Written evidence from Aon (PPF0062)

Background

1.1 We set out below Aon's submission to the Work and Pensions Committee's inquiry into Defined Benefit pensions.

1.2 By way of background, Aon is a leading global provider of risk management, insurance brokerage and reinsurance brokerage, and human resources solutions and outsourcing services with more than 69,000 colleagues in over 120 countries.

Executive Summary

2.1 The key points set out in our response below are:

- The inquiry into Defined Benefit pensions needs to be considered in the context of Defined Contribution arrangements. There are issues of intergenerational fairness given current pension arrangements are generally DC and expected to produce lower benefits than historic DB provision. For a given spend on pensions, more into DB will lead to less into DC.

- The balance between meeting pension obligations and ensuring the ongoing viability of sponsoring employers is the most important of the issues highlighted.

- There should be an intermediate solution available, where this is in the best interests of members and the regulator consents. This would provide an option between the current 'black and white' choice of an ongoing employer with a scheme paying benefits in full or an employer becoming insolvent with benefits being cut back.

- We outline various possible options for intermediate solutions, including a conditional indexation approach, along with safeguards to ensure that any such solution is not abused.

- The introduction of this conditional indexation approach would also suggest related changes to the structure of the PPF which would benefit all ongoing DB scheme sponsors without reducing members benefit expectations.

- The intermediate solutions we outline could make consolidation of such schemes a more realistic prospect, leading to economies of scale and improved scheme governance.

- For schemes which are not underfunded or where the employer is expected to be strong enough to finance the deficit, then 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.

- Separately, for scheme valuations, we suggest a more principles based regime, permitting a wider range of approaches.

- Another requirement that could be introduced to ensure directors treat
shareholders and pension scheme members equitably, would be to give directors a responsibility to consider the current, up to date, funding requirements of the scheme when deciding on dividends (for example, this may be particularly relevant where the deficit has increased significantly since the last valuation).

Introduction – context to the inquiry

3.1 The call for evidence focuses on Defined Benefit (DB) pension schemes but the underlying financial picture – lower future expected returns – is potentially an even bigger issue for Defined Contribution (DC) schemes and their members. Future DC contributions will yield much less than might have been envisaged. More contributions are expected to be required to fund a given level of retirement benefits.

3.2 Furthermore, if more money is required to increase security for the historic liabilities of DB pension schemes, then this may mean that there is less money available for current employees in DC arrangements to provide adequate retirement provision, reflecting these lower expected returns. This is important given the existing issues surrounding intergenerational fairness, where current DC members already expect to get less than DB members have accrued historically and it may be considered ‘fairer’ if higher contributions were paid into the current employees’ pension arrangements rather than providing additional security for historic DB benefits.

3.3 The comments above relate to the general situation for private sector pension provision. We note that the provision of pensions in the public sector is quite different with, broadly, DB accrual continuing for all employees, which, in itself, creates a dislocation in the benefits available to the two different types of employee.

3.4 Although we address each of the areas you highlight for submissions in the order you have set out below, our most significant comments are on the final section, which concerns the balance between meeting pensions obligations and ensuring the ongoing viability of employers.

DB pensions regulation by the Pensions Regulator

4.1 The Regulator has a difficult task in attempting to balance conflicting objectives with its limited resources. Our view is that it generally copes well and has improved its operations over the years in response to feedback from the industry.

4.2 The only high level point we would make is that the Pensions Regulator could consider moving to a more ‘outcome focused’ approach to regulation, rather than concentrating on issues of process. For example, the regulator could consider whether the regulatory burden is excessive for schemes which are well funded with well-matched assets and review its processes with this principle in mind.

4.3 There are areas in which the Regulator could make further improvements but these are detailed points which we do not believe should be the focus of this inquiry.
4.4 One aspect we have considered is whether the Pensions Regulator should do more to encourage the consolidation of schemes. This could allow smaller schemes to benefit from economies of scale and improved governance. The benefits of consolidation should not be just to drive down costs – they should be to upgrade the quality of skill, resource, advice and support available to meet DB pension promises.

