Written evidence from Broadstone (PPF0076)

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Broadstone is a company focussed on providing employer and Trustee services (actuarial, administration, consultancy, investment advice/consultancy) for Trust Based Defined Benefit/Defined Contribution Schemes and the establishment of auto-enrolment compliant arrangements for employers. The company employs actuaries, consultants and administrators across locations in London, Sheffield and Falkirk.

We are primarily focussed on the small and medium end of the market (scheme size). However, while the schemes may be relatively small it is often the case that for many of our clients DB pensions are of material significance relative to their balance sheets.

Executive summary

- Member protection is paramount. Member’s accrued rights should be protected until exceptional/extreme circumstances arise and those circumstances have not arisen.
- Current options for managing schemes with a funding deficit where the sponsor is in difficulty exist and should be made more accessible, in extreme circumstances.
- PPF’s powers could be strengthened and entry criteria reviewed to accelerate entry of failing schemes to avoid greater strain on the PPF.
- Defined Benefits rules should be relaxed to allow members to access benefits flexibly.
- It also seems astonishing to me that precipitous actions are being considered to solve the current pension funding situation when much of that “crisis” is the direct result of a broken and rigged gilt market.

Member protection

1. Any review of the Defined Benefit regulatory must not lose sight of the importance of member protection. Members, beneficiaries and contingent dependents should be at the centre of all considerations when reviewing the regulatory framework of Defined Benefit Pension Schemes.

2. I accept the consideration of the employer as a beneficiary (in many pension schemes the employer is a beneficiary as it may receive funds from the scheme in the event of a surplus of funding). However, the surplus is dependent upon the assets surpassing the liabilities based on the benefits of the scheme as described in the rules.

3. The scheme is established for the payments of benefits as promised and those benefits earned should remain protected.

4. Section 67 of Pensions Act 1995 has been drafted to protect members having their past service benefits unilaterally amended to their detriment. This section provides that no modification may be made to a scheme that would (or might amongst other things) reduce any pension in payment without the pensioner’s consent. Also no modification may be made that would have a detrimental effect on a member’s benefits earned up until the date of the scheme unless the member consents or the scheme actuary provides an actuarial equivalence statement. The Pensions Regulator has a Code of Practice\(^1\) detailing the application of this section.

\(^1\) [http://www.thepensionsregulator.gov.uk/codes/code-modification.aspx](http://www.thepensionsregulator.gov.uk/codes/code-modification.aspx)
5. This protection principle is a well-established bedrock of the Defined Pensions environment and has meant that members have had their rights protected over the recent years when Defined Benefit provision has dramatically reduced in the private sector. Without these rules members would have had existing rights curtailed as employers sought to reduce future costs.

6. The previous government, riding on the coat tails of pensions arrangements in the Netherlands, have tried to establish a system of pension provision which would allow pension increases promised to rise and fall during the good and bad times. The take up of these arrangements has, to my understanding, been close to or exactly zero.

7. There has been much discussion over recent years around the use of CPI increases for pensions. This was begun by the Government deciding to use CPI (in place of RPI) as the measure of inflation for state related benefits, which had an impact on schemes contracted-out on a salary related basis since April 1978 and so holding GMP benefits.

8. Since 1997 pensions in excess of GMP have also been required increase in line with RPI (subject to various caps).

9. The ONS have noted that RPI inflationary measure fails to meet international standards and so should not be used.

10. The Government allowed schemes, where the rules permitted, to use CPI as the measure of inflation for revaluation in deferment and increases to pensions in payment. However, this created the so-called “inflation scheme rules lottery” whereby schemes that did not “hard-code” RPI were able to switch to the lower inflation measure (CPI) more easily. However, schemes with the hard-coded RPI would remain with that measure.

11. This difference is considered unfair and much discussion has been had about how this could be overcome.

12. While I have sympathy with employers constrained in changes they would like to make to their schemes due to the drafting of their rules my first concern is for the members that have accrued benefits with a promise of RPI protection.

13. This is protected by fundamental principles that companies can only change benefits for future benefit promises but past benefits are protected. Legal contracts cannot be amended without protection from abuse and only in extraordinary situations.

14. I believe that allowing past service benefits to be amended unilaterally by the employer would be the thin of the wedge and result in a longer term devaluing of member’s benefits and contingent benefits.

15. Any changes to legislation to allow scheme rules to be overridden must be in situations that are truly exceptional, where it is justifiable objectively and members are protected as much as possible to not do so overtly prefers company shareholders as the expense of pension scheme members. To my mind this means only in situations where PPF entry is inevitable beyond reasonable doubt absent changes to the scheme.

**Employer failure**

16. Exceptional economic conditions have resulted in some of the largest pension deficits that we have ever seen. These may well be acting as a drain on some company’s finances. However, the existing legislative framework has tools in place for either:
1. The company to fall into administration (the past business assets bought by a competitor/investor if viable without the pension scheme) and the members to fall into the PPF.

2. The employer (if in financial difficulties) can construct a “Halcrow style” deal and so removing the pension scheme to “new scheme” (with member consent) and continuing in business without the DB scheme

3. Regulated Apportionment Arrangements also exist but can be complicated exercises to complete

17. Options 2 and 3 above can be costly and lengthy exercises. The Pensions Regulator and Government should work towards easing these processes to make them more accessible but only in exceptional circumstances. If members’ rights can be protected AND jobs and business able thrive then this outcome must one to be utilised.

