I am making this submission in a purely personal capacity and not as a representative or employee of any private, governmental, trade or professional body. I am currently a PhD candidate pursuing a collaborative degree at Queen Mary University of London and the Bank of England, with a dissertation on the private investors who financed Britain and its allies in World War I. I have recently completed an MSc in Economic History at the London School of Economics. From 1988 until 2014, I was a journalist at the Financial Times. From 1991 until the end of 1995, I was Investment Correspondent responsible for coverage of pensions and investment. Among my highlights, I count uncovering the personal pensions mis-selling scandal. From 1996 until mid-1997, I was part of an investigative team that looked at, among other things, what became known as ‘Nazi Gold’. From 1997 I was Property Correspondent responsible not only for writing news about commercial property but also for producing a weekly column that focused mainly on investment, balance sheet and corporate governance issues in the commercial real estate industry. From 2003 until the end of 2007, I was Senior Corporate Reporter with special responsibility for coverage of company pensions. I was also responsible for our coverage of stock exchange M&A activity and post-trade infrastructure. From January 2008 until the end of 2012, I was Economics Correspondent but I was asked to bring my coverage of occupational pensions with me into the team. From the end of 2012 until I left in 2014, I was the Demography Correspondent. From 1997 until 2007, I was a Member-Nominated Trustee of the Pearson Group Pension Scheme. I am a governor of the Pensions Policy Institute and earlier this year, was elected an Honorary Fellow of the Institute and Faculty of Actuaries.

Please feel free to follow up with any questions you may have.

BACKGROUND TO UK DB PENSIONS

My main purpose in offering this submission is to explain why corporate pension plan sponsors should be held accountable for making good the shortfalls in their schemes and why the retrospective claw-back of benefits from scheme members is both legally and morally reprehensible. This retrospective claw-back has been suggested by some commentators as a fair solution to mounting deficits at UK Defined Benefit pension schemes. I will show that it is nothing of the sort. I am making this submission to point out that companies have been subsidized by taxpayers for decades, that companies used their pension schemes for corporate restructuring that flattered their own profit and loss accounts and used actuarial sleight-of-hand to justify years of woeful underfunding. The beneficiaries of these actions included earlier generations of shareholders and management, as well as retirees. That is why handing the bill to former workers is shabby and wrong.

1 Defined benefit retirement provision has been a fixture of workplace remuneration for millions during the second half of the 20th century. It earned a boost from efforts to control wages and prices during and after World War II. Employers could use the promise of
retirement benefits to long-staying staff who might be tempted to seek higher wages elsewhere when labour was scarce. By the 1970’s, private workplace pension provision was seen as an increasingly attractive alternative to what would have been a further burden on the Exchequer at a time of high inflation, a currency crisis and historically high levels of taxation. An array of tax incentives were offered to both employers and workers to save privately for their own retirement rather than rely exclusively on State benefits.

2 Generally, private pension provision required contributions from both employers and employees. These were invested in securities that would deliver the cash flows – dividends on equities or interest payments on bonds – that would cover annual obligations made to workers years earlier. From the 1950s the late George Ross Goobey, an actuary who stepped in to head the Imperial Tobacco pension scheme in 1947, pioneered the idea that investment in low-yielding government gilts should be abandoned by pension schemes in favour of equities. Companies operating in a high-inflation environment, were able to increase prices, and with these, profits. Profits could be distributed in the form of dividends on shares which, owned by pension funds, could rise in line with – or even ahead of – inflation. Thus, reliance on equity investment cut the out-of-pocket pension costs for employers. By the late 1990’s, roughly 80% of UK pension assets were invested in equities.

