Institute and Faculty of Actuaries

Defined benefit pension schemes: security and sustainability

IFoA response to Department for Work and Pensions

14 May 2017

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

Institute and Faculty of Actuaries

DB consultation
Private Pensions
1st Floor Caxton House
6–12 Tothill Street
London
SW1H 9NA

14 May 2017

Dear Sirs

IFoA response to DWP Green Paper "Security and Sustainability in Defined Benefit Pension Schemes"

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to this consultation. Members of the IFoA's Pensions Board have led the drafting of this response. Many actuaries advise pension scheme stakeholders in different capacities - employer advisors, trustee advisors and investment consultants.

We have answered the questions in the Green Paper in the attached Appendix. However, we have set out the main points of our response in this letter.

Regulatory Framework

The IFoA believes the current framework offers a high level of flexibility. That flexibility is available to employers, trustees and the regulator. However, we recognise that not all stakeholders, including the regulator, will take full advantage of the flexibility. While we recognise the high media profile of two schemes last year, we do not believe such cases should be the driver for regulatory change in regards to scheme funding, as the failings were arguably more as a result of corporate governance than scheme funding. Failings in corporate governance should not be an excuse in amending pensions legislation.

Pension schemes are not risk free. There is no cast iron guarantee that all benefits will be paid to members. The measures taken in the last decade provide trustees with encouragement to manage schemes according to the specific circumstances in which they function. The establishment of the PPF provided the lifeboat for schemes affected by the failure sponsors.

The IFoA is clear that the broad framework should remain unchanged, but all participants should seek to use flexibilities to a greater extent if required.

Affordability

The evidence of the Green Paper is that pension schemes are affordable, although we recognise that aggregate evidence will mask the specific challenges facing individual schemes. As schemes do not operate in a risk-free environment, those challenges may prove too much for some schemes.

However, we do not believe affordability is an issue that should drive a reduction in member protections, including indexation.

The evidence suggests that the majority of schemes can afford to pay benefits, although a minority of individual schemes will default to the PPF.

Consolidation

While schemes could enjoy savings in annual costs through consolidation, the IFoA believes the route to consolidation may be expensive. The market currently offers options to consolidate and we believe it should be left to the market to demonstrate the attractions of consolidation.

The IFoA believes retaining schemes in their current form is likely to remain the most cost effective solution.

If you wish to discuss any of the matters included in our response, you should contact Philip Doggart, Technical Policy Manager, (Philip.Doggart@actuaries.org.uk / 0131 240 1319)

Yours faithfully

Colin Wilson
President, Institute and Faculty of Actuaries

Question 1

Are the current valuation measures the right ones for the purposes for which they are used?

a) Are the flexibilities in setting the Statutory Funding Objective discount rate being used appropriately?

- **If not, why, and in which way are they not being used appropriately?**
- **What evidence is there to support this view?**
- **How could sponsors and trustees be better encouraged to use them?**

1. Evidence from tPR suggests trustees are using a range of discount rates.[1] The advantage of the current valuation regime is that it provides flexibility, subject to certain constraints, including following a prudent approach. Schemes may use that flexibility any way they wish. Practice will vary not only from scheme to scheme, but also from valuation to valuation. We have no evidence that the flexibility is mis-used.

2. It is easy to focus on the discount rate as being the most important assumption within a valuation basis. However, it is important to consider the complete set of assumptions. If the discount rate is the sole measure under consideration, the view of the valuation may be distorted.

3. Our members consider tPR to be more open in discussions than most pensions regulators. However, trustees have been developing new approaches to managing deficits for example Special Purpose Vehicles, Asset Backed Contributions and outperformance in Recovery Plans. tPR has a role in ensuring these new strategies are appropriately embedded. It has a role in promulgating the requirements of the legislation and the flexibility within it.

4. While in practice some may wish to use a lower discount rate for technical provisions to reflect employer covenant, the assumptions used for a scheme's Recovery Plan may include a higher discount rate . The end result may be that Technical Provisions may be high, but Deficit Reduction Contributions reflect a higher discount rate.

5. Integrated Risk Management will play a role in assisting trustees balance the various aspects of scheme funding, investment and employer covenant.

b) Should we consider shorter valuation cycles for high risk schemes, and longer cycles for those that present a lower risk?

- **What should constitute a high or low risk?**
- **Or should a risk based reporting and monitoring regime be considered?**

6. The current valuation cycle is appropriate and there is little benefit in changing the length of the cycle. Shortening the valuation cycle may lead to an intense focus on consecutive valuation results, which may be subject to volatility beyond the control of trustees.

7. For high-risk schemes, the challenges facing the scheme will not disappear by bringing forward valuations. Trustees need to maintain the focus on the management of the scheme rather than be distracted by a new valuation.

