About Willis Towers Watson

1. Willis Towers Watson is a global consulting and insurance broking firm. We provide actuarial and investment advice to pension scheme trustees and to sponsoring employers.

Background and policy trade-offs

2. It is not possible to provide full security for all accrued DB pensions without substantial cost to the companies sponsoring those schemes (or to the taxpayer). While it is widely acknowledged that a balance needs to be struck, there are widely differing views as to how and where to strike this balance. The weight attributed by Government to these differing views tends to vary over time dependent on immediate short-term issues, leading to an unhelpful absence of a clear and consistent long-term policy.

3. For more than 30 years starting in the 1970s there was a progressive shift of the balance in the direction of greater member protection, with particularly substantial new provisions being introduced around 1997 following the Maxwell scandal and ensuing Goode report and then subsequently in response to the 2003 EU IORP Directive. But in the aftermath of the 2008 global financial crisis there were concerns that the drive for increased member security was having adverse effects on economic growth – these concerns led to the introduction in 2014 of a new objective for the Pensions Regulator “to minimise any adverse impact on the sustainable growth of an employer”.

4. Remarkably, this legislative change under the Pensions Act 2014 passed through Parliament without any significant debate, the relevant clause taking up just 20 minutes in the Public Bill Committee.

Pension scheme funding

5. For policymakers looking at scheme funding, there are two main questions: how should deficits be measured, and how quickly should these be paid off?

6. Valuing a scheme’s assets is relatively straightforward: most can be traded in liquid markets and could be sold today for a known price.

7. Valuing the liabilities is harder. A pension scheme’s liabilities are a stream of payments that will fall due gradually, usually over several decades. The payments due in each future month will depend on things such as when scheme members and their spouses die, what inflation will be, and the choices that members make.

8. To be compared with the market value of the scheme’s assets, the present value of this estimated stream of payments must be calculated. The lower the interest rate used, the higher the liability value will be: lower interest rates mean that more money would have to be put aside today to fund a given future payment.

9. Legislation requires the assumptions used to calculate the liability value to be “chosen prudently”. (This is consistent with the EU’s 2003 IORP Directive. Should it wish to, Parliament could change this in future if – as now seems to be expected – the UK leaves the European Economic Area as well as the European Union.) The degree of prudence varies between schemes. Usually, the measure of liabilities and the recovery plan must be agreed between the trustees and the sponsoring employer.

10. Much commentary suggests, erroneously, that the discount rates used to calculate a present value of liabilities must match gilt yields. In fact, the regulations say that discount rates should

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1 http://www.publications.parliament.uk/pa/cm201314/cmpublic/pensions/130711/pm/130711s01.htm
2 SI 2005/3377, regulation 5(4)
take into account: either or both - (i) the yield on assets held by the scheme to fund future benefits and the anticipated future investment returns, and (ii) the market redemption yields on government or other high-quality bonds. Virtually all schemes' discount rates are above gilt yields: the latest data suggests that, on average, schemes used real discount rates that were around 1% above gilt yields.

11. Some schemes use a fixed margin above gilt yields. Others anticipate that returns on equities relative to gilts will be higher following periods when equities have performed poorly, and vice versa. The Regulator's data shows the average premium relative to gilt yields varying between valuation tranches (and between successive valuations for the same tranche), partly because fixed margins above gilts are not ubiquitous.

12. Whatever method is used, a low interest rate and low expected return environment produces big liability numbers. In 2013, the Government consulted on whether liabilities should be made to look smaller by 'smoothing' discount rates, and concluded that the call for evidence "did not reveal a strong case for changing legislation to permit smoothing". That debate appears to have resurfaced.

13. Smoothing involves taking an average of gilt yields over a specified period as a starting point, rather than current market rates. There are two main problems with this. First, low interest rates inflate pension fund asset values as well as liabilities, and it would be inconsistent to adjust one but not the other. Second, it is what interest rates will be in future that matters, not what they once were.

14. Legislation permits schemes to assume that yields will rebound to a greater extent than markets imply, making gilts cheaper to buy in future, if they can justify this belief. Employers can also challenge the core expectations and prudence margins embodied in assumptions. It is not clear what a centrally prescribed change that made liabilities look smaller would be intended to achieve. If the aim were simply to allow employers to pay less over the next few years than they otherwise would, that could more transparently be achieved through flexibility over recovery periods.

