Written evidence from Railways Pension Trustee Company Limited (PPF0065)

Dear Committee

Executive Summary

- Having a defined benefit (DB) legislative and regulatory environment which fosters the sustainability of DB provision should be the key consideration of the Inquiry, even if the level of benefits provided in future are lower than they have been historically.

- Most aspects of the current framework are fit for purpose, although there is scope for refining some aspects and addressing factors, such as accounting standards, which encourage a short-term approach to investing.

- Pension schemes are generally long-term arrangements and scheme funding should not discourage investment in growth assets and a long-term approach to investing.

- Encouraging a long-term approach to investing will provide economic benefits and should give good member outcomes where there is a strong sponsoring employer.

- Adopting a long-term approach and helping DB pension schemes provide future benefits will improve inter-generational issues.

- Lifting aspects of the tax relief spreading rules will not discourage employers from paying larger deficit reduction contributions when schemes are in deficit.

- The Pensions Regulator (TPR) should be more proactive in its supervisory role and be more prepared to get involved in scheme funding discussions when there are protracted discussions between trustees and employers.

- Entry to the Pension Protection Fund (PPF) should be considered as the last resort for schemes and TPR should provide more active support in suggesting proposals to achieve better outcomes.

- PPF levies need to more fairly reflect the risk of a claim being made than they currently do.

- The legal and regulatory framework should encourage all stakeholders involved with DB schemes to act holistically.

Background to Response

1. I am writing to you on behalf of Railways Pension Trustee Company Limited (RPTCL) to provide a submission to the Pension Protection Fund and Pensions Regulator Inquiry (the Inquiry). It is helpful to have an opportunity to provide input on this important issue.

2. RPTCL is the corporate trustee of the main pension schemes in the UK railway industry. These schemes, of which the largest is the Railways Pension Scheme (RPS), have combined assets of over £23 billion and total membership of around 350,000 including more than 90,000 active members. Most active members are accruing benefits within a defined benefit (DB) section of the RPS.
3. More than 170 employers within the UK railway industry participate in the schemes.

4. Our schemes are uncommon within the private sector as they continue to provide DB provision for future service to a large number of members. In addition, around 45 railway employers continue to provide DB provision to new entrants. RPTCL’s view is that pension provision should provide an adequate income in retirement on a sustainable basis. We believe our schemes have met these criteria and the existence of a well-balanced legislative and regulatory framework will be a considerable factor in the continuation of future DB provision.

5. Another non-standard factor is the shared cost nature of our schemes. Although, in common with many DB schemes, deficits have become more common in recent years, and there has been upward pressure on contribution rates, increased costs have been shared between employers and members. It has become clear that members value DB provision very highly and are prepared to pay higher contribution rates, potentially combined with reduced benefits, to preserve future DB provision.

The importance of sustainability

6. The key issue that should be addressed by the Inquiry is a way to improve the sustainability of those DB schemes which have survived. If the trend of DB to defined contribution (DC) provision could be reversed that would be better still. However, we accept that most UK companies offer DC provision to new employees, and increasingly for existing members as well, and it is unlikely that changes in DB legislation or governance would reverse this.

7. Our experience of members within the RPS continuing in active membership, even when member contribution rates have been increasing, serves to illustrate how much people continue to value DB provision. Our opinion is that helping DB schemes to survive and provide benefits, playing a significant part of the UK pensions environment, is something that is worth pursuing.

8. If necessary, DB provision at a lower level than in the past, or with a lower level of guarantees, would be better than no DB provision at all. The legislative and regulatory regime should be able to support a lower level of provision where it becomes necessary and is agreed by trustees and employers as the best approach for members.

9. Over many years, DB schemes have provided good means for employers to attract, encourage and manage the workforce, with employees believing they have a chance of receiving a known retirement income. However, feedback from railway employees is that constantly changing pension legislation has undermined trust in pension provision, particularly amongst younger employees.