[1] http://www.thepensionsregulator.gov.uk/docs/scheme-funding-appendix-2016.pdf (Table 4.1)

8. Setting a definition of high/low risk will be difficult and may not be particularly useful. Schemes face changing circumstances and a scheme could easily move from one category to the other within a funding cycle. In any case, trustees currently have the option of obtaining an earlier valuation with the consent of the employer.

9. The provision of annual funding statements and adopting tPR's Integrated Risk Management (IRM) guidance ensure that trustees are aware of on-going scheme challenges. We note the exemption for small schemes in respect of annual funding statements; however, many of our members will notify trustees of any material valuation developments.

10. On-going monitoring can identify small problems and enable trustees take corrective measures at an early stage

11. The IRM framework considers the broader range of issues for schemes, of which valuations form only one part. It is important that trustees continue to assess the wider landscape rather than only focus on a single point-in-time result. We have not yet seen the full benefits following its recent introduction. These benefits will include more information for actuaries, trustees, employers and tPR.

c) Should the time available to complete valuations be reduced from 15 months?

- **What would be an appropriate length of time to allow?**

12. Valuations are time-consuming and can be extremely complex for some schemes. Although in many cases, valuations can be completed within 12 months, some schemes will require the complete 15 month period. In practice, reducing the time available to 12 months may make little, or no, difference for many schemes.

13. The 15 month limit exists as the date from which tPR can exercise its powers, some of which are strong. For that reason, we would not support reducing the deadline for completing valuations. We support tPR encouraging schemes to complete the documentation for valuations at an earlier stage.

14. Sometimes, particularly for large or open schemes, it can take some time for data for the valuation to be provided. After the scheme actuary provides the initial results, the time required for discussions between the employer and the trustees may also be significant. Such discussions may lead to additional actuarial work.

15. In effect, the time taken to complete the valuation calculations can be very short, but other parts of the valuation process will take longer to complete. DWP should not under-estimate the time required to consider covenant assessments and conduct negotiations, both for funding and recovery plans. While IRM processes become embedded in scheme management, it is likely that more schemes will complete valuations closer to the 15 months deadline.

16. We support tPR encouraging trustees, who know they will not complete a valuation on time, to notify tPR at an early stage of the challenges in meeting the deadline. Earlier involvement from tPR may help trustees engaging with employers in such situations.

d) Should other measures or valuation approaches, for example stochastic modelling, be mandated or encouraged?

- **If so, which ones and for what purpose?**

- **How would the information provided to the Regulator to explain the agreed recovery plan differ from that at present?**
- **What would the costs be, and would they outweigh the benefits?**

17. Although actuaries have significant experience of using stochastic models in advising clients, the IFoA does not believe making such approaches mandatory would be of benefit. In particular, stochastic modelling would add little benefit for small schemes, where the key risks are already evident to trustees. The costs and complexity would outweigh any benefits.

18. As IRM becomes more widely embedded, we expect trustees to consider a range of approaches to scheme management, not just in respect of funding.

19. However, we support the use of alternative approaches. Our members are fully aware of the benefits stochastic modelling can bring to schemes in understanding the potential range of outcomes, particularly where trustees have a longer-term target in mind for scheme funding. Such a target may not be a formal secondary funding target, but more of an intention for the scheme in the future.

Question 2

Do members need to understand the funding position of their scheme, and if so what information would be helpful?

a) Should schemes do more to keep their members informed about the funding position of their schemes?

20. The introduction of the Summary Funding Statement offered trustees the opportunity to communicate useful information to members about scheme funding. There are different approaches to these statements; some trustees will provide the information merely because they have to comply with the regulation; others will use the communication as a tool to provide the most useful information to members.

21. The second of these approaches is likely to be the most useful, although it is more costly. tPR should encourage such an approach for all trustees to follow, subject to there being value to members in doing so. In particular, the statement allows trustees to communicate the most important information. It is unlikely that providing more numbers will be of use to members, as information about different funding bases will only serve to confuse a large majority of members.

22. Members need to understand that DB schemes are not risk free. In general, members will receive their full benefits if the scheme continues or if it has a very high level of funding, or they will receive PPF compensation. Employers face risks to their continued trading; hence, future funding capability remains uncertain. Schemes will run risk in all aspects of their operation. It would be beneficial for members to understand what those risks were. Members' main priority is likely to know what benefits they expect to receive from the scheme. We suggest DWP uses the skills of communications experts to understand what exactly members need to know. This would also likely improve the accessibility of information to members.

