Summary

1.1 The Trades Union Congress (TUC) represents nearly six million members organised in more than 50 unions. We are the leading representative consumer voice on pension policy issues. We also operate a network of pension scheme trustees.

1.2 We welcome the opportunity to contribute to this much-needed debate about the future of workplace pensions. Too often discussions about pensions, and defined benefit pensions in particular, are conducted in apocalyptic terms. It is time for a more reasoned discussion about the future of workplace retirement savings over the long-term that pays full regard to the need of today’s workers to make provision for their later years.

1.3 For a range of reasons, including labour market changes and poor political and regulatory decisions, the provision of Defined Benefit (DB) pensions has declined markedly since the 1980s. But DB pension saving remains at the centre of UK retirement provision. In 2015, occupational DB schemes represented 45 per cent of total workplace pension membership. Currently, more than 11 million people are receiving, or will in time receive, benefits from a private sector DB pension scheme and DB pension schemes oversee some £1.3 trillion of assets. Workers with DB pensions place high value on this element of their remuneration.

1.4 This legacy of high quality pension provision was taken into account by the Pensions Commission, whose proposals led to the introduction of automatic enrolment. It predicted a rise in non-state pension income as a percentage of GDP until 2035.\(^1\) The existence of these substantial DB pensions assets means that auto-enrolment has time to bed in and for savings to build up to meaningful levels.

1.5 It is therefore vital to avoid prompting further decline in DB provision in the UK or undermining trust in workplace pensions. Turning on its head the longstanding protection of pension rights in allowing employers to change benefits already accrued by workers is the wrong approach.

1.6 In particular, it would be a mistake to lose the many benefits of collective provision, embodied in the DB approach, from our pensions system at a time when the challenging economic and investment backdrop means that every avenue for improved efficiency in workplace pensions should be explored.

1.7 The TUC believes the committee’s deliberations should have regard to the following points:

- DB pensions play a key role in the retirement provision of millions of workers.
- The future of DB pensions should be considered in the context of the goal of pensions adequacy. The over-riding aim of pensions policy should be to give workers the opportunity to achieve a decent standard of living in their later years.
- The regulatory and policy approach to DB pensions should be framed in the knowledge that pension liabilities arise over decades.
- The assets held by pension schemes have the potential to work harder in the UK’s wider economic interests.
- Pension regulation should not be used to deal with shortcomings in corporate governance.

We expand on each of these points further below.

Adequacy

2.1 The overriding aim of pensions policy across both workplace pensions and state provision should be to allow people to build sufficient savings to provide for a good standard of living in their later years. Our understanding of pensions adequacy in the UK is still underdeveloped and we tend to rely on a crude system of replacement rates. We have little sophisticated understanding about where current levels and methods of saving and decumulation will leave future pensioners.

2.2 However, the evidence we do have on adequacy is worrying. Coverage of workplace pensions is increasing after a long period of decline but there are substantial gaps. Data from the Annual Survey of Hours and Earnings published by the Office for National Statistics shows that workplace pension scheme membership increased to 59 per cent of workers in 2014. In 2014 there was an increase in pension membership in every earnings band for full time employees in the private sector. But millions continue to miss out, including the 4.6 million who earn less than the £10,000 qualifying trigger for auto-enrolment. Of these three-quarters are women, who make up the bulk of Britain’s army of part-time workers.

2.3 Contribution rates are inadequate to give savers a good chance of decent standard of living in old age. There is a huge gap between DB and DC schemes. The average total contribution rate (employee plus employer contributions) for private sector DB occupational pension schemes is 20.6 per cent, while for DC schemes it is just 9.1 per cent. And the trend is heading the wrong direction. The proportion of active members of occupational defined contribution pensions with employer contribution rates of less than four per cent increased from 22 per cent in 2013 to nearly 69 per cent in 2014.

2.4 This shows that the current funding for DC schemes, the usual form established in place of DB schemes or by employers who previously made no provision, is very likely to be inadequate to provide for a good standard of living. This is reflected in Department for Work and Pensions analysis which has found that, thanks to auto-enrolment, the number of people undersaving for retirement has fallen from 12.2 million to 11.9 million, a fairly modest drop. The Department for Work and Pensions should consider these factors, including taking into account trends in DB pensions, when it undertakes its review of automatic enrolment due in 2017.