10. A future challenge for employers who wholly offer DC schemes could be a reduced ability to manage an ageing workforce, if employees cannot afford to retire, especially when contributions paid to the DC scheme are low. This may cause intergenerational issues. We believe that this factor should be taken into consideration when developing a sustainable solution to long-term pension provision, as DB pensions could again be seen as a solution to these types of workforce pressures.

11. As the various factors that drive the UK pensions environment are inter-linked, it is difficult to single out one particular issue that must be resolved to enable DB schemes
to flourish once more. However, within this response we consider aspects that could be addressed to meet this aspiration.

The current framework often leads to short-termism

12. DB schemes, by their nature, are inherently long-term savings vehicles, especially when backed by a strong and secure employer. However, various external factors serve to influence how pension assets are allocated and can act against adoption of a long-term approach. In particular, company accounting standards can introduce an objective of minimising short-term volatility and encouraging investments in asset classes such as corporate bonds and government gilts. Significant investments in these asset classes do not complement a long-term aim of maximising expected returns.

13. A further factor, linked to this, is the impact that current levels of gilt and bond yields can have on decision making for DB schemes, the consequence of which can lead to poorer outcomes for members.

14. As well as addressing the threats caused by accounting standards, which arguably fall outside the remit of the Inquiry but ought to be considered nonetheless, it is important that the scheme funding framework does not discourage long-term investing.

Scheme funding

15. We have concerns that the measurement of “liabilities” has become largely driven by gilt and bond yields, with the resulting inappropriate and short-term impact this can have on investment strategies.

16. DB pension schemes, like their DC counterparts, are long-term investment vehicles. Although it is generally accepted that DC investments should be in growth assets for most of a member’s lifetime to maximise expected member outcomes, DB schemes commonly invest heavily in bonds to reduce the volatility in company accounting.

17. For DB schemes, the ultimate test is whether there will be enough money to pay member benefits, based on future (unknown) investment returns. As with DC funds, providing flexibility within the regulatory system to allow DB schemes to invest heavily in growth assets should allow expected investment returns to be maximised. Currently, aspects of the system impose short-term hurdles which can drive irrational behaviours inconsistent with the long-term needs of schemes. Although many DB schemes may no longer be considered long-term, we expect many trustees feel sufficiently pressured by, and act on, short-term aspects, with no element of smoothing.

18. Ultimately, short-term pressures can discourage DB schemes from investing in growth assets even when it is appropriate to the circumstances of the pension scheme and the strength of the employer covenant to do so. This impacts future returns as well as investment in the wider economy.

19. As part of its work, we suggest the Inquiry considers how other countries address these short-term pressures to establish whether alternative systems would better support a long-term approach to investing.

Encouraging a long-term approach to investing will provide economic benefits
20. We believe that encouraging a long-term approach to investing will provide economic benefits.

21. In particular, economic benefits may be achieved by greater alignment between the allocation of DB scheme assets and the objectives of the macro-economy. For example, increasing the volume of DB investments allocated to infrastructure could benefit both the economy and DB member outcomes. Increasing investment in infrastructure is achievable but would require government help (and underpins) to ensure the risk/reward trade-off is acceptable and attractive to DB schemes.

22. However, as well as the impact of accounting standards already noted, we expect that the level of guarantees provided within DB schemes makes greater alignment between the allocation of DB pension scheme assets and the government's objectives for the macro-economy more difficult to achieve. Although we would not endorse any removal of guaranteed rights already accrued, there may be merit in discussing the possibility of lessening the amount of benefits that are fully guaranteed in the future. As well as providing more investment flexibility, a lower level of guarantees may result in a lessened impact from factors such as accounting standards.

23. It seems reasonable to acknowledge that a high level of benefits cannot be guaranteed at an acceptable price. It would appear better to provide DB benefits which are not fully guaranteed than to provide none at all, especially if some element of the DB benefits is reinforced by a safety net, such as the PPF.