3 But there were other advantages that encouraged corporations to make private pension provision for workers. In particular, contributions to the scheme were exempt from corporate taxation. In 1972/73, the standard rate of Corporation Tax was 52%, falling to 40% by 1985/86. Companies with a bumper profit in one year could avoid losing half of that to taxation by contributing to the pension scheme. It was the possibility of tax avoidance that prompted then-Chancellor Nigel Lawson to seek to tax pension schemes whose assets were worth more than 105% of liabilities, even as he cut Corporation Tax. But that attracted far less revenue than might have been expected, and the reason it did so lies at the heart of some of the most contentious aspect of pensions today. The central question then, and now, is how to value the assets and liabilities. In this instance, it was left to the Government Actuary’s Department to set the parameters for valuing assets and liabilities. The GAD used a definition far more cautious than any used in private practice, leading to the conclusion that very few schemes had a surplus under this definition.
4 By the late 1970’s some of the inherent unfairness written into defined pension design began to manifest itself. Long-stayers – typically executives and other senior members of staff – benefitted because benefits accrued by short-stayers were frozen at the point of departure. The high inflation of the period eroded the purchasing power of pensions. Ultimately, employers were forced to increase frozen pensions in line with inflation – rampant during the 1970’s and early 1980’s – and finally all pensions had to be index-linked. Widows’ pensions became mandatory after too many tales of long-serving workers who died shortly after retirement, leaving an impoverished spouse. Another apparent unfairness stemmed from the size of “surplus” contained in many schemes, itself also partially a product of high inflation.

5 Employees, however, were required to continue contributing and the disposition of surplus became a matter handled under the only set of formal regulation covering pension schemes at the time, Trust Law. The only other body setting rules for pension schemes was the Inland Revenue which determined the features a scheme had to include in order to qualify for tax exemptions. Since investment income earned on investments is not subject to taxation, the inflation-plus returns that schemes earned on their portfolios were in effect, subsidized by taxpayers. Had those returns been earned by an ordinary fund operated by the employer, they would have been clawed back by as much as 52%.

6 There is no question that collective deficits at UK company pension schemes are now at eye-watering levels. The information has received ample coverage in newspapers and trade press and there is little point in re-hashing them. However, I cannot emphasize sufficiently that one common assertion about how these shortfalls came to be – that they are purely a function of unexpected rises in longevity combined with sharp falls in both inflation and interest rates – is so far from reality that it should be discarded immediately.

7 As a practical matter, company pension schemes have been running deficits for many years long before either of these two trends really took hold. Moreover, far from the hapless and well-meaning operators of pension schemes that many employers profess themselves to be, plan sponsors were themselves the architects of some of the most financially damaging measures adopted. These are now coming back to haunt them, although it may not be immediately obvious to those only newly familiar with occupational pension provision in Britain. What is happening now is that the current generation of shareholders are being asked to pay for benefits received by earlier generations of investors.
8 Pension provision, by definition, is inter-temporal; it occurs over a very long time period. From the time an employee makes his first contribution until the day his widow dies may take 70 or 80 years. During that time, not only will the workforce have turned over many times, but so will the board of directors and the identities of shareholders. Over the course of that 70- or 80-year period, different managements may have made alterations to scheme design, funding arrangements, investment strategy and overall operations. Taking a snapshot of a pension scheme at a single point in time thus offers a misleading picture of how costs and benefits are shared.

9 Why is retrospective claw-back of pension benefits so dangerous? The short answer is that in law, pension scheme members are unsecured corporate creditors. This has been upheld in courts and is enshrined in legislation and in the creation of the Pension Protection Fund. Retrospective claw-back, if enacted by Parliament, amounts to a raid on the property rights of former employees. It would be a statement that workers’ property rights are less worthy of legal defense than those of any other creditor. That position is so odd it is hard to imagine that legislation on that order would not bring a legal challenge.

10 A retrospective claw-back is even more morally reprehensible when one considers how scheme members became creditors in the first place. They are the only group of creditors never to have made a conscious decision to loan funds to the corporate sponsor. They had neither the tools or the foresight to evaluate the ability and the willingness of the employer to meet all promises in full. Even small businesses supplying a company can examine, say, a Dun & Bradstreet rating before deciding whether to offer goods on credit.

11 Unlike other creditors, pension scheme members have no formal legal agreement to enable enforcement of contract terms should a plan sponsor decide it will not honour its debts. Indeed, it may be the very absence of a “term sheet” that has allowed employers to view their pension obligations as promises they only need fulfill on a ‘best efforts’ basis. Forcing former workers to surrender property before any other unsecured creditor has had to make a similar sacrifice is to demand that the most vulnerable lender be the first to shoulder a corporate debt burden.
Perhaps worse, legislation along those lines would permit companies to effectively default on debt without incurring any damage to their existing credit rating. If Joe’s Burger Bar demanded that its pickles supplier take a 20% write-off on the amount it is owed, it is a fair bet that any other pickle supplier would be less willing to extend credit on deliveries and even then, would charge a higher rate of interest for it. After all, Joe’s Burger Bar just became a riskier enterprise.