23. Developing member-centred communications may force schemes to issue statements that are targeted for different categories of member. Provided the information is useful to the members that would be a helpful step, but while information on funding might help members'

financial education on its own it will not support good decision making. Since this would be costly, we do not think this approach should be mandated.

b) Do we need Government communications to provide information to the wider public and media about the degree of certainty and risk in the regime?

- **What difference could this make?**

24. If the DWP and tPR could provide clear information about the key messages for members, there would be advantages for trustees and members. Examples include being clear about the risks associated with pension scheme membership and correcting the misapprehension that the likelihood of members receiving full benefits is directly correlated to its funding position

c) Are measures needed to improve trustee decision making: skills such as enhanced training, more Regulator guidance, or the professionalisation of trustees?

25. The quality of trustees will vary from scheme to scheme. The quality of trustee within each category (professional, MNT, etc.) will also vary. One means of achieving better knowledge for trustees would be to expand the trustee toolkit. Encouraging trustees to deepen their knowledge would be beneficial.

26. As we noted previously, the most important component in trustee knowledge is the overall knowledge of the complete set of trustees rather than individual trustee knowledge. As we encourage better knowledge among individuals, we also support moves to ensure the breadth of knowledge among trustees covered all aspects of scheme governance.

27. Professional trustees may not provide the value expected, especially for small schemes given the cost.

Question 3

Is there any evidence to support the view that current investment choices may be sub-optimal? If yes, what are the main drivers of these behaviours and how could they be changed?

e) Do trustees/funds have adequate and sufficient investment options on offer in the market?

- **Is there anything Government could do to address any issues?**

28. There is a broad range of options open to trustees in respect of their investment decisions. The investment market has provided new products over a long period of time. Technological advancements offer investment opportunities that were previously unavailable to trustees, even the most sophisticated. The changing maturity profile of DB required trustees to think about what would best suit the needs of their maturing, and mainly closed, schemes. It is likely the investment market would evolve further, as asset managers continue to offer innovative solutions to schemes.

29. With that context, there are specific points to consider:

    i. Most of those in current employment, outside the public sector, will not have any opportunity for DB scheme membership.

ii. The aggregate of all DB promises is so large it cannot be matched with low-risk instruments. Despite the current trend in de-risking, there remains a need to back the promises with some degree of risk-bearing strategies and/or to pay some of these promises from future economic growth. Given the reliance for scheme "solvency" on the employer covenant, provided the covenant remains strong enough it seems reasonable for trustees to follow these strategies. The alternative would impose material extra cost on the employer, and so be potentially covenant weakening. This will remain unavoidable in the current system.

iii. There is significant debate about the use of infrastructure within DB investment strategies and for Government to provide guarantees for the riskier type of infrastructure investments, such as development stage infrastructure. One alternative is for Government to fund such projects by means of greater gilt issuance, especially of super-long gilts. We recognise such an approach may be politically unacceptable. Another alternative would be to ensure there was a secondary market for infrastructure investments.

iv. The IFoA would welcome a response to the 2011 consultation from the Debt Management Office on CPI-linked issuance which remains outstanding.[2] Despite that gap in the gilt markets, many trustees may wish to have access to CPI-linked securities in order to match scheme liabilities.

v. Investment choice for the largest of schemes is very broad and there are few limitations about the range of investments for those schemes. However, smaller schemes face some specific challenges in accessing some types of investment. Knowledge of trustees about more unusual investment types will remain a challenge to overcome, but the cost of such investments may also deter trustees from accessing such investments. Trustees may still be able to access a sufficiently broad range of investments that would allow them to meet their investment objectives; therefore, it may not be a significant problem.

vi. Medium sized schemes will be able to access more unusual investments by means of platforms; consequently, they should not be constrained by cost.

f) Do members need to understand the investment decisions that are being made?

- **If yes, are there any specific decisions that need articulating?**

30. No. Members do not need to understand the investment decisions. There are other more pertinent issues about DB schemes they should better understand. However, they do need to understand the consequences of the investment policy and the risks inherent in it

31. As long as trustees retain the fiduciary responsibility, the primary factors are that trustees have to invest in the interests of the beneficiaries and understand the investment decisions they take. The amount of risk trustees are willing to accept will have an impact on the investment decisions they take.

32. There may be some specific circumstances where trustees might wish to bring specific matters to members' attention in relation to investment decisions. Such communication could

[2] http://www.dmo.gov.uk/documentview.aspx?docName=publications/giltsmarket/consultationpapers/cons20110629.pdf

be more appropriate where the sponsoring employer(s) has a weak covenant.

g) Would it be appropriate for the Regulator to take a lead in influencing or determining an acceptable overall level of risk for a scheme in a more open and transparent way?

33. Setting a scheme's risk appetite is a complex process with a number of variable parameters, including the level of covenant support from the employer. The current regulatory regime enables the trustees and the employer to have those discussions. The IFoA does not recognise any need to alter that approach.

