Written evidence from First Actuarial (PPF0068)

ABOUT FIRST ACTUARIAL

First Actuarial is a consultancy providing pension scheme administration, actuarial and consultancy services to a wide range of clients across the UK. We advise a mixture of open and closed defined benefit schemes with our clients concentrated in the smaller end of the pension scheme market. Our clients range across a number of sectors including manufacturing, financial services, not for profit organisations and those providing services previously in the public sector.

Following its report on BHS, the Work and Pensions Committee invites written submissions on defined benefit pension funds.

- Inquiry: Pension Protection Fund and Pensions Regulator
- Work and Pensions Committee

Call for written submissions

The Committee invites written submissions addressing one or more of the following issues.

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

- the adequacy of regulatory powers, including anti-avoidance provisions

In our view legislation does provide the Regulator with sufficient powers, from issuing warning notices, imposing a schedule of contributions, issuing financial support directions and contribution notices. However, from an observer’s point of view, looking at the section 89 determinations published by the Regulator, the process for implementing any power has been very lengthy and no doubt incurred significant costs for the Pensions Regulator and the parties involved, with apparently limited success.

We understand that TPR is investigating whether they would have the grounds to use their anti-avoidance powers in relation to the BHS pension scheme. However, it would be worth considering whether other steps could have been taken sooner. The BHS pension scheme seems to have been starved of funds, but more fundamentally, the BHS business was not given the investment it needed to give it a future. On the contrary, BHS had money withdrawn from it.

It is unfair on PPF levy payers if the BHS pension scheme is not prudently funded on entry to the PPF. TPR has powers to impose a schedule of contributions. TPR needs to be alert to situations arising where the exercise of those powers would be appropriate, and act in a timely manner. Could or should TPR have used these powers in the BHS situation? The time for TPR to act is in the years before the BHS insolvency event, not in the months after it.

Large dividends were withdrawn from BHS in the early 2000s, prior to the coming into existence of TPR in 2005 and the “moral hazard” provisions contained in the Pensions Act 2004. Perhaps a lot of the damage had been done by 2005, but it is not clear what the TPR did between 2005 and BHS’s insolvency to identify whether the BHS situation warranted its intervention.

But the cause of entry of the BHS pension scheme into the PPF is the insolvency of BHS. If BHS had not become insolvent, the BHS pension scheme would be obliged to pay its benefits in full and BHS would be obliged to provide the resources to the scheme for it to be
able to do so (whether by paying the benefits in full from an ongoing scheme, or by insuring the benefits in full upon a voluntary scheme wind up). The only way in which an employer can “avoid” its pension responsibilities is for the employer itself to be dead, which is not really avoidance.

The issue at the heart of BHS seems to be mainly one of corporate governance, the withdrawal of money from a business and lack of investment leading to business failure.

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

It is perhaps surprising that TPR has never imposed a schedule of contributions on a continuing scheme. Has there really been no situation in the last 11 years in which that would have been an appropriate course of action? On the other hand, we cannot know how many times TPR has come close to imposing a schedule of contributions only for the trustees and employer to reach an agreement at the last minute, neither do we know in how many of those situations TPR’s intervention helped to stimulate the agreement.

- **the level and prioritisation of resources**

We would question whether TPR sets appropriate priorities in its work. The BHS situation was many years in the making. Did TPR identify BHS as a problem case and apply its weight and powers to the raising of the funding level in the BHS pension scheme?

The legislation places responsibility for decision making on funding in the hands of trustees and, if the trust deed gives power to the employer in contribution setting, the employer. It is not TPR’s role to embed itself in the decision making process. The role given to TPR is a right of review after the decisions have been made and a right to make impositions if decisions have not been made appropriately.

In recent years, TPR has engaged with the largest schemes and has sought to participate in the funding decision making processes. However, this is not its statutory role. TPR should trust that, in general, trustees and employers will, between them, make the best decisions they can, and leave them to it.