2.5 There is also a growing body of work showing that savers are incurring unreasonable costs in saving for retirement, which further hinders adequate saving. The cross-industry Transparency Task Force (TTF) has identified more than 300 lines of costs and charges on investments and pension schemes, including administration, investment and risk management fees, client communication, legal, governance, regulation, compliance and intermediary fees. These are inflating the costs of providing DB pensions, making it more likely that schemes will close, and reducing even further the ability of DC savers to generate funds for a good standard of living in retirement. Moves to improved scale and cost control are being undertaken in other jurisdictions, notably the Netherlands, Australia and Canada. The need for greater transparency and greater scale are issues which cross both DC and DB but which require leadership by policymakers.

2.6 Savers contributing to pensions do so in the expectation that it will give them a reasonable level of income in retirement. On current trends, it appears millions will be frustrated in that aim. There is therefore a need to consider how best to encourage adequate provision, the most efficient way of providing this, and the appropriate balance of risk between workers and employers.
2.7 There is an urgent requirement for a major modelling exercise designed to show the likely retirement income and replacement ratios that current workers are likely to achieve following the introduction of the new state pension, changes in the labour market developments and current auto-enrolment contribution levels and patterns. This could then form the basis for a long-term plan for the development of workplace pensions, including the role of DB pensions. The Pensions Commission showed the value of building an evidence-based consensus in facilitating sustainable reform.

The DB challenge

3.1 There are several challenges facing pension schemes. These include rising life spans, subdued investment markets and low interest rates. Other factors contributing to the current situation include past management of schemes when they had funding surpluses, which saw employer contribution holidays and employer use of surpluses for industrial restructuring that have also placed strain on scheme resources. This provides a reminder that the challenges facing DB schemes do not relate exclusively to the generosity of benefits promised to members. It also demonstrates the need for schemes to be managed with a view to their long term interests.

3.2 Low gilt yields are the most important of these factors in hampering scheme funding. Quantitative easing following the financial crisis of 2007/2008 has played a role in greatly reducing gilt yields. However, it is important to remember that the role played by gilts in pension valuation is a function of the perversity introduced into the system by the current approach to pension regulation in this area.

3.3 Scheme funding legislation quite correctly codifies the long-running approach that an efficient method of funding DB pension schemes is below the level necessary to facilitate its buy-out by an insurance company, combined with an employer covenant. The creation of the Pension Protection Fund ensures that workers whose employers become insolvent receive a substantial proportion of their expected pension on retirement.

3.4 However, present valuations of pension liabilities continue to increase as an (artificial) function of the yield on gilts. Depression of this yield has resulted in ever-increasing deficits. We therefore have the situation where the collective deficits in those 6,000 schemes rose by £100 billion in just one month to stand at £710 billion at the end of August, according to accountant PwC. Yet, with the expected return on gilts and UK equities having widened, a gilt-based approach is a poor predictor of investment returns. And the funding calculation it produces certainly provides little reflection of the ability of a scheme and its sponsor to pay the pensions of members. We suggest that the committee seek expert opinion on the role discount rates and gilt yields have played in current funding issues, the consequent impact on pension scheme funding and the businesses that sponsor these schemes, and the relative contribution this has made to deficits.

3.5 It is important to note that excessively conservative funding requirements carry risk. They can place an excessive burden on sponsors and contributing members. As bond yields fall, a scheme’s funding position weakens and actuaries and investment consultants encourage the scheme to de-risk by increasing investments in bonds and liability-driven investments. By moving to investments of lower expected return, the money required from contributions rises, to meet the benefit payments not met by the investments. This brings with it the danger that more schemes are closed or that pension

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2 See, for example, Rentokil Initial which took a long pensions contribution holiday until 2004 and then closed its scheme in 2005.

funding requirements draw resources away from investment in businesses, placing pressure on jobs and wages.