24. Given this, and reflecting the fact that guarantees to rights may only be as good as the ongoing nature of a sponsoring employer, there might be scope for the levels of benefit up to PPF compensation levels to be both guaranteed and funded for as part of the scheme funding regime, whereas benefits above that level could potentially be funded for but not guaranteed, subject to appropriate agreement by a scheme's trustees. For example, statutory requirements for indexation of pensions in deferment and payment could be lessened and replaced with provision on a “best endeavours” basis.

25. It would be hoped that a lower level of guarantees could also provide scope for some relaxation of accounting standards and scheme funding requirements to assist sustainability and allow greater flexibility in ongoing funding and investment choices. If this increased flexibility improves expected investment returns, this will increase member outcomes and security in retirement provided asset returns are delivered.

26. To make changes to the DB landscape to address this, however, will need a step change in regulations. Corporate accounting would have to change, as would scheme funding regulations, as well as possibly “Section 67” of the Pensions Act 1995 and legislation relating to the PPF. Reviewing these aspects would be significant but a worthwhile exercise, as the beneficial retirement incomes should far outweigh the potentially increased risk of benefits not being fully met.

27. If there were significant regulatory changes to achieve the above, it may be appropriate to ensure that trustees are able to protect benefits from any unscrupulous employers looking to exploit lower levels of guarantee. This could be achieved by providing appropriate powers to trustees and/or TPR to combat unjustified benefit reductions.

Provision of future DB benefits should improve inter-generational fairness
28. We believe that DB provision provides a better tool for employers to manage an ageing workforce than DC provision, especially where DC contributions are paid at minimum auto-enrolment levels. We have concerns that many individuals who have DC provision based on low levels of contributions, or poor investment decisions, will struggle to be able to afford to retire at the age they may want to. Many may be happy or able to continue working, whereas others may resent the inability to retire, causing some inter-generational friction. This could become a socio-economic issue.

29. Consequently, providing for the continuation of DB benefits, even if they are at a lower level than they have been provided in the past, would seem to lessen these inter-generational issues.

Lifting aspects of the tax relief spreading rules will not discourage employers from paying larger deficit reduction contributions when schemes are in deficit

30. We note from the BHS Inquiry report that contributions to meet the deficit were “inadequate” for their pension schemes. However, the tax relief provided on pension contributions, and the need to spread tax relief when there is a large increase compared to recent years, can act as a disincentive to employers paying off deficits quickly.

31. The tax framework for pensions should better encourage employers to pay deficits off quickly by removing tax disincentives relating to large increases in contributions.

TPR should be more proactive in its supervisory role and be more prepared to get involved in scheme funding discussions

32. A further suggestion of the BHS Inquiry was that TPR is “reactive and slow-moving”. We have recent experience that supports this view, although we do not consider that TPR needs to be changed fundamentally.

33. However, an area where the role of TPR should be improved is to ensure it has sufficient resource to act and provide advice, or make a decision, when it is called upon by trustees experiencing difficulties which require TPR support.

34. As an example, the TPR currently does little when trustees and employers fail to agree a valuation under the scheme funding regulations within the statutory timescale. This can play into the hands of employers, and act to the detriment of members, as many employers recognise this position. In circumstances like these, trustees should be able to both request support from TPR and receive it. In the past we have welcomed TPR’s involvement in discussions about scheme funding and corporate transactions, and their influence to help the Trustee reach a resolution with employers in the latter case has been very helpful, even without a formal application for Clearance being made.

The Pension Protection Fund should be the last resort for pension schemes

35. Even if more flexibility is given to how DB benefits are offered, there is still a risk that a minimum level of benefits promised cannot be delivered due to employer failure. We believe the PPF should continue to provide compensation in these circumstances.

