I am pleased to submit Mercer’s written evidence in relation to the inquiry for the Committee’s consideration. We would be happy to provide more information or answer any questions the Committee might have.

Mercer is a global consulting leader in talent, health, retirement, and investments. It has more than 20,000 employees based in 42 countries, and the firm operates in over 130 countries. Mercer is a wholly owned subsidiary of Marsh & McLennan Companies, a global team of professional services companies offering clients advice and solutions in the areas of risk, strategy, and human capital.

In the UK, our client base includes employers and trustees providing occupational pension schemes to employees in all sectors of industry. We provide pensions advice and services to companies in the FTSE100, but we also have a large proportion of clients that are employers classed as “Small to Medium sized Enterprises”, or trustees of pension schemes with sponsoring employers in this class. Our response takes the interests of our diverse client base into account.

1. Executive summary

1.1. The Pensions Regulator (TPR) has adequate powers to regulate how pension schemes are run but, by targeting their use differently, it could have a more positive effect on outcomes.

1.2. TPR does not seem the appropriate body to intervene in corporate decision making, even where it affects pension scheme outcomes. Other regulators are involved in corporate governance that could intervene more easily and effectively, and are better placed to take the whole range of stakeholder interests into account.

1.3. Regulation of the advisory market could also ensure that, in corporate restructuring, the interests of all company stakeholders, including pension scheme members, are considered.

1.4. Defined benefit pension schemes have become an increasing burden on employers. There are circumstances where it would be reasonable for that burden to be eased without forcing employer insolvency, with its consequent costs on the company’s existing employees and creditors.

2. Defined benefit (DB) pensions regulation by the Pensions Regulator (TPR), including:

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

2.1.1. The Pensions Act 2004 gives TPR certain functions, largely to do with how pension schemes are operated, for example, 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 for the security of members’ benefits and act to reduce the risk of calls on the PPF and to improve understanding of good administration. When it carries out its functions in relation to the funding of defined benefit schemes, TPR must also minimise any adverse impact on the sustainability of the sponsoring employer.

2.1.2. TPR has powers to intervene if trustees contravene their legal duties. In particular, if they do not meet their scheme funding obligations, TPR can impose a binding schedule of contributions, or a funding method and assumptions, on the scheme. To that degree, TPR can directly influence company cash flows.
2.1.3. Given the nature of its establishment, this seems appropriate: TPR’s powers to regulate schemes seem comprehensive, but its powers in relation to corporate behaviour that could affect schemes are limited.

2.1.4. However, 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 could be used to reduce the risk that senior company employees are motivated to inappropriately prioritise the interests of one group of stakeholders at the expense of another (such as scheme members). Although the extent of these powers differ according to a company’s status (for example, more control is possible over a listed plc than over a privately owned company), our view is that more attention should be 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.

2.1.5. 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. Sometimes they are members of professional bodies, which should have codes of conduct that discourage poor behaviour. Many advisory firms supporting companies’ strategic planning are regulated by organisations such as the FRC, the FCA or the PRA (banks and accounting firms, for example). These bodies can influence the cultures within the firms they regulate and therefore the quality of the advice being given (noting that advice given does not need to be followed). In particular, it would seem appropriate that, collectively, the senior leadership of firms with material pension scheme liabilities should be aware of the risks the scheme imposes on the business and take decisions that do not ignore the interests of pension scheme members and other stakeholders. Steps are being taken in this direction. For example:

2.1.5.1. 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 a more appropriate “home” for company related control than TPR.

2.1.5.2. The international accounting standards board expects, but does not require, the narrative accompanying financial statements to detail the material risks the company is exposed to, which could include pension related risks, and the actions the company is taking to mitigate those risks.

2.1.6. These actions have limited scope: in particular, while 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. However, clients can choose to ignore their advisers’ advice. Nonetheless, the entities already responsible for regulating those acting in these situations are likely to be better positioned than TPR to influence any required changes of behaviour in the corporate sphere.

2.1.7. 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. If the Committee accepts the premise that the statutory scheme funding regime is not intended to provide members with complete security, and that the PPF stands behind schemes when events play out in a way that could not have been reasonably anticipated or managed, the risks that need to be addressed are that schemes fail because employers and trustees did not act appropriately and with due regard to their legal responsibilities, or did not receive (or follow) appropriate professional advice.
2.1.8. **Mercer recommendations:**

2.1.8.1. Consider how all regulators with authority over organisations or individuals that can affect pension scheme outcomes could influence good governance in relation to decisions and advice affecting workplace pension provision.

