividends and/or refinance their businesses on favourable terms; and
- More failed businesses, such as BHS and Tata Steel, strangled by their DB pension liabilities, with consequential negative impact on economic growth and jobs, and more pensioners ending up in the PPF.

In our view, it is unlikely that a positive way forward for UK pensions can rely solely on changes to the UK’s pension legislative environment. The interaction with monetary and fiscal policy, FRC accounting requirements, PRA Solvency II and banking requirements, the likely post-Brexit economic environment for the UK, and the continued likely interaction with EU pensions law in the future, are all critical moving parts in an increasingly complex and global world. All of these should be considered together.

3. Possible ways forward

The questions being asked by the Committee are good ones and are fundamentally political in nature rather than technical. The Government will need to decide between three broad options:

- To (broadly) retain the existing balance of protections between businesses and pension scheme members, and hope that most pension schemes and businesses can ride out the current storm;
- To shift the balance of legislation to enhance protection for pensioners, with the risk of a significant negative impact on a wide range of UK businesses and the possible result that even more businesses become insolvent and more schemes enter the PPF;
- To shift the balance of legislation to soften DB pension promises, and give employers greater flexibility, which would be a very welcome easement to UK businesses, but would reduce the value of pension benefits payable to some or all members of pension schemes (for example, by allowing CPI inflation to be adopted for pension increases rather than RPI inflation, or making pension indexation subject to an affordability test).

Combinations of changes could also be explored, but these quickly become more complex to regulate. For example, to require businesses generally to contribute more to pension schemes and take less risk, but allow failing businesses to reduce pension promises. If you tried to prescribe the circumstances under which a business could avail itself of such an easement you would find it a significant challenge then to define the boundaries between “healthy” and “unhealthy” businesses to assess which businesses need to comply with different requirements. A better way might be to make any benefit reduction power exercisable jointly by the trustees and sponsoring employer; or permit such detrimental amendments provided that a sufficient majority of affected members agreed to the change (eg 67%).
It is not for LCP to take a view on the direction of Government policy, but we do want to stress that the Government should not underestimate the financial risk within the current system and the potential for significant negative consequences for the whole economy under various scenarios.

We think it unlikely that small changes to the current pension regulatory environment will have a major positive impact, and they may have negative unintended consequences. We strongly recommend that you do not propose changes to Government in order to be “seen to do something” in response to BHS. The underlying issues are deep, and there are many businesses that simply cannot afford, and will likely never be able to afford, their current pension promises.

Depending upon the nature of the settlement to be agreed with our European neighbours, Brexit may reduce some of the constraints on the UK’s pension rules and regulations. We recommend that this potential flexibility is actively considered by your Committee, just as is currently being done by your colleagues on the Treasury Select Committee in relation to Solvency II. For example, it may be possible to review the following as a result of Brexit in a way that it has not been possible to do to-date:

- the guaranteed nature of pension promises (eg constrained by European property law);
- the constraints for funding under the Pensions Act 2004 (eg constrained by IORPII);
- the rules around the Pension Protection Fund (constrained by European law);
- Capital rules for insurers and banks and how they apply to their pension schemes (constrained by Solvency II and Basel III);
- FRC rules for accounting for pension liabilities (constrained by the International Accounting Standards Board).

We have not commented on your detailed questions. We are in broad agreement with the Association of Consulting Actuaries’ responses on these points.

We are happy for our comments, which represent the collective view of a number of partners within LCP, to be attributed to LCP. We hope that our response is helpful but if you have any questions, or would like to discuss anything further then please contact me.

Yours faithfully

J P Camfield FIA
Partner

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