The Pensions and Lifetime Savings Association is the national association with a ninety year history of helping pension professionals run better pension schemes. With the support of over 1,300 pension schemes and over 400 supporting businesses, we are the voice for pensions and lifetime savings in Westminster, Whitehall and Brussels. Our purpose is simple: to help everyone to achieve a better income in retirement. Our pension fund members own over £1 trillion of assets and are responsible for the pensions of 16 million people.

INTRODUCTION

We welcome this Inquiry, which is coterminous with the work the PLSA has been conducting through our DB Taskforce. The ongoing work of the Taskforce in part informs our response to this Inquiry, and we will share the findings from the interim report with the Committee as soon as they are published.

The regulatory system that governs defined benefit (DB) pension schemes is designed to ensure that member benefits are paid in full while providing a safety net, through the Pension Protection Fund, (PPF) in circumstances where a scheme or its sponsoring employer becomes insolvent. This system contains inherent tensions between the objectives of protecting benefits, maintaining the financial health of the employers, which is essential to meeting the cost of paying member benefits, and the moral hazard injected through the introduction of a safety net.

These tensions are reflected in the objectives of the Pensions Regulator (TPR):

- to protect the benefits under occupational pension schemes of, or in respect of, members of such schemes
- to protect the benefits under personal pension schemes of, or in respect of, members of such schemes
- to reduce the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund (PPF)
- to promote, and to improve understanding of, the good administration of work-based pension schemes.
- to minimise any adverse impact on the sustainable growth of an employer

This system is in principle appropriate to provide good protection for member benefits and to regulate a maturing DB system. However, its success in practice depends on a regulator which has sufficient powers, uses those powers appropriately and is resourced in proportion to the scale and complexity of the system it is overseeing.
Although we believe it is possible to make improvements in both the powers given to TPR and its use of them we consider that there is a more fundamental problem facing the regulation of DB.

At a time when deficits remain persistently high, and the risks to both member benefits and corporate health continue to grow, the current structure of the DB system is simply too large and diffuse for TPR to adopt the supervisory approach we believe is needed to marshal schemes towards financial security and provide the best possible outcomes for members.

As a result we have a system that focuses its resources and attention on a limited number of the highest risk pension funds (and sponsors) and regulates the remainder less actively, through codes and guidance. Consequentially, for the generality of DB schemes regulatory activity is only well placed to steadily improving the level of the lowest common denominator, rather than demand and enforce ‘best practice’ universally.

**THE CURRENT SYSTEM**

The system of workplace pensions regulation is ultimately there to protect the benefits of scheme members and to promote the good governance and administration of workplace pensions.

There are currently around 6000 private sector DB schemes, each needing to fund their own running costs and operate their own governance, administration and investment management systems on an individual basis. Over two thirds of these schemes have fewer than 1000 members.

Over many decades this system had become increasingly complex. For context, since 1995 there have been in excess of 850 legislative or regulatory changes that have impacted the running of DB schemes and the requirements upon their sponsors. Notwithstanding the benefits of some of the individual changes, taken collectively the impact has clearly been to greatly increase complexity and costs, making the regulatory burden in the UK far greater than in other OECD countries.

Concerns about the impact of these changes were raised by a number of respondents to the DB Taskforce’s recent Call for Evidence:

“We believe that the single largest contribution to the decline (and ultimate demise) of DB provision is the regulatory obligations which have been imposed on DB schemes since 1997 (in our case 20 years after the Scheme had been established).”

”...a tangle of mess of good intentions but ill thought out regulations that don’t work well with one another, they have made the regulatory burden of running pensions, as far as I’m aware, the biggest it is in the world and certainly the worst in this country that it has ever been”

These factors were also felt to be drivers behind the decision of many scheme sponsors to close their DB schemes and move towards more DC schemes with more predictable costs.
“The previous generation(s) generally enjoyed higher benefits, based on higher investment returns and lower contributions. One problem today is that higher (and in some cases unnecessary) deficit contributions mean closure of DB schemes and lower contribution DC alternatives for the current and future generations.”