2.1.8.2. Review how different types of companies are regulated, to ensure good corporate governance, recognising this could be interpreted differently for different corporate structures.

2.1.8.3. Consider how effectively the advice market is regulated. For example:

2.1.8.3.1. What standards should apply to the knowledge and understanding of corporate advisers and the quality of the advice provided?

2.1.8.3.2. Would it be possible to review companies' reactions to advice given in particular situations, such as company restructuring, perhaps via governance audits?

2.1.8.4. Ensure (e.g. by TPR education) that trustees understand how different regulators could affect their advisors and the scheme's employer's actions.

2.2. **the application of those powers, including in specific cases other than BHS**

2.2.1. Regulators are limited by the resources available to them, as well as by their powers. Also, TPR has conflicting objectives, requiring it to protect the PPF from claims while minimising its affect on employers' plans for sustainable growth. In our view:

2.2.1.1. TPR's attention is not necessarily directed towards those that most need help. Although it uses risk metrics to target its "proactive" regulatory interventions, its metrics can include some schemes that are not at risk, and exclude many schemes that could be.

2.2.1.2. TPR appears reluctant to use its existing powers, meaning employers and trustees who do not do the right thing have less incentive to alter their behaviour.

2.3. **the level and prioritisation of resources**

2.3.1. We interpret this question as referring to prioritising TPR's resources.

2.3.2. The costs TPR incurs in regulating work based pension schemes (broadly, all its functions except in relation to auto-enrolment legislation) 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 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 as well as those operated by firms regulated by the FCA and PRA, as well as schemes providing defined benefits.

2.3.3. We expect it is not easy to allocate the levy between TPR's various roles, particularly when deciding the extent to which the levy should support specific regulatory action. We understand that TPR plans to target guidance towards those schemes where the trustees and employer do not engage with it: this seems sensible, compared with its current, more generic, approach. We can see similar opportunities in other areas, for example, reducing the attention given to schemes which are known to receive the full complement of professional advice on a regular basis (since the regulatory onus could be placed on the advisors directly, via the requirement to whistleblow to TPR, or through their professional bodies), or those that can demonstrate a rigorous integrated risk management approach.

2.3.4. Its current approach targets resources at larger schemes (expected to pose a higher overall risk to the PPF), which identifies risky cases at the cost of giving disproportionate attention to well managed schemes. Different criteria could focus attention on smaller, high risk, schemes, including those where well intentioned trustees actively seek TPR's input, but are sometimes rebuffed in the first instance, making it more difficult for them to influence the employer.

2.3.5. TPR already collects a lot of information from trustees annually. We expect it could operate more effectively with less, but more current, information. This could reduce
burdens on trustees, while enabling better targeted and more timely intervention from TPR.

2.3.6. However, TPR has limited powers to collect information from employers. Rather than TPR gathering information via scheme trustees, it might be more appropriate if organisations that regulate companies cooperate with TPR to ensure the ways they use their influence are appropriately aligned with TPR’s objectives. This might result, for example, in better information sharing when parties involved in company takeovers or mergers have pension scheme liabilities on their balance sheets. Better co-ordination between existing regulators could help TPR prioritise its existing resources, without the need for yet another regulatory regime.

2.3.7. **Mercer recommendations** (in addition to the observations in the text above):

2.3.7.1. The entities that regulate advisors and other individuals or organisations involved in corporate decision making could foster stronger governance standards in the advice and decision making processes. They could also clarify professional responsibilities when advice is not followed, to the extent that the outcome could be viewed as outside the range of reasonable behaviour.

2.3.7.2. TPR could use information about trustees’ standards of governance and access to advice, to inform how it prioritises its risk based interventions.

2.4. **whether a greater emphasis on supervision and pro-active regulation would be appropriate**

2.4.1. TPR has limited ability 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 the trustees have chosen is contrary to their statutory duties. TPR has no powers to intervene directly in company decisions and can only react after the event, for example, if it can demonstrate that decisions were taken with intent to harm the scheme or, indirectly, if its specific powers with regard to the statutory funding regime are triggered.

2.4.2. Its supervisory or “pro-active” powers are therefore limited to providing guidance and education, or where trustees voluntarily permit its intervention: TPR can only act within its powers and should not seek to intervene in a scheme’s operation, unless the statutory tests for it to do so are met or to seek (reasonable) information for it to carry out its role.