TPR should get involved in cases where either the trustees or the employer approaches TPR for assistance. TPR should also examine its database and make inquiries of schemes (of any size) with weak or weakening funding plans.

In getting involved, TPR should not start from the premise that “the trustees are always right”. It is quite possible that an employer needs assistance and support against excessive demands from trustees, we have seen this happen. TPR should not start from the premise that more funding is always better: the legislation requires prudent funding of an ongoing scheme. Legislation does not require “buy-out” or “self-sufficiency-in-gilts” funding. The existence of the PPF covers employer insolvency risk, there is no need for funding on a “buy-out” or “self-sufficiency-in-gilts” basis.

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

Schemes are for trustees and employers to run, not TPR. TPR cannot conceivably run all pension schemes. TPR does not need to get more involved in the supervision and pro-active regulation of all schemes. Rather, it should concentrate on doing good where its powers are needed.

The schemes in which TPR needs to intervene are the schemes which have a funding problem which the employer is able to address but is refusing to do so. TPR can use its
powers to impose a suitable schedule of contributions if the employer does not see sense and agree a suitable contributions soon after TPR has got involved.

TPR does not need to get involved with schemes which are prudently funded, or which have a technical provisions shortfall but the employer has agreed a suitable schedule of contributions.

TPR need not necessarily get involved with a stressed scheme where the schedule of contributions is inadequate, if the employer is already paying all it reasonably can. Such an employer is not shirking its duty to contribute. TPR’s role in such schemes might be in easing (note, not blocking) the path of the scheme into the PPF, leaving a viable employer in business and providing employment.

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

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

- powers relating to scheme recovery plans

If TPR made greater use of its powers to impose a schedule of contributions on a continuing pension scheme, to ensure prudent funding subject to the constraints of allowing the sustainable growth of the employer, what happened later to the employer as regards its ownership, growth or contraction would matter rather less.

As stated earlier, we cannot know how many times TPR has come close to imposing a schedule of contributions only for the trustees and employer to reach an agreement at the last minute, neither do we know in how many of those situations TPR’s intervention helped to stimulate the agreement. It is perhaps surprising that TPR has never imposed a schedule of contributions on a continuing scheme. The appearance is that TPR has not been ready enough to use these powers, but we cannot be sure on this point.

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

The Pension Protection Fund (PPF), including:

- the sustainability of the Pension Protection Fund

We have confidence in the future sustainability of the PPF.

The PPF must not seek a greater funding level than exists outside the PPF otherwise it risks draining schemes with its levies. If schemes are prudently funded for full benefits, then the PPF should be able to cope with similar funding for its reduced compensation.

If the PPF tries to fund itself at a higher level than exists outside the PPF, it risks setting up a vicious circle in which the more schemes join the PPF, the more the PPF raises levies. The more the PPF raises levies which are loaded onto the weakest schemes of the weakest employers (see next item), the more employers are driven into insolvency by their schemes and more schemes join the PPF.
The best protection for the PPF is a continuing pool of DB schemes which are open to new entrants. We argue later in this response that a mind set focussed on future DB pension provision would be good for the industry, for inter-generational fairness, and for productive investment by pension schemes in the economy. It would also be good for the sustainability of the PPF.

- the fairness of the PPF levy system and its impact on businesses and scheme members

The creation of the PPF was a great step by the Government. It means that DB pension schemes are no longer an island unto themselves, cut off from any help if their sponsoring employer goes into insolvency. Since the PPF started, employer insolvency risk has been collectivised in the PPF. Members’ benefits are either provided collectively in a scheme sponsored by their employer, or they are provided collectively in a scheme sponsored by all other employers i.e. the PPF.

Efficient pensions are collectively provided. An individual may provide for himself with a personal pension. But personal pensions are costly to administer, provide highly variable outcomes because there is no sharing of risk prior to and at retirement, and can only deal with longevity risk in retirement by insurance, which is expensive.