34. We believe the most valuable role for tPR to play in respect of investment decisions is to continue doing what has already been taking place. tPR can encourage good discussions between trustees and sponsors by providing guidance and case studies (e.g. IRM guidance and its recent DB investment guidance), rather than taking a lead role in determining, or even, influencing, investment decisions.

35. Such an approach does not diminish the relationship between funding and asset allocation, which are ultimately the biggest factors, alongside employer covenant, in achieving successful outcomes for DB schemes. Trustees and employers would benefit from having discussions about the setting of risk budgets and asset allocation. In some circumstances, it could be valid for tPR to expect trustees to present it with considered thoughts about specific investment decisions.

h) Would asset pooling or scheme consolidation help schemes to access better investment opportunities?

36. Our response to question six provides more detailed consideration of consolidation. A simple yes or no answer would be too simplistic, as it would not recognise the broad range of circumstances with which schemes and employers must deal. However, there are some specific points in relation to investment that we wish to highlight in response to this question.

37. In theory, pooling does enable trustees of schemes negotiate better terms with asset managers. Pooling may also help smaller schemes access opportunities that are only available with scale. An example of this is investing in illiquid assets, where there are additional governance requirements. Trustees would then face decisions whether the new investment opportunity was worth the increased governance and expense. It is possible that trustees trustees of rapidly maturing schemes might not value this.

38. As we noted in paragraph 30 (vi), small schemes can take advantage of insurance pooling and medium size schemes can access other platforms to provide the range of investments required.

39. Some investment options may not be appropriate for some schemes; therefore, consolidation of investments could be adverse for some schemes.

i) Is regulation (including liability measurement requirements) incentivising overly risk-averse behaviours/decisions that result in sub-optimal investment strategies?

- **If yes, which regulations and how do they impact on these decisions?**

40. We have no evidence of these behaviours. All trustees should be expected to manage their investment risks appropriately. For trustees of closed schemes, there will be a greater focus

on volatility, liquidity and cashflow requirements. Such trustees should be expected to invest more assets in bonds, of whatever type.

41. There is a growing trend of risk reduction via liability management within schemes. This has arisen from greater risk awareness in the industry. One driver of this increased awareness is the importance attached to regular reporting of mark-to-market liability measurement. While this remains contentious to many stakeholders, in itself mark-to-market reporting highlights the risk of not meeting benefits. It is ultimately a decision for trustees and employers to strike the right balance. As we noted previously, this continued de-risking process assumes sufficient "low risk matching assets" for pension schemes to buy.

42. Trustees may be influenced by high profile cases and the risk of "regret". We would note regret risk is not confined to investment decisions, but rather it reflects general risk aversion. It could be helpful to encourage trustees to take investment decisions that reflect their risk appetite and not just to consider the consequences of wrong decisions.

43. Trustees should look to strike a balance that considers long-term objectives, risk appetite, the maturity of the scheme and the strength of the employer. Naturally, this balance will continually change, so trustees will have to deal with the required changes to these factors to ensure the scheme's management remains at a high standard.

j) Are you aware of evidence of herding or poor advice from the intermediaries and advisors?

44. Understandably, stakeholders will want to know what other schemes are doing and what "acceptable" ranges for certain decisions are. Whilst we have no evidence of herding or poor advice we are not complacent about the risk of this. All actuaries are subject to standards, both ethical and technical, that put clients at the centre of their advice. The IFoA also has a Disciplinary Scheme to ensure that our members, who fail to meet the standards expected of them, face appropriate sanction.

k) Are measures needed to improve trustee decision making: skills such as enhanced training, more Regulator guidance, or the professionalisation of trustees?

45. tPR's guidance on DB investment was recently issued.[3] If the guidance led to a favourable change in trustee decision-making processes, the objective of the guidance would be met. We would prefer to understand the impact of the new guidance before proposing further changes.

46. Trustees will have different levels of investment knowledge. Investment is a complex subject so such a breadth of knowledge should not be a surprise. The following comments recognise the variability in that breadth, and indeed depth, of knowledge. While it would be unwise to rely on specialist knowledge of one or two individuals, a broad range of knowledge across the trustees may be the most effective means of ensuring investment issues receive the appropriate consideration.

47. In that respect, investment is no different from any other aspect of scheme management. We encourage tPR to focus on the broad knowledge of trustees rather than identify one area requiring more knowledge for all.

[3] http://www.thepensionsregulator.gov.uk/guidance/db-investment.aspx

48. Perhaps the most significant factor is the skill of the Trustees' Chair. An effective Chair can bring the best from all the trustees. Each trustee will bring different attributes to the collective group. A good Chair will ensure that this knowledge and skill will contribute to the overall effectiveness of the trustees.

