Written evidence from Hymans Robertson (PPF0084)

About Hymans Robertson LLP
We are a leading independent pensions and risk consultancy and are experts in UK private sector and public sector pensions.

Executive summary
A combination of high profile stressed Defined Benefit (DB) schemes being assessed for entry to the Pension Protection Fund (PPF) and historic lows in bond yields pushing aggregate deficit figures to record highs, has raised questions about how DB schemes are managed and the regulatory regime overseeing them.

In summary, we believe:

- The large majority of schemes are well managed and should be able to pay benefits in full;
- The regulatory regime should not be changed, with the potential to undermine the majority of well-run schemes, to deal with challenges of a few at the edges;
- A low interest rate environment does not warrant an exceptional approach;
- In most cases, giving schemes more time to heal by agreeing to longer term, and where appropriate, higher cash commitments and time for investments to deliver should be enough;
- There will be some schemes in a ‘stressed’ situation. Unfortunately it’s often companies with significant deficits seeking higher returns which have lower hedging who will have been hit hardest by low yields. The stress is likely to be felt most acutely by those least well equipped to handle it;
- Pressure relief valves could be considered for distressed schemes. These could come in a variety of forms, including simply a pause in cash contribution requirements, or could ultimately involve members sacrificing some of their promised benefit to make the scheme more affordable. Any sacrifice would need to be underpinned by the compensation awarded by the Pension Protection Fund;
- Allowing pressure relief valves in some very carefully prescribed circumstances could enable scheme members to still receive a higher pension than they would in the PPF, save jobs and prevent catastrophic calls on the PPF;
- If such pressure relief valves were to be considered, preventing use by unscrupulous employers would be paramount. The risk of abuse is high;
- Conditional indexation could be the most appropriate pressure relief valve as long as it comes with watertight safeguards. For example, the suspension of pension increases should be temporary and with strict restrictions on employers (such as dividend freezes) to align business and scheme members’ interests. Schemes could also be forced to reinstate lost increases before they could be wound up;
- We need to remember there is already a great deal of under-utilised flexibility in the current regulatory regime (e.g. the ability to take contribution holidays);
- The regulator has adequate power. It’s wrong to assume that committing more resource to the regulation of DB schemes will improve outcomes for pensioners. It might actually exacerbate the problem – because more onerous regulation could make DB provision more difficult for employers.
- Pensioner outcomes could be improved if the industry genuinely adopted an integrated risk based approach to managing DB schemes, as advocated by the regulator. Advisers should be pushed to produce strategic integrated risk based advice. By adopting a lower risk and higher income strategy, as well as extending the target time period and contribution commitment to reach goals, it’s possible to materially improve the security of member benefits across UK DB;

- Schemes also need to move away from basing their decisions on outdated information. They should be encouraged to embrace technology to ensure decisions are based on solid foundations rather than shifting sands.

**Section 1: Defined benefit (DB) pensions regulation by the Pensions Regulator (TPR):**

We believe the Regulator has adequate power. It’s wrong to assume that committing more resource to the regulation of DB schemes will improve outcomes for pensioners. It might actually exacerbate the problem – because more onerous regulation could make DB provision more difficult for employers.

However, pensioner outcomes could be improved if the industry genuinely adopted an integrated risk based approach to managing DB schemes, as advocated by the Regulator. Advisers should be pushed to produce strategic integrated risk-based advice. By adopting a lower risk and higher income strategy, as well as extending the target time period and contribution commitment to reach goals, it’s possible to materially improve the security of member benefits across UK DB.

Pension schemes appoint advisers in silos and are governed in silos. We need to challenge governance structures to serve the strategic needs of the scheme rather than following traditional procurement lines. If schemes structured themselves to genuinely integrate investment, contributions and covenant when making strategic risk management decisions, this would improve outcomes. The focus should be on encouraging the advisory community to raise its game rather than pointing the finger at Regulator.

**Section 2 - The Pension Protection Fund (PPF):**

We believe the PPF is sustainable. It is well run and other DB schemes should take note of its approach to strategic risk management. If all UK pension schemes were run in a similar way to the PPF then the UK DB universe would be in better shape.

Clearly the biggest risk to the PPF is covenant and a potential influx of schemes. Many worry that low interest rates could send more schemes towards the PPF. But low interest rates are a double edged sword as they are shielding many companies from insolvency. As such, we’re unlikely to see a huge number of schemes fall into the PPF.