It is (or should be) be better if the individual has access to an occupational pension scheme. Rather than many individuals each with their own personal pension with unpoled risks pre-retirement and expensively insured risk after retirement, the risks can be pooled in an occupational scheme, and spread over time and spread over many people. The need for inefficient insurance is avoided.

An occupational pension scheme depends upon the existence of sponsor(s), and most have only one sponsor or one group of companies (with a risk of failing together) as sponsor. This is a big risk, one which has been dealt with by collectivisation of sponsor failure risk through the PPF. The necessity to inefficiently insure a pension scheme after sponsor failure is avoided.

It is (or should be) cheaper for employers to fund an occupational pension scheme on a prudent ongoing basis and to pay levies as required to the PPF, than to fund the scheme on a cost-to-insure basis (or to fund on a bond matching basis, which is a near equivalent to the cost to insure). The levies to the PPF are (or should be) a small price to pay for the avoidance of insurance or bond matching funding.

To conclude, efficient pension provision is collectively provided: many individuals in one scheme, and many sponsors supporting the PPF for those schemes whose sponsors have failed.

The PPF levy is not a burden on employers when compared to the cost of funding a scheme to “buy-out” or “self-sufficiency-in-gilts” levels if the PPF did not exist.

The drive in the industry, perhaps encouraged by TPR, to improve scheme funding towards “buy-out” or “self-sufficiency-in-gilts” levels is unnecessary and inappropriate for many employers since the creation of the PPF. The PPF provides cost efficient collectivisation of employer insolvency risk.

Trustees have been told by TPR that they are not allowed to take PPF protection into account when managing the scheme. This may result in schemes pursuing a lower risk and higher cost investment strategy than would otherwise be the case. But the PPF does exist,
and it provides an extremely valuable function of collectivising employer insolvency risk. It is absurd to pretend that the PPF does not exist.

Having commented on the PPF levy in general, and how it is not a burden on employers in aggregate, we do need to criticise the way the burden of the levy falls excessively hard on the weakest schemes sponsored by the weakest employers.

Loading the PPF levy onto the weakest schemes and the weakest employers risks unsustainability. The highest rate of levy is too high, at 0.75% of S179 liabilities pa. This equates to around 15% of the liabilities to be paid in levies, and more in expenses, before a penny is paid off any deficit. It is an intolerable burden on weak schemes and employers. The maximum rate of levy needs to be much lower and the levy more evenly spread, for the PPF system to be sustainable. It would be disastrous if the levy burden results in the weakest schemes entering the PPF, only for the next weakest schemes to be burdened with an excessive levy and for those to go into the PPF, and so on in a vicious downward spiral.

**The role and powers of pension scheme trustees**

In the answer to the next question, we talk about the importance of the sponsoring employer being close to the running of its pension scheme. A lack of awareness of its pension scheme amongst senior employer management is dangerous for the scheme: the scheme’s needs might be ignored by the employer, alternatively, what is unknown is feared and what is feared is axed.

For an employer to volunteer for the large financial commitment of DB scheme sponsorship, it is important for the employer to be able to manage its commitment. If it cannot, it will withdraw from the commitment, or not make it in the first place.

Whatever the committee decides on the role and powers of pension scheme trustees, if there is to be a future for DB schemes, it is vital that employers are able to manage their DB commitments. Employers must not be (further) discouraged from DB scheme sponsorship, and employers must not be driven away from close engagement with their schemes. Trustees must not be set up in opposition to employers.

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

This is a very wide ranging question.

We feel that employers should be more involved in scheme funding and investment decisions. We have advised many employers who are at their wits end with the cost of their pension scheme, who have appointed us to assist them in the latest valuation funding negotiations. Often, we are left feeling that the employer has suffered because it has not engaged closely enough with the management of the scheme in the past. The employer has left the scheme to the trustees to manage, who without sufficient objection from the employer, proceeded to raise the funding target and to invest more cautiously. More cautious investment may have been explained to the employer as “stabilising the balance sheet” which the employer interprets as meaning “reducing the risk of higher contributions” but of course, earning less on the investments guarantees the need for higher contributions.

