Written evidence from SEI (PPF0070)

SEI’s Response to the Work and Pensions Committee Call for Evidence on Defined Benefit Schemes

SEI welcomes the opportunity to respond to the Work and Pensions Committee’s (WPC) call for evidence for Defined Benefit Schemes. Given SEI’s position as one of the first and largest fiduciary managers and the close partnership we enjoy with our clients, we are uniquely positioned to comment on the issues and challenges raised in this call for evidence.

We support the approach taken by the regulator thus far in its efforts to prevent problems from developing. However, the number of schemes entering the Pensions Protection Fund (PPF) is perhaps an indication that greater efforts are needed to protect member benefits. In general we believe that more prescriptive regulation may assist in surmounting the current shortcomings. Our response focuses on this theme and highlights specific areas for consideration. We have chosen not to comment on every point, but only those where we have identified potential improvements or recommendations.

We look forward to examining the output and subsequent proposals resulting from the call for evidence in due course. In the meantime we would be happy to discuss any of the issues raised in our response.

Work and Pensions Committee issues:

- Defined benefit (DB) pensions regulation by the Pensions Regulator (TPR), including:
  - the adequacy of regulatory powers, including anti-avoidance provisions;
  - the application of those powers, including in specific cases other than BHS;
  - the level and prioritisation of resources;
  - whether a greater emphasis on supervision and pro-active regulation would be appropriate;
  - 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; and
  - the impact of the TPR’s regulatory approach on commercial decision-making and the operation of employers.

SEI response

One of the key challenges facing the UK DB pension scheme system is the often unbalanced relationship between the Trustee board and corporate sponsor. It is clear from several scheme-specific recent events such as the BHS incident that pension schemes could benefit from greater powers to more closely scrutinise their sponsor’s financial position and future
plans. This could take the form of regulation that enforces information sharing at the highest level in a number of different ways:

- The introduction of a more formal protocol for information sharing to ensure the Trustee board is aware of any corporate developments which may affect the employer's ability to fund their scheme. This should include a high level of transparency between the trustees, direct sponsoring employer and any overseas parent.

- Corporate sponsors could also be required to include a representative from the pension scheme on the Company Board should decisions be discussed that may adversely affect the health of the scheme. This could include the need for a positive vote from the pension scheme representative on significant corporate actions such as mergers and acquisitions.

With regards to regulation, it is easy in hindsight to say that more stringent directives in the past (e.g. the introduction of minimum funding requirements, solvency stress tests etc.) may have helped avert the current pension scheme funding difficulties. However, it is less clear as to whether stricter funding regulations today would be beneficial given the potential impact on sponsors (who are already struggling with pension funding) and current employees. It should also be noted that corporate failure is an inherent consequence of capitalism so regulation should aim to lessen the social impact of failures.

However, on balance we favour a more interventionist approach backed up by enhanced powers for the TPR to take action before a scheme reaches potential entry into the PPF. This may help stem the currently high flow of schemes going into the PPF at the expense of well-managed schemes which seems particularly unfair, where default comes as a result of excessive risk taking. Such measures could include:

- Regular solvency-based tests with TPR powers to intervene in the investment strategy where appropriate.

- Less subjectivity in discount rate setting with perhaps the TPR offering a choice of a fixed number of discount rates (or discount rate models) based on asset allocation along with autonomy to adjust the discount rate where it is deemed unsatisfactory or not sufficiently justified by the scheme strategy.

- Less subjectivity around recovery plan horizons, again with potential for the TPR to offer a choice around horizon (to be justified by the scheme).

- More frequent valuations of pension schemes. The current three year valuation cycle can allow potential scheme level (non-covenant related) threats to go unnoticed until it is too late. A regime where schemes must proxy their valuation position at regular intervals, be alerted to negative funding events (potentially at levels pre-set by the TRP) and account for their actions may foster a better approach to risk management.

In terms of whether specific additional measures for private companies or companies with complex and multi-national group structures are required, we are able to mine our unique vantage point. SEI has extensive experience of working as a strategic partner to UK DB schemes with overseas parents. As such we have witnessed first-hand how difficult it can be for UK schemes to (i) access corporate group level information which may impact their UK
obtain items such as guarantees from parent companies. Our experience leads us to the following suggestions and conclusions:

- Where a UK DB scheme represents a material risk (‘material’ perhaps to be defined versus the UK sponsor balance sheet) to the UK sponsoring company, rigorous safeguards should be in place before permitting an overseas acquisition of the company including:
  
  o a pension scheme funding guarantee (to fund the Scheme to a predefined level) between the overseas parent, UK sponsor and Scheme (to provide for funding based on a material diminution in UK sponsor covenant).
  
  o a formal information sharing protocol being signed between the scheme, UK sponsor and overseas parent to provide a high level of transparency on the UK sponsor’s business plans and forecasts and some form of transparency on matters which can materially affect the wider group covenant.