The diverse nature and legislative basis underpinning the DB system has also meant that regulatory changes have been applied in hugely differing manners across all funded schemes. As a result in the most straightforward cases, employees of the same company may receive a range of very differently structured DB benefits, even if their pension entitlement is exactly the same sum. In more complex situations, employers will have multiple schemes or sections of schemes with the differing arrangements. The sheer complexity of unravelling and navigating the accompanying regulations has meant that simplifying the administration or the structure of benefits has, in most cases, proven impossible even where wholly desirable and where significant efficiencies could be obtained.

At the same time, and as a result of many of the same causes, schemes have increasingly become reliant upon legal, actuarial and investment advisors, creating a ‘governance gap’ due to, in many cases, an asymmetry of expertise.

FIGURE 1: A significant proportion of DB Schemes have fewer than 100 members

There is significant evidence that this fragmented landscape is not the most effective way to mitigate risk, optimise investment returns, attain the best possible scheme governance and ultimately achieve the best outcomes for savers. For example, a DeNederlandscheBank Working paper found that a pension fund with 10 times more assets under management has on average 7.7 basis points lower annual investment costs. Performance is also better by up
to 50 basis points in larger schemes according to Dyck and Pomorski\(^2\). Consolidating the number of schemes, as has happened in the Netherlands, Denmark and is in train in Ireland boosts efficiency and ultimately retirement income.

We believe there is considerable merit in simplifying the benefit structures and regulations that govern pension schemes, and that changes can be achieved which also protect member outcomes.

**TPR’S OBJECTIVES**

As stated above, TPR has a number of objectives which are intended to govern the running of pension schemes, and to mitigate the moral hazard activities that the Government recognised could occur because of the presence of the PPF. This Inquiry specifically asks about TPR’s objective to ‘minimise any adverse impact on the sustainable growth of an employer’ and indeed the balance between this and meeting pensions obligations.

The PLSA recognises that there are inherent tensions between some of these objectives, but our members take the view that these tensions are a natural and necessary consequence of the fact that DB provision is a balance between a sustainable scheme and a strong, sustainable employer. Navigating between these tensions can be difficult, but is not insurmountable.

We would however note that the ‘statutory funding objective’ as set out in the Pensions Act 2004 (that requires a pension scheme to sufficient assets to cover its pension commitments, and to agree a recovery plan with the regulator) is not strictly speaking a legal obligation, given sponsors are only obliged to agree a schedule with their trustees.

As the Committee will be aware, this provision can be problematic, as evidenced by BHS declining to make the contributions considered necessary (by the scheme trustees) to sustain their schemes.

We believe there is merit in strengthening either the objective itself or its enforcement.

More broadly TPR has a number of powers to regulate the DB sector, including the ability to prohibit individuals from acting as trustees where it considers them not to be fit and proper, or impose fines or prosecute offences in the criminal courts.

The most discussed of the Regulator’s powers is its ability to address acts which could lead to material detriment of pension schemes by employers seeking to sever their link with their pension scheme. These powers, introduced in 2008, permit TPR to take action to recover unpaid contributions from employers or issue improvement notices to individuals or companies requiring specific action to be taken within a specified time.

Our understanding is that since their introduction TPR has issued several s.89 Reports regarding the use of its powers to issue Contribution Notices or Financial Support Directions, including in complex and multi-national jurisdictions, but has, to date, not fully exercised its anti-avoidance powers.

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\(^2\) DNB Working Paper 474, Scale economies in pension funds 2015

\(^3\) Rotman School of Management Working Paper No. 1690724 2011
Based on publicly available information and their limited usage it is difficult to assess whether there are any specific issues with the legislative powers granted to TPR to address avoidance activity.

Our members recognise that preventative enforcement i.e. early warnings about possible action may have proven to be successful in many cases. However many are also doubtful about their effectiveness, in the absence of evidence to prove the counterfactual.

We therefore encourage the Regulator to be far more transparent about its regulatory interventions and welcome the Inquiry’s review of these powers and the additional areas where TPR have already indicated their powers may not be sufficient e.g. information gathering, notifiable events, employer activity.

THE BIGGER PICTURE

Taken in isolation, the PLSA believes that the current system is effective in so much as it is operating within the framework of objectives as set and the powers that have been granted to meet them.