Failure to honour promised increases to pensions in payment represents nothing less than forcible deprivation of property directed at a single class of creditors.

How did company pension schemes become mired in their current state? The popular answers are well known; former Chancellor Gordon Brown eliminated the 25% ACT rebate on UK dividends, government regulations required companies to share the benefits of inflation-fuelled returns on equities with retired members and pesky long-term interest rates have fallen sharply. Suffice it to say, the first one – loss of the tax rebate on dividends – is the weakest explanation of the lot and it bears little, if any, blame for the current state of affairs.

The answer begins with plan sponsors – employers – themselves. Data collected by what was the National Association of Pension Funds through the 1990’s showed a majority of members were enjoying ‘contribution holidays’. Data from the Office for National Statistics also showed that from 1987 until the early 2000s, the value of annual contributions from members into occupational pension schemes exceeded that of employers by a large, but dwindling margin. Part of the reason for that is the ONS counts investment returns on invested funds as money contributed by members, because it believes members benefit from high investment returns. But as a practical matter, those returns were used primarily to finance contribution holidays for employers.

As the outcry over the holidays increased and challenges to trust law arose, company-appointed trustees (there were almost no Member Nominated Trustees at that time) put in place increases to pensions in payment in line with the Retail Price Index. In other words, those RPI-linked increases, which it is now proposed to roll back, were a mechanism to ensure that Trustees could justify allowing companies to make no contributions to pensions. Here is a section from an article I wrote for the FT published on 9 July 2010:
“A change to the way pension promises are protected against inflation is likely to be far less sweeping, and hit the savings of employees far less drastically than many retirement experts initially assumed, pensions experts said on Friday.....Robin Simmons, partner at Sackers, a law practice specialising in pensions, noted that there were two key pieces of legislation that required employers to write inflation-proofing into their schemes. First was the 1993 Pensions Act, which required that deferred benefits – pension pots of former employees who were too young to retire – had to be increased in line with inflation...Mr Simmons noted that the reason so many schemes had inflation proofing went back to the 1990s when companies were recording large surpluses. Employers wanted to take contributions holidays but boards of trustees could not allow the surplus to be used by them entirely. In the interest of fairness to employees, they often improved benefits, linking pensions in payment to inflation.”

16 Indeed, so prevalent was this habit that when companies were permitted to substitute CPI increases for those linked to RPI from 2011, most found they were unable to take advantage of the new flexibility; they had effectively spent the savings decades earlier in contributions holidays. This was spelled out in an article I wrote for the FT published on 8 December 2010 based on a survey of employers:

“More than two-thirds of UK company pension schemes will be unable to take advantage of a change in the law that would have reduced their future payments to pensioners, a survey released on Wednesday will show...The new rules allow company schemes to increase retirement benefits in line with consumer price inflation, rather than at the faster rate of retail price inflation...However, 68 per cent of the schemes surveyed by the National Association of Pension Funds said that the link to RPI is written into their trust deeds.”

17 Meanwhile, taxpayers have been subsidizing increases to pensions in payment. Contracting out rules, with employers receiving rebates of National Insurance Contributions, amounted to billions of pounds. HMRC’s PEN6 Table of tax expenditure on pensions shows that in the years 2001/02 to 2010/11, tax relief on NIC rebates exceeded that offered on investment returns. Employers promised to deliver index-linked benefits equal to the GMP portion of a state pension in exchange for these rebates. How much did this save employers? Rolls Royce recently offered an insight in a document released to members explaining planned changes to its retirement scheme. The loss of contracting out rebates will increase its NIC bill by 3.4%.
18 Over time, it was becoming clear that the pension scheme was a badly needed ‘piggy bank’ available for the underwriting of corporate restructuring during the 1990’s. Companies seeking to dispose of unprofitable businesses did so by offering employees enhanced early retirement benefits, allowing them to draw pensions from age 50 on terms that were not actuarially neutral. The actual cost of those enhanced benefits was not calculated using assumptions about inflation and investment returns which might have been judged realistic. They were more generous to employees than they would have otherwise been, but equally, they allowed companies even more extensive gains.