15. When it comes to how quickly newly enlarged deficits should be paid off, not all public authorities appear to be giving consistent messages:

- In its latest annual defined benefit funding statement, published in May, the Pensions Regulator said that: "Our analysis indicates that for the majority of schemes there may be sufficient affordability for the sponsor to increase contributions so that their existing recovery plan end date can be maintained". At the same time, it published analysis showing that FTSE350 firms' deficit recovery payments were around 9% of dividends, down from 17% five years earlier. (Deficits have since widened further; the Regulator has said that its May statement "remains relevant".)

- For its part, the Bank of England has noted that economic activity could be affected if companies responded to the higher deficits created by its monetary policy stance by reducing dividends, investment or labour costs. However, it appears to have concluded that this need not be a big concern, as "companies that see an increase in their deficit may also be able to extend the period over which they bring it back to balance, while maintaining the current level of contributions".

16. Similarly, while the 'portfolio balance channel' of quantitative easing is supposed to work through institutional investors selling bonds to the Bank and buying riskier assets, the Regulator would say

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3 ibid.
4 http://www.thepensionsregulator.gov.uk/docs/scheme-funding-appendix-2016.pdf, table 4.2
6 http://www.thepensionsregulator.gov.uk/docs/db-annual-funding-statement-2016.pdf, p5
7 http://www.thepensionsregulator.gov.uk/docs/db-analysis-tranche-eleven-review-2016.pdf, figure 9a
9 http://www.bankofengland.co.uk/publications/Documents/inflationreport/2016/aug.pdf, p12
that schemes should be looking to reduce investment risk if they perceive that the employer’s covenant has weakened following the Brexit vote.

17. The Pensions Regulator has the power to impose a liability measure or a recovery plan if the trustees and employer cannot agree within the prescribed timescale, or if it believes that the employer and trustees have not complied with legislative requirements in reaching their agreement. When employers and trustees negotiate, they will have at the back of their minds a view about what (if anything!) the Regulator might do if they fail to agree. (The ‘herding’ of recovery plan lengths just below 10 years when this was a trigger for regulatory attention suggests that employers and trustees may also tweak agreements to avoid detailed scrutiny, which can be a time-consuming process.)

18. So far, the Regulator has not used these powers. Perhaps it has been reluctant to establish a precedent: if it imposed a relatively ‘soft’ settlement, this would send out a message that many employers could get away with doing less; if it imposed a ‘tough’ settlement, it may risk having its decision overturned on appeal and could struggle to justify singling out that particular scheme.

19. Another possible constraint on the use of the Regulator’s powers is the subjective nature of requirements that assumptions are ‘chosen prudently’ and recovery plans are ‘appropriate’, and the consequent difficulty of proving that these requirements have not been met. The Regulator’s hand here could be strengthened by defining these terms more tightly and/or by shifting the burden of proof as to whether the funding plan meets the legislative requirements towards the trustees. Either change would weaken the role of trustees. A prescriptive approach would be likely to undermine the much-valued ‘scheme-specific’ nature of the requirements and prove unsuitable in many cases, but it would at least be transparent. An opaque, case-by-case strengthening of funding requirements by regulatory fiat would make it difficult for employers and trustees to know what was expected of them and whether they were being treated fairly in comparison with other schemes.

20. It has also been suggested that the statutory timescale for producing valuations (15 months) is too long. If it were to be shortened then it would be important to do this in a way which ensures an appropriate division of the time between different stages, in particular that adequate time is available for the process of negotiation between trustees and employer.

Corporate transactions

21. One suggestion we have heard mentioned is that the ‘clearance’ process should be made compulsory. Other commentators are better-placed than us to comment on the possible practical implications of this for transactions or other actions that are ‘urgent’ or highly sensitive, and on the potential difficulties of adequately defining the events that would fall under this requirement. However, in order to consider this suggestion it is important to be clear what ‘clearance’ is (and what it is not).

22. Companies (and individuals) that take actions which have a detrimental effect on the employer covenant may be required by the Pensions Regulator (within the parameters set by the Pensions Act 2004) to make that detriment good. ‘Clearance’ is an option for parties who would potentially be subject to tPR pursuing them for money or other financial resource to achieve assurance and certainty by agreeing any such mitigation for the detrimental effect of their actions in advance. The widespread perception is that the money and/or other resources offered by way of ‘advance’ mitigation are as a general rule likely to exceed those that tPR would extract under its statutory powers where no ‘clearance’ had been granted.