49. On average, trustees lack sufficient investment knowledge and are overly reliant on consultants/advisors.. Although the use of investment-committees is relatively widespread in larger schemes, smaller schemes often struggle with their governance budget. Even in committees, the range of experience is too wide.

Question 4

Is there a case for making special arrangements for schemes and sponsors in certain circumstances such as a different regime for employers who can afford to pay more, and/or new or enhanced flexibilities for stressed sponsors and schemes?

a) Do you have any evidence that Deficit Repair Contributions are currently unaffordable?

50. Paragraphs 102 to 111 of the Green Paper provide a lot of evidence to suggest employers can afford to pay Deficit Reduction Contributions. The caveats with using aggregate, or survey, data are that individual schemes can be hidden within the overall picture. There will always be a cohort of schemes that will struggle to meet contributions. In addition, the data has to be appropriate for the purpose: it is possible that the comparisons made (e.g. size of DRC to dividend) do not provide useful information since, for example, some companies would lose investors if they materially reduced their dividend payments in absolute terms, or as a percentage of their share price.

51. We do not have other evidence in respect of the unaffordability of Deficit Repair Contributions. Our members have suggested that in their experience, because of the negotiations between trustees and employers, generally the position is that contributions are affordable. As noted in the previous paragraph, that experience depends on the circumstances of individual schemes. However, this does not mean companies can necessarily afford to pay more, or that there are no cases where contributions stress the employer's ability to remain profitable.

b) Should we consider measures to encourage employers who have significant resources as well as significant DB deficits to repair those deficits more quickly?

- **If so, in what circumstances, and what might those measures be?**

52. Well-resourced employers should make sufficient contributions to their schemes. It is our view that there is no need for additional measures. The flexibility in the current framework enables trustees to ask for higher contributions where they are affordable.

53. tPR's objective to have regard for an employer's sustainable growth when enforcing the statutory funding regime, together with the trustees' obligation to follow a prudent process, should ensure that a balanced outcome is achieved.

c) If measures are needed for stressed sponsors and schemes, how could "stressed" be defined?

- **If so, in what circumstances, and what might those measures be?**

54. The creation of a special definition of “stressed” will be extremely difficult in practice. Schemes will face unique circumstances that will not fit neatly within a definition of this type. It may be more appropriate to apply the flexibility in the system rather than create an artificial definition that may encourage moral hazard or defy practical application. Within the current framework, tPR can make a decision on scheme circumstances about the future direction of the scheme.

d) Are there any circumstances where stressed employers should be able to separate from their schemes without having to demonstrate that they are likely to become insolvent in the near future?

55. No, it is better to use all aspects of the flexibility within the current framework more effectively. In particular, we would like to see greater use of Regulated Apportionment Arrangements (RAAs) and employers and trustees being encouraged to recognise how best to use them for the most stressed employers.

e) How would it be possible to avoid the moral hazard of employers manipulating such system in order to off load their DB liabilities?

- **Would some sort of ‘quid pro quo’ be appropriate to ensure the scheme is not disadvantaged relative to other creditors of the employer/stakeholders?**
- **What could this look like?**

56. We do not believe it would be possible to avoid moral hazard. That is one of the reasons we would prefer to see greater use of the current framework, which works for most schemes, rather than introduce changes that could adversely affect members’ benefits.

f) Are there any circumstances where employers should be able to renegotiate DB pensions and reduce accrued benefits?

- **If so, in what circumstances?**

57. tPR should use discretion on a case-by-case basis. That discretion should consider the impact on members’ interests. The current framework allows for two approaches and we support the continuation of that framework. It is possible to alter benefits with the consent of members. This should remain a valuable tool in the management of schemes. Altering benefits without consent should also remain as it too provides an approach that could ultimately benefit members who would otherwise see greater reductions in benefits.

g) Is there any evidence to suggest that there is an affordability crisis that would warrant permitting schemes to reduce indexation to the statutory minimum?

58. We are unaware of any evidence to support this

h) Should the Government consider a statutory over-ride to allow schemes to move to a different index, provided that protection against inflation is maintained?

- **Should this also be for revaluation as well as indexation?**

59. The indexation provisions were written at a time when no one would have envisaged moving to a different index. As such, the rules of individual schemes would have been drafted by different lawyers using different words that intended, at the time, to provide for the same

outcome ie the scheme's indexation rules met the statutory requirements and no more. Therefore, there is a theoretical argument for allowing such an over-ride.

60. As we have noted previously, it does not appear to us there is an affordability crisis, and there is no compelling evidence to make such a provision on grounds of affordability alone. In that case, this would largely be a political decision.