19 It is a mistake to view enhanced early retirement as a benefit solely to workers; indeed, the biggest beneficiaries were often shareholders and managements. That is because unloading older, more expensive workers in unprofitable parts of a business filtered through immediately to the bottom line of the company Profit & Loss Accounts. Under the inadequate accounting rules at the time, the costs of pension promises were never spelled out, either on the balance sheet or in the P&L. That made corporate restructuring appear cost-free. Share prices inevitably received a boost and managements, delivering on share price growth in excess of inflation, reaped big bonuses on the back of this restructuring. How much did companies actually extract from their pension pots via these redundancy/restructuring exercises? No one can tell for certain without a careful analysis of years of pension fund and company accounts. But one analysis suggests that for BT, it was a particularly lucrative move. This article, which concerns the single largest pension scheme in Britain, appeared in the FT on 28 February 2010. It offers some insight into the scale of costs borne by pension schemes that would otherwise have been borne by shareholders.

“BT's £8.8bn pension deficit is almost entirely of its own making because it failed to make adequate contributions and took big risks with its investment strategy, according to documents submitted by its rivals to Ofcom, the regulator....C&W said the research offered “overwhelming ... evidence to support the view that BT has been the sole architect of the entire deficit...It said the research showed that BT’s efforts “in trying to persuade Ofcom that its deficit is in some way an act of God”’ was not supported by the facts. ...The research concludes that the enhanced early retirement scheme offered by BT from 1990 to 2004 to help it shed staff – and boost profits – cost £3.2bn. But BT only added £1.1bn to the pension fund to cover the cost of the scheme, increasing the deficit by more than £2bn.”
And here is an excerpt from an article I wrote about the widespread use of corporate pension schemes to absorb what were otherwise legitimate company expenses. This one appeared on 17 February 2008:

“A swath of companies, from General Motors in the US to Olivetti in Italy, used their pension schemes to subsidise corporate restructuring without labour strife. Because much of the cost was absorbed by the scheme, the impact on corporate profitability was limited...But much of this restructuring occurred at a time when accounting rules did not require companies to make clear their full liabilities on their balance sheet. Indeed, the process was helped by actuarial standards that allowed the manipulation of key assumptions that could transform a deficit into a surplus or vice versa...Beginning in the 1990s, there has been a drive by accounting regulators to force companies to be much more realistic about the cost of pension promises they have made. That effort threatens to throw into stark relief the cost of encouraging employees to leave the workforce with 20 or 30 years’ of life ahead of them...The UK’s pensions regulator is this week to publish proposed rules that would prod companies to use estimates of pension expense that take account of latest scientific data. These show that a 65-year-old man retiring today will, on average, live to 89. Fewer than 0.5 per cent of schemes in the UK are using the latest data, suggesting that reported liabilities are already lower than economic reality....The proposals have unleashed a storm of protest, particularly from actuaries and accountants who advise schemes. Danny Vassiliades, principal at Punter Southall, an actuarial firm, says the rules “could represent the end for occupational final-salary schemes in Britain”...It is not, as Mr Vassiliades concedes, that the proposals would increase costs. They would merely alter the way the costs were displayed. “The fundamental economics are unchanged. But once you put it in the balance sheet it becomes a cost that has to be managed,” he says...Pension schemes were a cheap form of industrial restructuring,” says Ros Altmann, a specialist in pensions economics. “They were very useful for hiding costs.”...But when accounting standard setters started tackling the issue, they forced companies into more transparent valuations, making them mark their assets and liabilities closer to their current market price rather than allowing them to “smooth” the numbers over long periods......Peter Elwin, head of accounting and valuation at JPMorgan Cazenove, points out that behind the arcane debate lies a grave social policy consideration. “If you default on a 40-year bond, some investors lose money. But if you default on a pension, people lose everything. It really does matter to lots and lots of people. It matters for the economy.”...Finance directors might oppose the rules because, as at BT and elsewhere, promises were made to workers at a time when the implications were clear to no one, he adds. “Because you made this promise and didn’t have to disclose it, pension schemes became like a giant cookie jar.”