23. The effect of ‘making clearance compulsory’ would be to amend the legislation so that tPR exercises its so-called ‘moral hazard’ powers in advance of potentially-detrimental events, rather than after them. This should have a benefit in situations where the person subject to exercise of the tPR powers no longer has the same resources (at the time when the powers are eventually exercised) as they did at the time of the detrimental event. But, because tPR’s hand would be significantly stronger where it has power to approve (or otherwise) an action than where that action has already taken place, it is also highly probable that mitigation for potentially-detrimental
events would become more expensive to sponsoring companies than it is now. Thus, this legislative change would represent a material shift in the balance between member protection and cost discussed earlier.

24. Additionally, it should be borne in mind that potentially-detrimental events are not limited to explicitly-recognisable corporate transactions. Moving assets away from the sponsor to elsewhere in the corporate group (for whatever motive and at whatever time, e.g. whether as an integral part of an acquisition or subsequently) can do just as much damage to the employer covenant, as can transfers of value to employees, shareholders or other stakeholders. Although such actions can be addressed (with the benefit of hindsight) under the current ‘moral hazard’ legislation, it is difficult to see how they could practically be made subject to a mandatory ‘advance clearance’ process.

**Benefit compromises**

25. The complaint is often heard that defined benefit pensions have turned out to be vastly more expensive than envisaged and that the obligation on employers (not made explicit until 2003) to honour these historic promises, in full, in all circumstances up to the point of insolvency, is too onerous, drags down economic growth and creates substantial inter-generational inequity between current pensioners and younger workers. There is a justification for such comments, and it is inaccurate to see this as a debate solely between the interests of pensioners and those of shareholders.

26. However, it is not obvious why pensions should be treated differently from any other historic promises made (and companies – or Governments – allowed to renege on them). Allowing companies an option to cut back on accrued rights would place many in an invidious position – certainly, there are employers who would not wish to contemplate such action and would be disappointed if their competitors were given an opportunity to gain a competitive advantage in this way.

27. Nevertheless, it is possible to make a case for a statutory override to allow a unilateral switch in the index used for pension increases (and, less commonly, revaluation). If this switch is from RPI to CPI it would represent a ‘transfer of wealth’ from members to sponsors. Scheme rules will normally have been written with the general aim of providing protection against price inflation but without any deliberate commitment to a particular way of measuring this. The precise way in which the rule is worded has then led to a lottery as regards whether that scheme is ‘boxed in’ to the old RPI methodology or whether it may switch to what the Government (and others) now regard as a more reliable measure. The extent to which basing increases on CPI would reduce liabilities varies from scheme to scheme. A reduction in funding targets of about 12% might be typical for affected schemes, which would in some cases eradicate the deficit. However, the impact on settlement costs would be smaller because the lack of CPI-linked gilts makes it hard for insurers to hedge CPI-linked liabilities.

28. Reports indicate that the Committee might recommend some flexibility around indexation where this appears to be the ‘price’ for the sponsor’s ‘survival’.

29. Without a prescribed ‘trigger’ (analogous to an insolvency event), trustees would have to decide whether compromising benefits was in the interests of the membership as a whole, knowing that the risks and rewards would not be the same for all members – for example, some members who would suffer from an immediate suspension of indexation will be dead by the time of the possible future insolvency that the trustees hope to avert.

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10 [https://www.ft.com/content/55579acc-855b-11e6-a29c-6e7d9515ad15](https://www.ft.com/content/55579acc-855b-11e6-a29c-6e7d9515ad15)
The Pension Protection Fund (PPF)

Sustainability of the PPF

30. The PPF currently has a strong expectation of having more money than it needs. As at 31 March 2016, it:

- envisages being fully funded in 2030 in more than 95% of modelled scenarios,
- projects a median 2030 funding level exceeding 150% (assuming no changes to the levy formula or to its investment strategy in the intervening period)\(^\text{11}\),
- assesses its chance of being ‘self-sufficient’ by 2030 at 93%.

31. Nevertheless, aggregate £179 billion in schemes with a total shortfall totalled £489 billion at the end of August\(^\text{12}\) – which dwarfs the PPF’s £4 billion surplus measured at the end of March\(^\text{13}\). Even if tPR were to focus hard on improving funding levels, extreme adverse scenarios will inevitably challenge the sustainability of the PPF.

32. In such circumstances, the level of benefits paid out by the PPF and the investment returns achieved on its assets would be key. Even big increases or reductions in the PPF levy have little effect on sustainability: at 31 March 2016 the PPF says that a 10% reduction in levies would reduce its chance of being self-sufficient by 2030 from 93% to 92%\(^\text{14}\).

33. The PPF can seek to make its money go further by taking on investment risk, which it already does to a limited extent. However, this then raises the question of who underwrites that risk – if the investments underperform, do the (remaining) schemes need to pay increased levies or do the compensation benefits get pruned?