61. On a technical point, the ONS has indicated there will be no further changes to RPI, but it will continue to make changes to CPI. As a result, RPI will become an out-of-date index. ONS should state whether it considers RPI to remain fit for purpose in the wide range of contacts, including pension scheme documentation and index-linked gilts. Also, DWP should indicate whether publication of RPI should continue despite potential flaws in the index.

i) Should the Government consider allowing schemes to suspend indexation in some circumstances?

- **If so, in what circumstances?**

66. No, suspending indexation would create an administrative problem for schemes and is probably the worst of potential solutions.

j) How would you prevent a sponsoring employer from only funding a scheme to a lower level in order to take advantage of such an easement?

67. This is not possible.

k) Should Government consider allowing or requiring longer, deferred or back loaded recovery plans?

- **If so, in what circumstances?**
- **Should other changes be considered, such as the valuation method of Technical Provisions?**

68. No. As we have noted throughout our response, the flexibility within the current framework allows variation in approaches to funding. If a scheme does not have an appropriate funding plan, tPR does have the power to investigate the circumstances of the scheme.

l) Should it be easier to take small pots as a lump sum through trivial commutation?

69. This is an administrative issue and does not make much difference to the challenges of funding DB schemes.

Question 5

Do members need further protection, and should this be delivered by a stronger and more proactive Regulator, and/or trustees with enhances powers?

70. tPR has sufficient powers to protect member interests operating, as it does, on a principles-based approach to regulation. tPR could do more to protect the interests of members of smaller DB schemes, which currently attract very little attention from tPR, although they represent the majority of scheme members. tPR could use random sampling to address this issue.

a) Would greater clarity over the requirements for scheme funding be helpful to members and to sponsors?

- **If so, would this be better set out in detail in legislation or through increased guidance and standards from the Regulator?**

71. The current requirements for scheme funding provide the opportunity to strike the right balance between employer flexibility and member benefit security. We would be concerned that any further legislation, or even guidance, for the purposes of providing greater clarity, could shift that balance.

72. DWP should not extend tPR's remit so that it could set binding standards. We prefer principles-based regulation. There is already sufficient guidance and reference material available on current scheme funding requirements.

73. We urge DWP/tPR not to consider adjustments to the regulatory framework based on the recent high profile cases. As most employers and trustees can manage the pensions issue within the current framework, changes to reflect a couple of cases may not achieve the desired outcomes.

b) Is it possible to design a system of compulsory proactive clearance by the Regulator of certain corporate transactions, without significant detriment to legitimate business activity?

- **If so how?**
- **What are the risks of giving the Regulator the power to do this?**

74. This would be difficult to achieve and would require tPR to increase its resources, thereby increasing costs. It will be a drag on legitimate corporate activity. Therefore, we do not believe DWP should pursue a system of compulsory proactive clearance, unless it is confident that the additional cost and complexity would provide better outcomes for members, companies and shareholders.

75. We welcome strengthened corporate governance in relation to pension scheme liabilities, including the development of strategies designed to help trustees and employers work collaboratively and have an open working relationship. We believe this will facilitate the sharing of information between trustees and employers. Consequently, any corporate transactions could be carried out with greater cooperation. However, other regulators, other than tPR, may be better placed to create this behavior amongst employers.

76. Trying to force an employer to negotiate with trustees would not work. However, trustees should be encouraged to identify ways in which they could operate to a higher standard than may currently be the case in such transactions.

77. Such encouragement may enable trustees to discuss with employers the level of Deficit Repair Contributions to the scheme, alongside current plans for dividend payments by the employer (or other significant cash flow from the employer) that could have an effect on the security of member benefits. This could enhance the trustee/employer relationship and help to avoid future funding problems. If trustees could have additional powers to ask for the sharing of timely information in transactions, they may reach better outcomes for members, whilst not stifling corporate activity.

c) Should the Regulator be able to impose punitive fines for corporate transactions that are detrimental to schemes?

- **If so, in what circumstances?**

78. This should only be possible if DWP is confident that any additional complexity and costs associated with enabling tPR to impose punitive fines will result in overall benefit for members. For circumstances where, for example, the employer has not been transparent with the trustees in respect of a corporate transaction that contributes to material detriment, the capacity to levy a punitive fine may prove useful.

79. Issuing a fine may deter future errant behaviour, but it would do little to improve the scheme in question. It may be a better outcome for the specific scheme if tPR issued a Contribution Notice (CN) or a Financial Support Direction (FSD). Such issuance may also encourage more appropriate behavior from employers considering detrimental measures in the future.

d) What safeguards could ensure that any additional powers given to the Regulator do not impact on the competitiveness of the UK business or the attractiveness of the UK market?