4.5 Consolidation could occur, broadly, one of two ways:

- The first is to keep the balance of powers, benefits and finances of each predecessor scheme distinct from one another in separate sections, but sharing in a common board of trustees, governance structures and asset pooling facilities. This offers some efficiencies of scale but still requires each section to be maintained separately and so the efficiencies are limited. For example, separate consideration of covenant, funding and investment strategy is still likely to be required for each section.

- The alternative is to completely merge each predecessor scheme into a single, centralised scheme, thereby achieving the maximum efficiencies. However, consolidation in this way is generally only feasible if the schemes involved have similar (generally low) risks, covenant strength and balance of powers, so that the cross subsidy between participating employers is minimised. In the current legislative structure this makes consolidation, and the benefits that would flow from such consolidation, difficult to achieve.

4.6 In the final section of this paper we outline proposals for an 'intermediate solution', where this is in members' interests, which could make consolidation of such schemes a more viable proposition. In such an environment the Pensions Regulator could actively encourage consolidation where this is appropriate. The benefits of economies of scale could also flow through to members. Further gains could be made if it were easier to rearrange benefits from such schemes into a consistent, single common format that does not involve loss of value for members. Currently this may be possible via an actuarially certified "Transfer without Consent", but the process could be streamlined, leading to lower costs of administration of the single benefit scale.

4.7 It would remain important to maintain market competition. Large schemes that adopt an intermediate solution should be able to continue as a separate legal entity, and may even allow similar smaller schemes to merge with them. The regulator's role could be to encourage such schemes to consolidate where significant benefits would flow from consolidation.

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The Pension Protection Fund

5.1 The PPF is being managed in a sustainable way but it is less clear that it is fair, particularly whilst the scheme-based levy and levy-cap remain in place. Low risk schemes pay more than they should whilst the levies for high risk schemes are capped.

5.2 Our view is that the PPF does a good job within the constraints of the current legislation. Like the Pensions Regulator, there are areas in which
PPF could make further improvements but these are detailed points which we do not believe should be the focus of this inquiry.

5.3 One fundamental problem with the existing structure is that schemes can only enter the PPF if there has been an insolvency event. In the final section of this submission we outline various intermediate solutions, including proposals which would enable schemes to convert to conditional indexation if certain conditions are met.

5.4 In order to improve consistency with the possible ‘conditional indexation approach’ we have described below changes that could also be made to the PPF compensation levels. We would propose that the pension currently subject to guaranteed levels of revaluation in deferment or pension increases in payment should become subject to conditional indexation – targeting the same level as currently guaranteed.

5.5 To facilitate this ‘conditional indexation approach’, the PPF should be required to invest the assets underlying the conditional indexation liabilities in growth assets – this will reduce the levy payable without reducing the benefit expectation of members.

5.6 If experience is better than anticipated, PPF members will receive higher benefits than they currently receive. If experience is worse than expected, conditional indexation can be reduced – this will limit the exposure of ongoing schemes to PPF funding deficits and hence increase 'fairness'.

5.7 Making these changes would ensure the PPF level of compensation remains consistent with the conditional indexation approach we outline in the final section below. In fact, the existence of an intermediate solution should reduce the number of employers becoming insolvent because of their pension liabilities and hence reduce the levies payable in future years, reflecting the reduced risk of insolvency.

The role and powers of pension scheme trustees

6.1 The extent of trustee powers can still vary to a large extent depending on a scheme's rules. For example, some trustees have a unilateral power to set contribution levels and/or decide to wind-up the scheme and call a significant debt on the employer. Other trustees require employer agreement.

6.2 The Pensions Act 2004 made the playing field slightly more even for scheme funding, by requiring trustees to agree contributions with the employer where under scheme rules those contributions could be set unilaterally by the employer. The Pension Act 1995 also provides for the Pensions Regulator to wind up a scheme if this is necessary to order to protect members. It is not clear to us that further changes to this balance of power should be made.