3.6 There certainly should not be a further tightening of schemes’ funding requirements. If DB schemes were obliged to be funded at levels sufficient for a buy-out by an insurance company, they would become so expensive to provide that there could be no schemes left in the private sector. This is not an efficient system of pension funding.

3.7 The requirement on the Pensions Regulator “to minimise any adverse impact on the sustainable growth of an employer” is welcome and should be maintained. It is important that businesses facing significant deficit funding requirements continue to invest in company growth, while protecting members’ pension benefits.

3.8 The liabilities that schemes face arise over decades and can be managed by solvent, responsible employers. Trade unions already work closely with many employers to help them understand and manage their DB pension obligations.

3.9 If a more realistic approach to valuations was taken, then corporate Britain has resources to handle long-term scheme funding. We note recent figures from the Pensions Regulator that found that, even under the current regime, the ratio of deficit recovery contributions to dividends has declined over the last five years. For FTSE-350 companies, the median fell from around 17 per cent in 2010 to less than 10 per cent in the latest data, meaning more than half of FTSE-350 companies paid out ten times or more to shareholders than to their scheme. This suggests that many sponsors have more room for manoeuvre in meeting their pension promises over the long term.

3.10 We therefore believe there is little case for addressing issues around valuation by making it easier for companies to break their pension promise and eroding the value of deferred pay by changing accrued benefits. This includes the often mooted plan of allowing sponsors to change annual inflation increases paid on accrued benefits, which would represent a significant reduction in the real level of pension payments received by members.

3.11 The flexibility on benefits already given to schemes should be acknowledged. Section 67 of the Pensions Act 1995 provides that pension promises cannot be changed retrospectively. But it does provide mechanisms that will allow changes with member consent. Many sponsors and schemes have run Pension Increase Exchange exercises, in which schemes offer members higher initial payments but lower uprating in order to minimise their exposure to inflation-linked rises.

3.12 There is certainly no case for seeking to improve conditions for DB schemes by cutting member benefits while leaving other stakeholders, such as shareholders and creditors, untouched.

3.13 It should be noted that the same challenges of rising life spans and muted investment returns also affect savers in DC pension schemes. However, in their case such burdens fall solely on the shoulders of the individual. And it is by no means obvious that savers are equipped to manage those risks.

**Real assets**

4.1 One of the consequences of the current emphasis on a gilt-based discount rate and the regulatory emphasis on eliminating deficits, is to drive schemes towards fixed interest assets and away from return-seeking assets. In the current environment this has the impact of potentially locking in negative real returns, making the funding of schemes more expensive and depriving the real economy of finance.
4.2 Between 2006 and 2015, the equity share of total assets fell from 61.1 per cent to 33 per cent, while the gilt and fixed interest share rose from 28.3 per cent to 47.7 per cent.

4.3 Another way of looking at it is that of £1.3 trillion of defined benefit assets, £428.4 billion is invested in equities, £619.3 billion in gilts and fixed interest and £250.6 billion in other investments. It would be better for those who fund pension schemes (and ultimately for members who draw the benefits) and for the British economy if more assets were put to work seeking a return in productive sectors of the economy.

4.4 It is notable that when it comes to financing British infrastructure, overseas pension funds, operating at scale and with the long-term mind-set to seek real returns, play a key role. Canadian pension schemes own the likes of High Speed One, the railway line that connects London to the Channel Tunnel; Scotia, Scotland's biggest gas network; the ports of Southampton and Grimsby; and Birmingham and Bristol airports.

4.5 To put it in context the £619 billion held by UK pension scheme in fixed-interest assets is the equivalent of 154 Thames Super Sewers or would meet the estimated £18 billion cost of expanding Heathrow Airport 33 times over.

4.6 The committee should seek to examine how pension schemes in other countries developed this appetite for return-seeking assets and diversification while continuing to protect member benefits. This should include the merits of allowing regulators to examine methods for scaling-up defined benefit pension schemes in a similar manner to that being undertaken in the Netherlands and with the Local Government Pension Scheme in the UK.