36. However, where trustees actively monitor the covenant of the sponsoring employer accurately and are able to be engaged in discussions with both the employer and TPR,
if necessary, entry to the PPF can be avoided. Instances of claims on the PPF could be reduced – and potentially better outcomes achieved for both pension scheme members and employers – if the regulatory system would better support solutions such as the recent restructuring in relation to the Halcrow Pension Scheme.

37. Being able to provide support to DB schemes and their employers when a scheme is in jeopardy of entering the PPF – and creating a belief amongst employers that TPR can help – could provide great value in protecting the PPF, employers and their members. This would require TPR to be better equipped to be fast-moving and decisive in order to get solutions in place quickly, as well as ensuring that measures put in place are not exploited by unscrupulous employers.

38. Reducing the level of guarantees associated with future service benefits may also help schemes stay out of the PPF. For example, there may be scope for the powers of Section 67 to be reduced in some way for benefits accrued beyond a future date.

39. One possibility may be that only those accruing benefits that would be covered by PPF compensation are guaranteed in the same way that Section 67 currently requires, with a lower level of protection applying for the remainder of these benefits. In practice, the current legislative regime only provides protection of benefits to members of pension schemes above PPF compensation levels whilst their sponsoring employer remains solvent, so this area seems to warrant further exploration.

40. Alternatively, benefits above a certain level accrued in the future could be provided on a discretionary basis, as was often done with pension increases in the past, with the element of benefits guaranteed being suitably aligned with PPF compensation.

41. If a lower level of guarantees, provided on a top slice of benefits, could be structured in a way to allow a relaxation of how this element of liabilities are dealt with for accounting and scheme funding benefits, this could give further merit to such an approach.

There needs to be fair distribution of PPF levies amongst employers

42. As well as ensuring that the PPF is truly a last resort for pension schemes, where alternative rescue forms are not possible, it is important that the funding of the PPF by levy payers is fairly distributed.

43. RPTCL has previously responded to PPF consultations about PPF levies. In particular, concerns have been raised about the lack of an allowance within the PPF levy framework for the fact that no risk is posed to the PPF by railway employers such as the Train Operating Companies (TOCs), due to the nature of their franchise arrangements with the government. These concerns remain and the current approach is detrimental to both the TOCs themselves and members within their sections of the RPS, due to the shared cost nature of the scheme. There is also a knock-on impact on the Department for Transport, and costs to the taxpayer and travelling public, because these employers’ sections of the RPS are required to pay c.£25m p.a. for insurance they will never draw on. These sections have around 50,000 active members, so the PPF levy equates to c.£500 per member per year.

44. With most UK companies offering DC provision for an increasing percentage of their workforce, but a need to keep DB sections open to new entrants for TOCs as part of franchising requirements, we fear that the RPS will be paying an increasing percentage of PPF levies over time. Ultimately the RPS could be picking up most of the costs of failed DB employers/schemes, once few DB schemes are left to do this.
45. We hope the Inquiry will address this inequality. We would be happy to provide copies of previous consultation responses provided to the PPF on their levy framework structure in order to give further information on this important issue.

Advisers, professional bodies and regulations need to act holistically

46. Although it may fall outside the remit of the Inquiry, we believe that the roles of the various professional advisers who play a part in DB pension provision should also be reviewed in addition to the overall regulatory regime. We expect that many professional bodies will provide submissions to the Inquiry.

47. As part of the Inquiry, it would be worthwhile to get together representatives of various stakeholders, to consider a collaborative approach to how the DB framework should best operate to achieve an optimal outcome in terms of sustainable DB pensions. As it stands, stakeholders and professional bodies may operate appropriately and professionally within the parameters they are given. However, the combined impact is not always considered. For example, approaches to company accounting can drive actuarial funding and investment strategy approaches, but they are not necessarily considered holistically at the outset.

48. We hope this response is useful to the Inquiry and we would welcome the opportunity to provide oral evidence to elaborate on any of the points, if requested.

Yours faithfully

John Chilman
Chairman
RPTCL

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