2.4.3. For example:

2.4.3.1. TPR uses its ‘proactive valuation engagement’ programme to follow the statutory funding valuations of (in 2016) around 20 large (£500m+) schemes. Taking part is voluntary but, in our experience, most trustees agree to do so. We expect the process absorbs a lot of TPR’s resource, but the benefits to the schemes involved, and schemes more generally, are unclear.

2.4.3.2. TPR contacts trustees where it has concerns, to seek information and/or assurances that the trustees are acting appropriately. Examples include cases where TPR has identified an unusual dividend distribution and other covenant influencing events.

2.4.4. It’s possible the Select Committee is considering whether TPR’s statutory powers should be changed to give it the authority to be more pro-active. Were that to be the case, there would need to be further examination of exactly what these powers would entail, but generally our view is that:

2.4.4.1. Before giving TPR new powers, the way it uses its existing powers should be properly considered, since it seems likely to us that they are sufficient although perhaps not used effectively.

2.4.4.2. New powers would not necessarily reduce the risks faced by pension scheme members and might impose additional costs on trustees and employers for no apparent gain. 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, and giving TPR extra powers will not change this.

2.4.5. Making TPR more interventionist would not guarantee better outcomes and could draw regulatory attention away from schemes with more need of TPR’s attention.

2.5. whether specific additional measures for private companies or companies with complex and multi-national group structures are required

2.5.1. Companies have to balance the actions they take in relation to their defined benefit pension schemes with other potentially affected parties, including other creditors and 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 should be reflected in the discussions they have with the employer about how the scheme should be financed. TPR can already intervene if it feels these discussions have not led to appropriate outcomes.

2.5.2. Generally, corporate responsibility for balancing the security of company pension schemes with their other priorities seems a matter for those regulators responsible for good corporate management and governance. However, company regulation differs according to a company’s size and legal status; perhaps greater emphasis should be given to the effect a company’s failure could have on its stakeholders (for example, employees, suppliers, creditors, pension scheme members) and the degree of control they have over their circumstances, rather than the nature of its ownership.

2.6. the pre-clearance system, including whether it is adequate for particular transactions including the disposal of companies with DB schemes

2.6.1. TPR provides “clearance” to companies with DB schemes on a voluntary basis, to give them comfort that their involvement in events such as corporate restructuring will not be found wanting at some point in the future, so that TPR will not use its ‘moral hazard’ powers. Sometimes companies have to pay a “fee” (that is, provide mitigation for expected detrimental effects due to the event) to gain clearance.

2.6.2. Companies often choose not to seek clearance because they feel the “fee” can be penal and there is no statutory basis for the protection it provides. Also, the “fee”, paid with certainty, is likely to be similar to any “penalty” imposed by way of the moral hazard powers: since TPR might not use these powers, not seeking clearance might seem a risk worth taking.

2.6.3. Statutory protection for pension schemes, in the event of corporate restructuring, 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 (that is, which do not have current or former scheme members), 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.

2.6.4. The crucial point here is that schemes should not be funded on the basis of a covenant that includes employers who have no financial obligation to the scheme. TPR already provides guidance in this area.

2.7. powers relating to scheme recovery plans

2.7.1. It seems more appropriate to consider TPR’s powers in relation to all aspects of the statutory funding regime, rather than only recovery plans since, 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 because 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, including a schedule of contribution (of which the recovery plan is a part) that imposes financial demands on the employer. However, as mentioned previously, TPR has rarely exercised these powers.

2.7.2. **Mercer recommendation:**

   2.7.2.1. TPR should review how it uses its existing powers in relation to the statutory funding regime.

2.8. **the impact of the TPR's regulatory approach on commercial decision-making and the operation of employers**

   2.8.1. 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:

   2.8.1.1. By way of its clearance facility, it can influence the cost of particular transactions or other corporate decisions that potentially affect the scheme’s security;

   2.8.1.2. 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;

   2.8.1.3. 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.

   2.8.1.4. TPR’s guidance can result in trustee behaviours that affect how the company reacts to, for example, scheme funding negotiations.

   2.8.2. **Mercer recommendation:**

   2.8.2.1. TPR should increase the degree to which it works with organisations that can influence how parties other than the trustees can influence pension scheme outcomes, to ensure that appropriate regard is given to the security of scheme members.