Fairness of the PPF levy system and impact on employers and scheme members

Surplus funds

34. Although the most likely (albeit not certain) scenario is that the PPF will end up with a surplus, there has been little discussion on how this would be used. In our view, transparency (and consequently perceptions of fairness) would be improved if the basis on which any surplus would be distributed were made clear.

35. A refund to levypayers might be the most equitable use of spare resources: employers would be happier about paying for the PPF to build up a buffer fund if they knew they could get back any money that turned out not to be needed\(^\text{15}\). But administering this could be difficult.

36. A levy holiday at a distant future date would not do the job well: some schemes (and employers) will have removed themselves from the levypayer universe by then, and the levy bills that remaining employers pay in future will not be proportionate to what they paid when the PPF’s ‘war chest’ was built up.

37. Alternatively, any surplus that is no longer required could be used to improve compensation to PPF members. However, improving compensation in a way that is fair between individuals is more complicated than it sounds. If PPF compensation were subsequently improved, those schemes that had been through assessment and subsequently bought out benefits with an insurer at higher levels than current compensation could end up with lower benefits than members who entered the PPF.

38. We note that the PPF has recently been consolidated into the Whole of Government Accounts\(^\text{16}\). We assume this does not foreshadow Government designs on any eventual surplus, nor a plan for the Government to take over both the assets and obligations of the PPF.

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\(^{11}\) PPF Long-term funding strategy update 2016, chart 6.2
\(^{12}\) PPF 7800 index
\(^{13}\) PPF Annual Report and Accounts 2015/16
\(^{14}\) PPF Long-term funding strategy update 2016, table 7.1
\(^{15}\) Technically, levies are charged to schemes rather than employers. As employers are responsible for ensuring that schemes have sufficient resources to pay benefits, it is they who ultimately pay. Often, employers agree to pay the scheme an amount equal to the PPF levy bill, in addition to regular/deficit contributions.
Insufficient funds

39. Contrary to what is often thought (and said), the PPF does not provide ‘insurance’ or ‘guarantee’ pensions. It is not capitalised like an insurance company (and to do so would be prohibitively expensive). Parliament specifically framed the legislation to include a facility for compensation levels to be reduced if there is no other viable alternative.

40. The PPF Board can reduce or suspend the (limited) inflationary increases applied to compensation in payment and in deferment; its latest funding strategy update confirms that this would only happen in “exceptional circumstances”\(^{17}\). If all indexation has been removed and further cuts are needed, the Secretary of State (on the recommendation of the PPF Board) can then reduce the core level of PPF compensation.

41. These are sensible provisions to ensure the sustainability of the PPF. However, it is important that they are properly communicated. It would be helpful if policymakers said more about the circumstances in which they would be used and about what they see as the ‘least bad’ ways of cutting compensation. (For example, would similar cuts be applied to people already receiving compensation and to those yet to retire?) Beneficiaries need to know that their protection is not absolute and employers to know how far the levy might rise before benefits are cut.

Levy distribution between employers

42. We would make three points in relation to how the levy is distributed between employers.

- First, the levy should ideally be 100% risk-based. The levy cap, paid for by a levy component that is a flat percentage of liabilities, is a cross-subsidy from employers with less risky schemes to employers whose schemes pose more risk. If an employer wants to benefit from this cap, it would be reasonable to ask that they first close their scheme to future accrual so that other levypayers are not subsidising future promises as well as past ones.

- Second, the strongest 29% of employers are currently lumped together in the top insolvency risk band (out of ten)\(^{18}\). The PPF argues that this is reasonable because, beyond this level, it found little evidence in recent history of a correlation between Experian score and insolvency experience. By definition, insolvencies of strong employers are rare, but that does not mean that extremely strong employers cannot be distinguished from employers that are merely very strong. The PPF rightly put a lot of effort into developing bespoke ways of assessing not-for-profit entities’ insolvency risk and should try to do the same for the strong employers who provide a much bigger share of the levy.

- Finally, a significant part of the levy charged to strong employers with large schemes reflects ‘tail risk’ – the claim that would be made on the PPF in disastrous circumstances. If these employers do see their situation deteriorate, their levies would rise to reflect this; arguably, they would then be paying for the same risk twice.

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\(^{16}\) 2014/15 edition, paragraph 1.4
\(^{17}\) PPF Long-term funding strategy update 2016, p.16
\(^{18}\) PPF 2016/17 levy consultation, table 1