80. As noted in the previous paragraph, issuing an FSD or CN may have the desired effect.

e) Should the Regulator have new information gathering powers?

81. tPR already has strong information gathering powers and does not need additional powers. We do not believe there would be much benefit to schemes, or tPR, if all schemes supplied the same information. Random sampling of small schemes may assist advisors ensure trustees are aware of the importance of good governance.

f) Should civil penalties be available for non-compliance?

82. We do not have a view on this matter.

g) Should levy payers be asked to fund additional resources for the Regulator?

83. Levy payers should only be asked for additional funding if changes are made which require additional resource and it is clearly demonstrated that these changes are clearly of benefit to scheme members. Whilst increases in the levy could be seen as a ‘further nail in the DB coffin, it would not seem fair to levy the cost on non-DB activity. One alternative is a flat fee for services; however, this could have an adverse impact on smaller schemes.

h) Should trustees be given extra powers such as powers to demand timely information from sponsors, to strengthen their position?

- **If so, what extra powers might be helpful?**
- **Should trustees be consulted when the employer plans to pay dividends if the scheme is underfunded – and if so, at what level of funding?**
- **Is action needed to ensure that members are aware of the value of and risks to their DB pensions?**

84. Although this would seem to be consistent with the aim of enhancing the trustee/employer relationship and help to avoid future funding problems, we are not sure what “powers” the trustees would have, nor how they would enforce them.. In many cases such sharing of

information already exists in practice. Trustees should be aware of expected dividend payments. Therefore, there would only be a requirement to provide the information if dividends were to depart from those anticipated.

85. We have commented in our response to question 2 that some thought should be given to the re-drafting of the Summary Funding Statement. It should be accessible, concise and clearly written. Its focus should be on communicating essential elements of the scheme. This may be the only document that scheme members regularly receive, therefore trustees must aim for it to be fit for purpose and meets scheme member needs. We suggest the essential elements for communications include:

i. the recent and expected future progression of the funding level;
ii. an explanation of the nature of the arrangement with the employer (including any risks); and
iii. the long-term aim for the scheme.

86. Our members' experience suggests that some schemes have not revised their Summary Funding Statements, since tPR's original example document. Many trustees view it as a compliance exercise, rather than as a valuable communication tool. We believe this is in part, due to how the rules around the Summary Funding Statement are drafted and we would encourage tPR to consider how its guidance might be amended to encourage better use of the Statement.

Question 6

Should Government act to encourage, incentivise, or in some circumstances mandate the consolidation of smaller schemes into vehicles with greater scale and better governance in order to reduce the risk to members in future from the running down of closed, especially smaller, DB schemes?

a) Is there anything in the existing legislative or regulatory system preventing schemes for consolidating? How might such barriers be overcome?

87. Yes, there are a number of barriers to overcome. The barriers include:

- the small saving in operational costs if the benefits and scheme rules are left unchanged;
- the considerable number of issues to consider if benefits and scheme rules are rationalised;
- the need to consider benefit security if each scheme's funding levels, investment strategy or covenant are different; and
- the risk of one employer paying for the liabilities, or costs, of other employers.

88. These barriers could be overcome only if the existing protections for benefit security were discarded.

b) What other barriers are there which are preventing schemes from consolidating? How might they be overcome?

89. Paragraph 345 of the Green Paper shows the significance of small DB schemes in the UK. As has been discussed in a number of parts of the Paper, there are some disadvantages to small schemes in terms of economies of scale:

- investment choices;
- schemes expenses; and

- governance standards.

90. In addition, there is a significant cost of regulating small schemes for tPR.

91. However, it would be unfair to ignore the advantages of small schemes, the most significant of which is the greater understanding of the requirements of the particular group of scheme members, their benefits and the nuances of the existing scheme rules.

92. Where consolidation is already occurring, it is typically in cases where one company (or group of companies) sponsors several pension schemes. In such situations, our members' experience is that advisers, companies and trustees are actively considering the merits of consolidation options. It should be noted that the consolidation only goes ahead where there is a clear business case to do so and if members are not adversely affected.

93. In many cases, the financial benefits of the consolidation do not out-weigh the costs or if they do, the cost savings are immaterial or the payback period is very long. The main reasons this cost-benefit analysis often fails are:

- that the trustees of each scheme will usually require a levelling up of funding positions in order to be satisfied that the consolidation will not adversely affect the security of their members' benefits; and
- the complexity and cost of practically combining the schemes. This will require addressing any inconsistencies in benefit structure, discretionary practice, contracting-out benefits, scheme documentation, communications, administration and the balance of powers within the scheme rules. The consolidated scheme will then require administration of a scheme with multiple categories of member and benefit structures.