20 It wasn’t just wholesale corporate restructuring. Companies found that the ability to offer early retirement to employees they no longer wanted – or found too expensive – was a good way to clear the payrolls. It would have been difficult for most of the past two or three decades to find large companies that did not have early retirement schemes. Indeed, the presence of one at RBS contributed to the mammoth pricetag attached to the value of Sir Fred Goodwin package. As recently as 2009, RBS was offering workers it wished to shed the
chance to begin drawing their pension on favourable terms from age 50. It was hardly alone. The following is from an article I wrote which appeared in the FT on 25 August 2009:

“The scheme offers full retirement from 60 years of age, with pensions indexed to rise with inflation. Those retiring after the age of 50 at the request of RBS suffer no penalty. From April 2010, that age will rise to 55 in line with new tax rules... But it was the combination of these terms that ratcheted up the lump sum value assigned to the pension of Sir Fred, who was pilloried for bringing the bank to the brink of collapse last year. Sir Fred has since agreed to give up some of his annual pension payments.”

21 Why did employers then feel they could use their pension schemes with such abandon? One reason, discussed in the section on corporate restructuring, was that accounting rules were so opaque that it was impossible for finance directors – let alone shareholders – to understand the real cost of making pension promises. And why was the accountancy profession so confident that its approach in the 1990's was the correct one? They, in turn, had reassurance from the actuarial profession that schemes were “fully funded”.

22 By the turn of the 21st century, it was becoming obvious that the actuarial approach used for company pension schemes was not only woefully wrong, it was lulling members and corporate managements into a false complacency. I am attaching a link to a report written in 2004 by widely respected senior members of the actuarial profession urging a rethink on scheme valuation. In particular, I would like to call the attention of members of this committee to sections 6 and 8. But I especially want to draw attention to Section 6.2.4. It discusses an actuarial paper prepared in 1992 by two of the senior partners, referred to here as Thornton and Wilson, at what was then Watson, the UK’s largest and most prestigious actuarial firm and which had roughly half of the FTSE 100 as clients. That paper spelled out the standards which governed actuarial valuations throughout the 1990’s.

“It appears to us that, from around the time of Thornton & Wilson (1992), actuaries moved towards funding targets that would inevitably result in severely insolvent pension schemes. We advance the following reasons to explain this: ô There is a natural tendency for clients to want low contribution rates and to present a positive picture to members. This creates
commercial competition between advisers, leading inevitably to strong pressure towards weaker actuarial bases and methods. (We understand that, preceding this, there was a time when consulting actuaries adopted funding methods that implied higher company contributions than those advised for broker-arranged pension schemes. This collective sense that consulting actuaries had previously been demonstrably prudent may account for why the Actuarial Profession has taken time to react to more recent changes.) Actuarial funding target methodology is obscure and opaque. This means that bases can be weakened or strengthened through what those outside the profession might, possibly unfairly, describe as ‘sleight of hand’, and those within the actuarial profession sometimes describe as ‘actuarial magic’.”

23 In other words, actuarial consultants competed for business on the basis of the most generous assumptions possible, justifying for corporate clients many years of contributions holidays and minimal contributions in the years that followed. The pattern is similar to the way that accountancy firms once competed on the basis of offering financial accounts that flattered their client. Just as it took an accountancy regulator to put a stop to that practice, so too was an actuarial standards-setter needed.