- We think that any form of preclearance for transactions surrounding the disposal of companies should attempt to accurately capture any material diminution in the covenant as a result of other corporate activities such as outsourcing key functions to other group companies. We have witnessed for instance the case of a US sponsor transferring key operational duties away from a UK corporate to a European territory causing a potential weakening of the UK sponsor without further guarantees from the US parent. This was combined with a poor information sharing protocol and between the UK sponsor, US parent and UK scheme.

Work and Pensions Committee issue:

  o Whether the current wider environment, including very low interest rates, warrants an exceptional approach

SEI response

This depends on one’s views of low interest rates and whether they reflect lower long term asset returns across the majority of asset classes, i.e. do they create a long term pension funding problem which should be reflected in valuations today? The answer is of course specific to each scheme. We believe it does materially impact returns in fixed income assets and to a lesser extent expectations in other asset classes such as equities.

However, there is a misconception in the market that current regulations force schemes to link their discount rates to gilts. In practice they are flexible enough to allow schemes to link their discount rate to other instruments and their expected long term asset returns. For example, we are currently working with a pension scheme that is focusing on an evidenced based approach to demonstrating that long term income yields and capital growth primarily from equities will be sufficient to meet long term asset return requirements (while building in prudence). On this basis we do not favour any manipulation of gilt based (or risk free) discount rates from the TPR as we think the regulations allow for a considered and prudent adjustment to discounting that is scheme specific.
Part of the blame for the significant number of schemes linking discount rates to gilts can be apportioned to the UK Consultant community who have not adequately demonstrated to schemes that the regulation is flexible and can be interpreted differently. This issue has been compounded by the dominance of the Big Four Actuarial Consulting firms and the resulting herding of ideas (effectively constituting converging house-views). As many schemes reference gilts in the discount rates, so schemes have been encouraged to invest in gilts (and LDI / leverage) to mitigate risks that are, arguably, in part an artificial construct.

We suggest a two-pronged approach to address the issue of low interest rates:

- Issue guidance to remind schemes that the regulation does provide flexibility to use different discount rate methodologies.

- Schemes use the newfound flexibilities to wisely review the way that liabilities are valued.

In cases where Schemes elect to use a different methodology (which may increase the discount rate) it may also be prudent to add some form of cost (above any increase in PPF levy) to account for the cost of risk taking. UK insurers must tie up greater amounts of capital to back a business if they take market risk on investments. This concept could be applied in some form to pensions. At present, taking equity risk is often considered a ‘free lunch’ and may even encourage corporate sponsors to underfund pension deficits. Accordingly, perhaps regulation could link contributions with the quantum of equity risk taken i.e. if Schemes take more equity risk then the sponsor should increase the level of contributions to explicitly support the risk taken. Further, codifying the ability for sponsors to recoup any resulting ‘trapped’ surplus may make this suggestion more equitable.

Should the TPR look to adjust the way liabilities are valued, there are many models which could be considered e.g. simply prescribing increased discount rates by asset class, prescribing higher gilt (or risk-free) rates for actuaries to embed in their models, or a longer term averaging of return expectations (with less emphasis on the recent low yield environment). As stated above, we believe the current regulations do allow flexibility but most schemes simply do not employ this and only if the regulator cannot encourage schemes to approach discounting differently should a more drastic manipulation of discount rates be considered. Perhaps enhanced guidance on interpretation of discount rate regulation could be issued to illustrate distinct discount rate models. The discount rate does not need to be prescriptive by asset class but rather schemes may benefit from clarity on the range of assumptions that are possible given the TPR’s views.

**Work and Pensions Committee issue:**

- The sustainability of the Pension Protection Fund

**SEI response**

Overall we believe that the PPF should be retained as it enhances protection for pension schemes. However, the volume of schemes that have entered the PPF demonstrates that more needs to be done (notwithstanding that some businesses will always fail creating potential pension funding problems, we consider that some schemes have ended up in the PPF through mismanagement of pension strategy). Toward that end, we have made suggestions in our response for your consideration and would welcome the opportunity to discuss these further.
Overall, we believe the problems are related principally to the manner in which schemes are currently funded and past and current regulation rather than the PPF itself.

However, that some schemes may consciously or subconsciously regard the PPF as a fall back option is a potential moral hazard. Accordingly, more effort should be concentrated into showing that entering the PPF is a last resort representing a failure of the sponsor.

About SEI

SEI is a leading provider of investment services to Defined Benefit and Defined Contribution pension schemes working with over 485 institutions in 7 different countries. Starting with the goals of each pension scheme, SEI offers fully tailored solutions, from Investment Consulting to Fiduciary Management and Master Trust. Through its scale, expertise and over 20 years heritage of providing investment services, SEI aspires to give trustees greater control over the strategic development of their scheme whilst reducing volatility and improving their funding level. For more information visit: http://www.seic.com/enUK/institutional-investors.htm.

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