We think that TPR has perhaps been over-zealous in criticising the appointment of trustees who have a potential conflict of interest because of their position at the employer. It is important that the employer is closely involved with its pension scheme. The employer is making a big financial commitment, it needs to be able to manage its commitment. If an employer does not feel in control of its commitment, it will withdraw from making it. We have
seen this over the past 20 years: employers do not feel in control of the rising costs of their DB schemes, so they withdraw from offering DB to new recruits then existing employees too.

We would criticise some employers for failing to engage. When introduced the current scheme funding regime brought about an environment in which trustees and employers were expected to act as if they are parties in opposition. This is most unhelpful. Rather, the trustees and employers are parties who should act in co-operation. The employer has promised a pension, the trustees’ job is to provide it, they are engaged in a joint endeavour of delivering the promised pension.

It is pleasing to see that, in TPR’s publication on Integrated Risk Management, TPR is encouraging trustees and employers to work together. In paragraph 18, TPR wrote, “IRM works best when the trustees and employer work together. Their interests are often aligned such as with their mutual interest in sustainable growth of the employer. IRM helps the trustees and employer to understand each other’s risk capacities and appetites.”

There are examples of where TPR, the PPF and employers have worked together to provide the optimum outcome in the circumstances for both scheme members, levy payers, the employers and their employees.


TPR perhaps puts too much effort into seeking to influence but not enough into exercising its powers. TPR should not seek to be involved in the normal valuation processes of pension schemes. It should trust that trustees and employers will implement a solution within the requirements of the law. But we have seen occasions when either the trustees or the employer have needed to approach the TPR for support in a funding negotiation, only to find the TPR positively avoids giving an opinion which might help to resolve the difficulties. TPR’s default positions are to “take more advice” (which cannot alter the difficulty of the situation in dispute) and to support the trustees’ position, which does not help when it is the trustees (or the trustees’ advisers) who are being unreasonable. We have experience of TPR calling meetings at which TPR’s representatives do not appear to have studied the papers sent to TPR beforehand and consequently they are not in a position to adjudicate. TPR needs to actually engage with a case before it, to understand it and form a balanced opinion and then positively help the trustees and employer move towards the best available solution in the circumstances.

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

- TPR's objective to "minimise any adverse impact on the sustainable growth of an employer"

TPR prioritises the protection of accrued benefits above the provision of future benefit accrual. This is not a helpful approach. It leads to more resources being poured into DB schemes to raise the funding level for accrued benefits, at the expense of cuts in spending by employers on the provision of pensions for future service.

The Government observed the growing problems for employers and introduced the new objective for TPR quoted in this question, in a bid to require TPR to be less defensive. Government wishes a balanced view to be taken of DB pensions. It would like private sector employees to have pensions, but it would not like the burden of pension sponsorship to suffocate employers. The drive in the pension industry to set ever lower discount rates which raise the funding target, and to invest in assets of low expected return, which raises
the balance of cost to be paid by the employer, has resulted in funding and investment strategies which no sane employer would voluntarily adopt were it to introduce a new scheme.

We propose a new objective on TPR on the lines of “to promote the increase in the number of DB schemes which are open to new entrants, and to promote the increase in the active membership of private sector DB schemes”.

Were the industry to focus on the design, funding, investment and management of DB schemes which are suitable for the provision of future benefit accrual and which employers are willing to volunteer to sponsor, then efficient, sustainable schemes would emerge. We would then find that the cost of providing accrued benefits is not as severe as some commentators imagine it to be.