Even if we were to see more schemes enter PPF assessment, it has sufficient pressure release levers at its disposal, including levies, benefit reductions and changes to its investment strategy.

**Section 3 - The role and powers of pension scheme trustees:**

Trustees remain the guardians of the pensions promised to scheme members. Their roles have evolved and complexity has increased manifold. Today, trustees are essentially non-executive risk managers, overseeing complex financial engineering within a constantly changing regulatory world.

The Pensions Regulator is actively promoting high quality of trusteeship through its 21st Century Trustee initiative. The emphasis is on training, development and experience, to upgrade trustee boards and ensure they are up to today’s challenges.

While trustees do hold the cards when it comes to scheme management, their role and powers remain proportionate. The problem is not the scope of trustees’ responsibilities; the current financial climate is the problem.
We believe the role and powers of pension fund trustees remain fit for purpose.

**Section 4 - Relationships between TPR, PPF, trustees and sponsoring employers:**

Most schemes are well managed and should be able to pay benefits in full. For example, taking a subset of the UK DB universe, our recent analysis of all DB schemes in the FTSE350 shows that 80% of companies will be able to pay off their IAS19 deficit with less than 6 months’ earnings.

Despite the ‘affordability’ of DB pensions for the majority, the increase in IAS19 pension deficits in the last six months has been eye-watering, going from a surplus of £50bn in March 2016 to a deficit of £165bn at 31 August 2016. This peak-to-trough swing of over £200bn exceeds the annual earnings of the FTSE350, and is more than double the total dividends paid by all UK listed companies.

The way in which schemes have been affected is by low yields is by no means uniform. Funding outcomes have been split between those schemes that hedged and those that did not. The former are largely in a reasonably strong position. However, the latter group have suffered. Unfortunately it’s often companies with significant pension deficits that are seeking higher returns and have lower hedging. The stress is likely to be felt most acutely by those very companies that are least well equipped to handle it.

In most cases, giving schemes more time to heal by agreeing to longer term, and where appropriate, higher cash commitments and time for investments to deliver should be enough. However, pressure relief valves could be considered for distressed schemes. These could come in a variety of forms, including simply a pause in cash contribution requirements, or could ultimately involve members sacrificing some of their promised benefit to make the scheme more affordable. Any sacrifice would need to be underpinned by the compensation awarded by the Pension Protection Fund.

Unfortunately, safeguarding the benefits of scheme members and preventing pension schemes with unmanageable liabilities sinking companies are somewhat irreconcilable objectives. To make liabilities affordable to genuinely distressed companies, where all current routes to recovery have been exhausted (such as taking contribution holidays), the only option available is to cut back members’ benefits.

Allowing pressure relief valves in some very carefully prescribed circumstances could enable scheme members to still receive a higher pension than they would in the PPF, save jobs and prevent undue strain on the PPF. If such pressure relief valves were to be considered, preventing use by unscrupulous employers would be paramount. The risk of abuse is very high.

In principle, there are three possibilities:

- **RPI to CPI over-ride.** This would see an end to the current ‘scheme rules lottery’. Some schemes are bound by the wording in their rules to use RPI as the basis for pension increases, while others are free to use CPI. Switching to CPI would improve the affordability of schemes for sponsors. The UK’s combined DB deficit could be reduced by £175bn if all schemes could switch from RPI to CPI for pension increases and revaluation – but this would result in an irreversible reduction in benefits of an average DB scheme member by £20,000.

- **Pull back to statutory minimum pension increases.** This would allow schemes to reduce pension revaluation and increases to the statutory minimum requirement (which is no pension increases at all on pensions accrued prior to 1997). It provides an even bigger release of pressure, and would cut the average scheme member’s benefits by £32,500.
• **Conditional indexation.** This would enable schemes in dire straits to stop paying pension increases altogether for a limited time, until scheme funding and business performance recover. It could allow struggling schemes to temporarily stop paying pension increases to help them get back on track while avoiding permanent cuts to members’ pensions. It could be a way to create the breathing space to allow businesses to turn themselves around rather than being pulled down by struggling pension schemes.

The risk of abuse here is high. Preventing use by unscrupulous employers would be paramount. It would need watertight safeguards to be effective. Creating alignment of business and scheme members’ interests would be key to that. For example, the suspension of pension increases should be temporary and with strict restrictions on employers (such as dividend freezes and substantial pension contributions).

*September 2016*