**Corporate governance**

5.1 One of the challenges of a funding regime that rests in part on the employer covenant is that it assumes certain norms of corporate behaviour. These include a desire to operate a business prudently and for the long-term and with appropriate regard for the interests of all stakeholders, including employees.

5.2 There still appears to be scope for the small minority of unscrupulous company owners to take unreasonably large returns from their businesses while leaving pension schemes in a precarious financial position. The TUC is particularly concerned that there are few restrictions on the owners of privately-held companies, often managed as part of a portfolio of businesses, who seek to extract short-term value at the expense of a firm’s longer-term interests and those of other stakeholders. Likewise, when a privately-held business is sold it is not subject to Takeover Code stipulations requiring a potential new owner to disclose its plans for a target’s DB scheme. This puts workers at greater risk of reduced benefits in retirement if their employer becomes insolvent and their scheme enters into the Pension Protection Fund.

5.3 However, we believe it is very important that we do not attempt to overcome shortcomings in corporate stewardship by unreasonably increasing the regulatory burden on pension schemes, for instance by tightening funding requirements.

**Intergenerational fairness**

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4 “Focus DIY puts private equity in the spotlight”, Financial Times, September 3, 2008; “Regulator to break new ground in EMI pensions struggle,” Financial Times, May 1, 2008
6.1 Issues of intergenerational fairness span issues far wider than DB pensions. The TUC set out its 
views on the issue in its submission to this committee in written evidence which the committee 
published on February 24.

6.2 Since then we have published research highlighting the many challenges facing what we term 
young core workers (21–30, earning low to average wages, not in full-time education), which include 
low pay, low-skilled, low-quality jobs, underemployment and precarious working conditions.5

6.3 But we have yet to come across convincing evidence that the provision of DB pensions, 
typically to older workers, restrains the amount going into DC pensions that might typically be 
provided to newer and therefore younger workers. Indeed, we find that those employers with high 
quality DB schemes very often provide DC contributions of a reasonable size. For example, Royal 
Bank of Scotland offers 15 per cent contributions to staff who are not eligible for its DB schemes and 
Total UK’s Upstream division pays up to 30 per cent contributions to members of its DC scheme.6

6.4 Trade unions have been at the forefront of attempts to ensure that DB schemes remain open for 
the new generation of workers

6.5 There are important examples where this has been a success, sometimes on the back of 
industrial action. At household goods giant Unilever co-ordinated action by several trade unions led to 
a final salary DB scheme being replaced by a career average DB scheme with DC benefits on top. 
Crucially this scheme is Unilever’s auto-enrolment scheme so young workers have access to it. At 
EDF, trade unions recently secured a deal to retain a final salary scheme for existing staff but a new 
career average scheme - with a better accrual rate than the final salary scheme – for new joiners.

6.6 We would like to see workers of all generations provided with access to high quality pension 
schemes that give them a good chance of a decent income in retirement.

6.7 However, we are concerned that excessively conservative funding requirements has the impact 
of restricting wages more generally. The answer to this problem lies not in cutting pension benefits 
but in reforming a regime that places an inappropriate emphasis on the short-term funding of scheme 
liabilities.

Conclusion

7.1 The TUC believes that there is a need for an examination of the workplace pension system’s 
ability to provide adequate retirement income to members.

7.2 With careful stewardship, DB pensions will play a role in meeting the needs of many workers 
over decades to come.

7.3 We believe that any effective action on DB pensions will have to start by considering the way 
their funding needs are determined rather than seeking methods of cutting worker benefits or 
tweaking regulations.

7.4 We would like to see:

• A major modelling exercise to show the likely retirement income and replacement ratios that 
current workers are likely to achieve.

5 Living for the weekend: understanding Britain’s core workers, Trades Union Congress (2016) 
6 Re-energising DC, Pensions Age, October 2014; “Pay shock at RBS in pensions shake-up”, Scotsman, September 4, 2010
- The canvassing of expert opinion on the role that discount rates and gilt yields have played in current funding issues.
- An examination of methods to allow pension schemes better access to return-seeking assets.
- Linked to this, we would like to see a study of means that would allow regulators to build scale in UK pensions.

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