6.3 In theory, the role of a trustee is very similar, irrespective of whether their scheme has £5,000M or £5M in assets. In practice, trustees of larger schemes are likely to devote more time to their role and have access to better resources. We support the Pension Regulator's focus on
encouraging all trustees to ensure they have adequate levels of knowledge and understanding irrespective of scheme size. However, adopting the 'outcome focused' approach we suggest above might lead the regulator to conclude that the 'adequate' level is quite different for a well-funded well-matched scheme than for a scheme where full payment of benefits may be in some doubt.

**Relationships between TPR, PPF, trustees and sponsoring employers**

7.1 Relationships between trustees and sponsoring employers clearly vary from scheme to scheme. The regulator encourages a collaborative approach and we support this in principle whilst recognising that there are some cases in which relationships are difficult – particularly in strained financial situations.

7.2 Both TPR and PPF have a high level focus on maintaining good relationships with the industry. In practice there are improvements that could be made but, as noted above, these are detailed points which we do not believe should be the focus of this inquiry.

**The balance between meeting pension obligations and ensuring the ongoing viability of sponsoring employers**

8.1 The current legislative requirement forces trustees to focus on the present value of the assets and liabilities.

8.2 A present value approach is not wrong. It encapsulates the valuation in a single figure, which probably does reflect where the scheme is trying to get to in the long-term. It also tends to encourage more immediate action in response to changing circumstances, although this means reducing deficit contributions when deficits reduce, as well as increasing deficit contributions when deficits increase. However, the present value approach does have a number of disadvantages which are becoming more apparent in the current low yielding and volatile environment, namely:

- The present value approach focusses the attention of the trustees on the current value of the assets and the liabilities, which is very sensitive to the discount rate assumption, rather than the ability to meet pension payments as they fall due

- For many schemes, the deficits are now large and volatile. While it may be appropriate to assume that deficits have increased, it is difficult to make decisions when the underlying figures keep changing and it may be too simplistic to focus on one figure. This can put significant strains on sponsoring companies. This may impact either on the company's ability to grow its business or on pension scheme members, where all future benefits are cut to reduce costs.

- It can lead to less optimal investment decisions. For example, it may lead to an increased incentive to invest in a way to reduce the risk measured against the chosen funding target regardless of longer term fair value considerations.

8.3 We would favour an environment where a wider-range of approaches...
can be used rather than requiring all valuations to be based on a present value type approach. One alternative approach is a "cash-flow" type approach whereby the assets are projected forward over time and the focus is on the likelihood of being able to meet all benefit payments as they fall due.

8.4 Such an approach does involve more calculations and perhaps some changes to systems. This higher degree of sophistication would not be appropriate for most pension schemes and trustees could recognise some of the merits through a more flexible application of the current present value methodology. Therefore, we are not suggesting that a cash-flow approach should replace the current present value approach but that a more principles based regime should apply for valuations permitting a wider range of approaches.

8.5 Currently 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 is for the employer to become insolvent and for the scheme to drop into the Pensions Protection Fund (PPF) or otherwise secure reduced benefits with an insurance company. This has the following adverse consequences:

- Members will have their benefits reduced. Typically, for a scheme entering the PPF, there may be a loss in value of around 25% for pensioner members (over Normal Retirement Age) and around 35% for other members. The 2015 Purple Book shows that Section 179 benefits represent 73% of Solvency benefits – an average (current) reduction of some 27%.

- Where a scheme enters the PPF, there will be a shortfall relative to the basis that the PPF reserves on. In turn, this could lead to an increased strain on PPF funding levels.

- Employees may lose their jobs.

8.6 Our view is that there should be an intermediate solution available. The question of schemes becoming unaffordable for the sponsor will not be restricted to a small minority of UK pension schemes. In particular if current conditions persist – and interest rates in particular stay “longer for lower” - there may, in our view, be a substantial number of the remaining 6,000 DB schemes that will be facing unaffordable pension commitments. 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 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 insolvency.