**Pension Protection Fund**

18. The PPF appears to be coping well with the influx of schemes over the past 10 years or so. While the rate of schemes failing may increase in the future the funding and investment strategy of the PPF seem robust. The PPF can also, if funding becomes tight, reduce compensation benefits (increases in payment/deferment or the cap).

19. Some schemes with weak sponsors employers are heading for the PPF but have been allowed to continue with ever worsening positions. We could accelerate this journey and push some schemes in to the PPF earlier.

20. This realises the issue more quickly and would be bad news for members, who would have their benefits restricted earlier, but ultimately reduces the rise of “PPF drift” where the cost to the PPF increases over time. A ratio could be established by which the schemes least likely to ever make it to control their own destinies are tumbled into the PPF in a controlled manner rather than in panic. I have dubbed this ever widening funding gap PPF Drag. This would involve re-writing PPF entry rules and some very difficult decisions.

21. The PPF could also become involved in investment strategies of failing schemes to mitigate the PPF drag as schemes slowly enter the pre-assessment period and assessment period.

**Other measures to manage Defined Benefit liabilities**

22. Benefits held in Defined Benefit pension schemes are inflexible when compared to flexible benefits created by George Osborne’s pensions freedoms. This is a good thing on one hand as the guaranteed benefit is secure and should be able to provide an income for the member for their life.

23. However, as members demand more flexibility I see no reason why some of the restrictions within Defined Benefit schemes can be relaxed. This would have a dual result of assisting both member’s received their benefits in a manner more suited to their circumstances and schemes reducing their exposure to risk (longevity and inflation risk) but paying out benefits earlier or in different sizes and shapes.

24. Schemes are already able to make members offers to exchange future pension increases for a higher pension now. With the principles of freedom and choice and the ability to re-shape Defined Benefit promises that has been well established, I suggest a consideration is made of the following:
• Relax the rules (and complications) around trivial commutation from DB schemes. For instance make the £30,000 limit higher, scheme specific and remove the 12 month window for any trivial commutations to increase the flexibility for individuals. Many members are blocked from taking a small pension as cash due to this technical minutiae over which they have little control.

• Review the advice requirement for transfer values. Reduce the limit for advice and increase the visibility of statutory warnings or allow for transfer value sums to contribute towards the cost of advice in a similar manner that DC schemes will soon be able to contribute towards advice up to £500 tax free. The current advice requirement while providing good protection is acting as a blockage to members accessing their pensions flexibly.

• Allow pensioners to transfer-out (if it’s good enough for annuities why not Defined Benefit). The secondary annuity market will be launched next year for holders of annuities bought with insurance companies. Setting aside my views on the appropriateness of the endeavour, the principle of selling a guaranteed income is the same here as it is in the insurance sector. There is a risk of the income stream reducing if the member’s scheme enters the PPF but this could be priced into the offer from the buyer if that’s seen as a risk. With the same levels of protection as for the annuity market some pensioners could accelerate their income.

• Allow DB schemes to pay higher cash sums (taxed over 25%) on retirement – Member’s with DB benefits can currently only access the larger sums of cash enjoyed by DC scheme members if they transfer out. However, as alluded to above this can be a costly and difficult exercise. Allowing the scheme to “commute” more pension for cash at retirement (with a tax charge for the excess of 25%) may well introduce just enough flexibility for members to not transfer all their benefits from a guaranteed source but still allow them to receive funds early in their retirement when desired.

• Legislate to allow members to partially transfer benefits so that they can access flexibilities without crystallising everything from the DB scheme. There will need to be safeguards so schemes are not left with trivial pensions in payment as this would create a disproportionate cost.

• Create a statutory override to the rule that statutory transfers cannot be paid within 1 year of reaching NRD. This is an unwelcome barrier to members wanting to transfer as they approach retirement and can properly assess their retirement income needs.

• The ability for key decision makers to forgo benefits in exceptional circumstances. For example, a scheme we worked with had an owner/director with large pension benefits which, if surrendered, would have greatly helped the funding and security of benefits of remaining members.

25. I have not studied the potential saving to schemes and these will differ across the spectrum of schemes and member demographics but if we can take the principle of gains from small margins (as shown by our Olympians) these could assist schemes, employer and members. Liabilities will be reduced and benefits reshaped more appropriately.

26. I am sure that the actuarial profession will have comments on the selection risk of allowing accelerated benefits or benefits reshaped also where benefits a reshaped to “game” the PPF must be examined. However, in principle where members would transfer to access their flexibilities it seems to make sense to allow the would-be ceding scheme to restructure the benefits at source.

27. Some of these options could result in member detriment (as all financial decisions can) and should be countered with statutory risk warnings and advice as required.
28. The Government promised a consultation on these kinds of flexibilities and I urge them to revisit that promise.

**Broken Gilt Market**

29. It also seems astonishing to me that precipitous actions are being considered to solve the current pension funding situation when much of that “crisis” is the direct result of a broken and rigged gilt market.

*September 2016*