3. **The Pension Protection Fund (PPF), including:**

3.1. **the sustainability of the Pension Protection Fund and the fairness of the PPF levy system and its impact on businesses and scheme members**

   3.1.1. The PPF is the insurer of last resort. 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 high and employers and scheme members need to understand the value it provides. In particular, legislation permits the PPF to reduce levels of compensation in certain circumstances. Although it seems unlikely it would do so, we expect that, if the PPF was clear about its policy in this regard, it would contribute to its sustainability if it did have to cut compensation.

   3.1.2. 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 pension 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).

   3.1.3. Few people are affected by the cap: in a “typical” private sector scheme with 1/60ths accrual, only people with complete or near 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.

3.1.4. Other aspects of the PPF’s approach to compensation have more systemic effects. Initially, the PPF took the view that, in the interests of simplicity, it would ignore certain aspects of scheme design in determining what compensation it paid. However, it has become clear (for example, the BSPS consultation) that the windfall gains that accrue, as a result, to certain classes of member can influence how a scheme is operated, which seems dysfunctional. We believe these aspects of PPF’s compensation should be reviewed.

4. The role and powers of pension scheme trustees

4.1. TPR is currently considering the trustee model. Recent legislation has increased trustees’ responsibilities, by transferring to them decisions that were previously made by their advisers. This seems appropriate, since trustees are ultimately responsible for the scheme but, as a result, their role was altered.

4.2. Trustee advisers take pains to understand the needs of their clients and seek to be “trusted” by them, with the expectation that trustees can follow 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 clients’ interests and be aware of the wider consequences of their activities. This is particularly the case for trustees of smaller schemes, who are likely to be less well resourced and might rely more heavily on third parties. As mentioned above, many advisers are members of professional bodies or otherwise regulated. 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.

4.3. In some cases, trustees (and companies) do not take the advice they are given. This is their prerogative and, in many cases, their decision will be reasonable to the adviser. However, if the adviser views the client as acting unreasonably in rejecting their advice, this should put them in a difficult position. If regulators enabled whistleblowing that did not risk regulatory consequences, this could help all parties resolve these, and other, difficult situations.

4.4. Mercer recommendation: “Whistleblowing” should be made easier, to address situations that are not obviously professional or legal transgressions, but that raise questions about the public interest consequences of a particular action or event.

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

5.1. We have no extra comments on this point.

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

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

6.1.1. This objective only applies to how TPR carries out its functions in relation to the statutory funding regime. TPR’s guidance 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 less immediate security, trustees should seek agreement to share in any positive outcomes expected as a result of the investment.

6.1.2. 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.
6.1.3. However, this does not always flow through into how TPR actually regulates. It is possible that the interventions TPR makes in trustees’ scheme funding processes are influenced by its objective to reduce claims on the PPF, which conflicts with its “sustainable growth” objective. This would lead it to concentrate on larger schemes, even though they are well supported compared to some smaller schemes that struggle to engage their employer.

6.2. **whether the current framework is generating inter-generationally fair outcomes**

6.2.1. The pension regime does not result in inter-generationally fair outcomes. Because of the risks and costs of financing defined benefit schemes, younger generations of employees only have access to money purchase provision. The contributions employers pay to money purchase schemes are less than they would need to pay for ongoing accrual in their DB scheme (although similar, on average, to 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.

6.2.2. As a result, new (and mostly younger) employees take all of the risk of pension provision, and on average will receive considerably lower pensions than previous cohorts of employee.

6.2.3. **Mercer recommendation:**

6.2.3.1. The ability to reduce benefits without a scheme falling into the PPF would reduce inter-generational cross subsidy and cross subsidies between insolvent and solvent employers. If reducing scheme benefits enabled employers to continue to operate (perhaps using PPF compensation as a floor), it is sub-optimal to drive them into insolvency, adversely affecting current employees, suppliers and other creditors.  

6.2.3.2. Advantages would also accrue to employees that are not DB scheme members, since reduced pressure on funding DB deficits would release cash for investment in employees and in future company growth.

6.3. **whether the current wider environment, including very low interest rates, warrants an exceptional approach**

6.3.1. Unfortunately, it is not possible to tell if the current environment is exceptional, and so difficult to say it warrants an exceptional approach.

6.3.2. Our view is that the purpose of a valuation is to impose some controls over the future expected cost of providing the scheme and the pace at which that cost is met. The statutory funding regime achieves that. If a non-market related approach were introduced, the results might be different, but they would also have no context, be virtually meaningless (for example, they might not give appropriate signals to inform investment strategy), and inevitably short lived.

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