- The pension scheme would not fall into the PPF and therefore not
adversely affect the PPF funding.

- Employees are less likely to lose their jobs.

8.7 However, if trustees were allowed to adopt an intermediate solution, then there is the risk that employers would try and force schemes into this position so as to reduce benefits or that employers would fund the scheme less well in the knowledge that this option would always be available if things went wrong.

8.8 Therefore, there would need to be some safeguards. We suggest an intermediate solution should only be possible if:

- the trustees decide that it is in the members' best interests, and

- the Pensions Regulator (tPR) gives its consent. TPR'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.

8.9 In practice, we suspect these tests are most likely to be met in circumstances where it is likely that, if the intermediate solution was not adopted, the scheme would go into the PPF in the near future.

8.10 There are various features which we envisage could form part of an intermediate solution for such a scheme:

- Reducing from RPI to CPI-based indexation
- Reducing benefits (perhaps in a way which would not reduce the level of PPF protection, such as reducing increases relating to pre 97 service)
- Swapping a variable employer obligation for a fixed obligation – perhaps converting the obligation to fund the scheme to an equity holding in the employer
- Swapping guaranteed increases for conditional indexation – we discuss this approach below.

8.11 Under a 'conditional indexation approach' there could be a reduction or removal of the guaranteed level of pension and/or deferred pension increases (including a conversion of current statutory protections for revaluation and indexation). This would result in no immediate reduction to pensions and ensure no step change in the level of PPF protection for members. Increases would still be anticipated but these would be conditional rather than guaranteed.

8.12 This approach could allow significant flexibility. Again the trustees would need to decide that it was in the members' best interests and the Pensions Regulator would need to consent. The changes we have suggested above to the level of compensation offered by PPF could help trustees reaching a decision that a move to full conditional indexation was in the members' best interests. The following option could then be available to trustees, for example:

- a conversion of all pension increases and deferred revaluation into increases that were conditional on the funding position of the scheme
(and could even lead to higher increases than the previous scheme benefits), and

- the trustees being given an equity stake in the business.

8.13 While there would be a reduction in the guaranteed level of benefits, the conditional indexation approach could provide scope for the members to get their original benefits, or even higher benefits should the investments do well. The approach would permit the trustees more scope to invest in higher return seeking assets. If combined with the trustees taking an equity stake in the business it would also provide a mechanism for the scheme to automatically receive additional funds based on the fortunes of the employer. Conversion of benefits to a common format, as part of an intermediate solution, would further drive the efficiency of the system.

8.14 For many current members of DB schemes, an intermediate solution would mean changing to a reasonable chance of success (of receiving their current pension promises) rather than a guaranteed certainty of failure to receive those benefits. It would also provide a substantial "release valve" for the UK DB pension system.

8.15 Earlier we raised in this note the possibility of consolidating schemes. One obstacle to this is the potential cross-subsidy caused by variable employer obligations and different funding levels in schemes. A consolidated scheme with fixed employer obligations and conditional indexation (perhaps where the amount of conditional indexation depends on the initial funding level) could reduce or eliminate the risk of cross-subsidy and make consolidation more attractive for those schemes adopting an intermediate solution. It would also free any employers entering into such arrangements from their requirement to report pension obligations under pension accounting standards.

8.16 For schemes which are not underfunded or where the employer is expected to be strong enough to finance the deficit, then 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.

8.17 Another requirement that could be introduced, to ensure directors treat shareholders and pension scheme members equitably, would be to give directors a responsibility to consider the current, up to date, funding of the scheme when deciding on dividends – perhaps requiring the directors to sign a statement to this effect. (For example, where a scheme was in surplus two years ago but is now obviously in significant deficit and likely to require significant extra contributions soon, the precise details of which are not clear yet, the directors could be required to consider funding the current deficit before deciding on dividends.)