However, the more fundamental challenges facing the current regulatory system are in our view the challenges caused by a ‘bottom up’ regulatory approach that stems from the requirement to oversee 6000 DB schemes (and tens of thousands of DC schemes).

In our view it needs to evolve to meet the challenges of today and to ensure the best possible outcomes for members in the future. The need for the Regulator to continue to evolve to meet the challenges of the system it regulates was recognised in the 2014 Triennial Review of Pensions Bodies, which rightly pointed out that TPR should change as necessary to fit any model of regulation as opposed to regulation being determined by the current structure or its current capability.
Based on TPR’s current working practices, moving to apply a more supervisory approach, requiring judgement and nuance, to 6000 schemes would be next to impossible without a disproportionately enormous increase in its resources and running costs. PLSA members are clear that simply ‘throwing money’ at the problem would not be an effective means of addressing the underlying issues.

Instead we should transition towards a system where increasingly, the TPR acts as a supervisor rather than a regulator. Future developments would therefore also need to involve focusing on making sure the right governance framework is in place and that those governing schemes have the right understanding, powers, qualifications and resources to do their job.

To make this feasible, significant aggregation amongst the 6000 pension schemes would need to occur, and alongside it, a significant consolidation and simplification of regulations. This would create many efficiencies and opportunities for schemes, and enable the TPR to perform fuller oversight of the DB sector, rather than a selective and sometimes box-ticking approach across the board.

If these underlying issues are not addressed the inherent issue will remain, that a high-degree of behaviour will be self-policied or enforced at a micro-level by compliance with relevant funding codes and a heavy reliance upon trustees fulfilling their fiduciary obligations. This will undoubtedly lead to outcomes that do not provide the best possible results for the health of DB schemes and for member benefits.
AVOIDING BINARY OUTCOMES

To address the wider challenges facing the DB sector the Association believes it will be important to address the binary outcomes that are ‘baked in’ to the current legislative framework.

At present this means that schemes can either be (a) in a position to provide full benefits or (b) transfer into the PPF, with members receiving 90% (if below pensionable age) or 100 percent (above) of their benefits. 45

This PPF underpin provides extremely valuable safety net for members of schemes following an employer insolvency, and in providing protection to over 200,000 member is an important part of the UK pensions system. Nonetheless, this binary structure can foster a ‘regulatory misalignment’ and in response to the DB Taskforce Call for Evidence many respondents argued that TPR’s objectives and regulatory obligations to only wind up a scheme only when in the members’ interests meant that the Regulator and often trustees were either incentivised to keep poorly funded schemes ‘limping on’ for as long as possible in the hope of recovery or failure to act in case of crystalizing a problem that may recover. And equally, that schemes only sought to truly examine alternative benefit structures when insolvency was inevitable.

In our view this approach unnecessarily narrows the options available to schemes, their members and their sponsors, many of which could provide better long-term outcomes than the status quo.

CONCLUSION

The PLSA believes that over the last 20 years, successive government policies, reviews and legislative provisions have developed a strong regulatory framework. This system is in principle appropriate to provide good protection for member benefits and to regulate a maturing DB system.

Defined Benefit schemes are however facing unprecedented challenges in the current environment, which places even greater importance on the need for the Regulator to have sufficient powers, and to use those powers appropriately.

Most importantly, these challenges require us to question the issues at the heart of the problems facing the DB sector. In our view, at a time when deficits remain persistently high, and the risks to both member benefits and corporate health continue to grow, the current structure of the DB system is simply too large and diffuse for TPR to adopt the supervisory approach we believe is needed to regulate schemes and provide the best possible outcomes for members.

We welcome this Inquiry, and look forward to sharing the findings from the work of our DB Taskforce, to inform the Committee’s considerations as soon as they are published.

September 2016

4 Barring exceptional circumstances following an insolvency e.g. a Regulatory Apportionment Arrangement
5 In practice members may receive less than these percentages over the long term due to differences in scheme benefit payments e.g. PPF does not provide indexation on pre-97 benefits. Some members will also be subject to the PPF cap.