But it took years before an actuarial standards body was created, and many in the industry fought it. The collapse of the Equitable Life Assurance Society prompted a much-needed look at how the actuarial profession worked. Even then, pension actuaries were slow to put reforms in place. Even when faced with mounting evidence on one of the trends most frequently blamed for rising pension costs – rising longevity at older ages – the profession turned a blind eye. But the medical profession and insurance industries were able to spot the trend. The following is from an article I wrote in the FT and which appeared on 1 July 2009:

“By the late 1990s, the actuarial profession became aware of something that the medical profession had noted years earlier – that the number of deaths at older ages appeared to be falling and more people were living into their 90s...By 2004, a group of actuaries working as the Continuous Mortality Investigations unit and most employed in the insurance industry, found that in the previous eight years, male longevity rose by 20 per cent alone, possibly the biggest single gain in life expectancy since data were first collected in 1924...And by 2007, one thing became obvious: not only were improvements to longevity not tailing off, they were rising and, in some years, even more rapidly than before...But, while actuaries advising life insurers about the reserves they needed to set aside to take account of rising life expectancy appeared to be recognising the trend, those who were advising companies on their pension schemes did not...As a result, liabilities appeared smaller than they probably were, allowing employers to justify putting less cash into
schemes...That observation forced the UK Pensions Regulator to step in and order companies to use “realistic” assumptions.

One consultant offered me this explanation around 2003 as equity markets tanked and bond yields fell sharply. “I guess they had told their clients so much bad news they didn’t want to tell them any more.”

Here is an example, which I wrote in the FT on 20 April 2007, showing how the use of unrealistically low longevity estimates allows companies to understate their liabilities, and thus their funding requirements:

“Alliance Boots could see its pension liabilities rise by anywhere from £186m to £645m if it used a more up-to-date table to calculate the life expectancy of its members, an analysis of its last annual report and accounts shows....According to the Alliance Boots annual accounts dated March 31, 2006, the company estimates that its male employees who retire at 60 will live, on average, to 83. That estimate is already substantially short of the UK average. ...Stephen Richards, an actuarial consultant specialising in longevity risk, said that a move of that order would increase liabilities by 5.3 per cent. Based on the £3.5bn in pension liabilities in the last report, that would result in a further shortfall of £186m...However, Mr Richards said that if the trustees were to use a mathematical approach – known as P-Spline – which takes trends from the past 40 years and projects them forward, it would increase the cost of providing a pension for each male member by 18.3 per cent.

Here is a chart, based on ONS data, of changes in the number of years of average British Male Life Expectancy beyond Age 65, from 1911 until 2010. It was a chart I used in my capacity as Demography Correspondent when I would be asked to speak about changes in longevity patterns. As you can see, male longevity beyond age 65 remains fairly stable at 11 to 12 years from 1911 until around 1971. It then begins to rise slowly, but by 1990, it begins to rise very rapidly. The evidence of rising longevity have been there for all to see. And yet, when it came to company pensions, the Regulator had to step in to force companies to face up to their rising costs.
24 So where are we today? Regardless of how occupational pensions arrived at their current state, there are two reasons advanced by industry to justify passing the cost to former members from current shareholders.

25 The first of these is that companies are so busy filling the holes in their under-funded pension schemes that they have no capital left over for investment. This is patent nonsense; it is only a relatively small number of UK companies that have legacy Defined Benefit obligations. The vast majority have none. If it were truly the case that it is the need to shore up scheme shortfalls that is crimping investment, then all those employers without legacy obligations would be pumping capital into new investment, taking advantage of current ultra-low interest rates. But that is not what the ONS data on business investment are telling us. Moreover, the evidence suggests that the largest companies at least have plenty of capacity to meet pension deficits in full; the latest analysis of corporate accounts from actuarial consultants Lane, Clark & Peacock found that in 2015, FTSE 100 companies paid around five times as much in dividends to shareholders as they did in contributions to their underfunded pension schemes. Shareholders, as providers of equity, are legally at the head of the queue to take losses when insolvency strikes. Unsecured creditors, such as pension scheme members, only take losses after shareholders are wiped out.

26 The second argument is related to inter-generational fairness; employers have to pay so much into their schemes on behalf of retirees that there is nothing left over for pay rises for
the young. Again, if this really were the case, we would see higher salaries for the best staff offered by employers without legacy benefits and who hope to improve their productivity by poaching talent. Again, we do not see that in the data.

27 Of course, I realise that political pressure for relief of employers is currently very strong. But we have been here before, for example in March 2003 and again in March 2009. In a nutshell, the choice to unilaterally pass the cost of pensions to former workers is nothing short of an assault on their property rights. It is also an affront to taxpayers who have been footing the bill for the massive tax breaks Britain has long offered to employers who make pension promises.

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