What would be the characteristics of such a scheme? It would be invested in assets of good expected return. It is not in the interests of the employer and employees for a scheme to be inefficiently invested: it puts the cost up for the employer and reduces the benefits for the employees. It would be prudently funded using an actuarial valuation which compares the expected income from the assets with outgo on the benefits. Gilt yields do not indicate the return on non-gilt assets, they should be dropped by the industry and TPR as the main driver of the valuation discount rate. Benefits may include a discretionary element, typically the annual increases, in order that the benefits payable may be adjusted to match the assets.

If we focus on what an efficient scheme for future service benefit provision looks like, we can then apply the lessons to the management of accrued liabilities. We could see that investing unproductively only makes things worse. We could see how to do our actuarial valuations better by basing the discount rate on prudent income expectations from productive investments. In current market conditions, we would find that providing for past benefits is quite manageable, if only we avoid investments which earn as little as gilts and avoid using gilt yields as a basis for the discount rate.

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

TPR prioritises the protection of accrued benefits above the provision of future benefit accrual. This is not a helpful approach. More resources are being poured into DB schemes to raise the funding level for accrued benefits, at the expense of cuts in spending by employers on the provision of pensions for future service. This is generating inter-generationally unfair outcomes.

One can argue that the present situation of fewer than 1m active members in private sector DB schemes which are open to new entrants and low quality replacement DC schemes is inter-generationally unfair. However, we cannot pin the blame for this on the legislative framework. Sustainable DB and hybrid schemes are possible within the existing legal framework. That such schemes have, by and large, not been developed is due to:

- the lack of imagination of advisers and employers who are unwilling to recommend and implement anything other than a switch to DC.

- the excessive funding targets and excessively cautious investment strategies being set for DB schemes are discouraging employers from DB. More sustainable approaches to DB are going unconsidered.

- the fear that future legislative change will increase the burden on employers who offer such a scheme
In the previous section, we proposed a new objective on TPR on the lines of “to promote the increase in the number of DB schemes which are open to new entrants, and to promote the increase in the active membership of private sector DB schemes”.

We argue that the industry and TPR needs to switch its attention from the past to the future. We need to design and manage schemes which employers would volunteer to sponsor for future service. If we do this, then we will see how to manage accrued liabilities efficiently.

- whether the current wider environment, including very low interest rates, warrants an exceptional approach

**Scheme funding**

The current wider environment, including very low interest rates, warrants a *better* approach in which DB schemes are productively invested and ongoing valuation discount rate is based on prudent expectations of the income from the assets. We have a double problem of a) valuation discount rates being based on gilt yields, despite gilt yields not being indicative of the income receivable from non-gilts, and b) investment strategies involving increasing amounts of gilts, corporates and LDI, because the discount rate is based on gilt yields.

The better approach of basing the valuation discount rate on prudent expectations of the income from the assets is explicitly available in the funding regulations. No new regulation is required, and no exceptions need to be made.

Perversely, the fear of the risk of higher contributions if growth assets do not perform has led to increasing investment in assets of low expected return, which guarantees a higher contribution requirement. Making an increase in contributions certain is not risk avoidance, it is risk crystallisation.

**Company accounting for pensions**

An area where the current low interest environment is causing concern is the accounting treatment of defined benefit pension schemes. This measure does not provide a realistic view of the funding requirements that employers may have to meet (unless the scheme is invested 100% in corporate bonds). However, deficits on this notional measure, are likely to have an adverse impact on an employer’s balance sheet, dividend policy, banking covenants etc. This is bad news for UK plc.

The approach required by IFRS and UK GAAP is to discount a best estimate set of future benefit cashflows using the yield on high quality corporate bonds. Such yields are currently around 2.0%. For many schemes this does not reflect the expected investment income. Many pension schemes hold equities for whom the dividend yield is around 3.5% pa and the internal rate of return on equities will be between 6% to 8%, depending on views of changes in future levels of dividend.

An urgent review of the accounting standard is required.

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