94. These barriers are not easy to overcome.

95. Trustees have a duty to consider the security of their members' benefits. The trustees have the flexibility to take a broad view of the level of security available to the scheme before and after any consolidation, beyond the current level of assets. However, in most scenarios it is difficult for trustees to be satisfied with a lower level of asset cover. Regardless of this, trustees should focus on value for money, rather than the level of costs.

96. The complexity and costs of consolidation could be lower, if it were possible to harmonise to some extent (our response to question 6d explains this position further).
.

97. Given the barriers that exist to single-company (or within a group) scheme consolidation, it is perhaps not surprising that multi-employer consolidation is uncommon. The cost-benefit analysis can be even less attractive due to:

- more complicated governance resulting from multiple stakeholders with diverse objectives; and
- increased complexity of scheme rules, benefit structures, discretionary practices etc.

98. The significance of the threat of a future significant Section 75 debt becoming payable, including a share of orphan liabilities, should not be dismissed. Our response to questions 6i and to 6n set this out in more detail.

99. Sharing a pension scheme with other companies, including competitors or totally unrelated companies, carries a risk in terms of potential sharing of data and commercially sensitive

information. Companies would only be willing to take that risk if the potential financial benefits are significant. Again, the Government should not dismiss the significance of these barriers and the difficulties in overcoming them.

100. Consolidating using a ring-fenced approach, or using a master trust, can provide broader investment options and some efficiency, but each section must still operate as a separate scheme. Our response to question 6h considers this in more detail. All this means that any future efficiencies and cost savings are typically insufficient to make an attractive business case, or at least to reduce any priority consolidation would have in making use of company resources.

101. It is clear that there are circumstances where consolidated schemes work effectively e.g. The Railways Pension Scheme. This can offer valuable efficiencies, pooled investment arrangements and sensible controls to manage cross-subsidy. However, these arrangements still face Section 75 debt issues. The effort and resources needed to establish these arrangements are considerable.

102. Even if there was “the will”, “the way” is, within the current regulatory framework, long, complicated and expensive. Consolidation is currently a company-led activity, derived from a motivation to achieve cost efficiencies. Trustees are typically reactive to consolidation – i.e. they consider it only where the company has come to them with a proposal.

103. One approach, which may encourage some further consolidation, would be for tPR to provide guidance to trustees considering consolidation. The guidance would have to suggest how to hold discussions with the company, if and when they consider that it would be in the best interests of their members.

c) Should Government define a simplified benefit model to encourage consolidation?

104. We do not consider this approach would achieve much in practice. There is now a very large range of benefit designs across UK pension schemes. Therefore, the actual setting of the model would appear to be a challenging obstacle. There would inevitably be individual winners and losers even if benefit value is preserved on average.

105. One further complexity would be how the benefit model would compare with the auto-enrolment minimum level. It would be helpful to understand which model would meet the Government’s view of an adequate level of benefits.

d) Should rules be changed to allow the reshaping of benefits without member consent? In what circumstances? Should there be prescribed restrictions to the types or limits of such reshaping?

106. The current regulatory framework offers a substantial degree of flexibility. The options are either to reduce members’ benefits with their consent, or to re-shape members’ benefits without consent using the actuarial equivalence approach. This approach is sufficiently flexible and robust and it is not necessary to impose further limits or restrictions.

107. The only possible exception to this is in scenarios where the only alternative is that the scheme falls into the PPF, and where the trustees therefore consider a particular re-shaping of benefits is in members’ best interests. The requirement to provide the statutory level of indexation to post 1997 pensions is also a constraint, as are statutory controls around the provision of benefits provided under contracted out employment.

108. On the actuarial equivalence approach, we agree with the comments in the Green Paper that trustees are sometimes reluctant to use this approach. However, this may be partly due to trustees considering the effect on individuals and not just averages across the membership.

109. Many schemes have evolved over time to have extremely complex benefit structures, with various different rules applying for different groups of members and in respect of different periods of membership. In many cases it would make sense to rationalise to make the scheme:
- more straightforward to administer;
- easier to understand for the members;
- improve insurance “buy-out” pricing; and
- make consolidation more straightforward.

110. It may be appropriate for tPR to provide additional comfort or encouragement to trustees in considering benefit simplification, perhaps through a statement or further guidance.

111. There is discussion in the Green Paper about the use of winding-up lump sums (WULS) to simplify schemes and remove risk and expense. Enabling members to cash in their small pensions can be attractive to members and can be an effective way for small (and large) schemes to reduce their administration and other costs, which can be disproportionate for members with lower levels of benefit. However, allowing partial wind-up to enable WULS could be a very complex process, difficult to implement and difficult for members to understand.

112. One easier way to achieve a similar impact could be to increase the limit for small lump sums (currently £10,000). This process is well established, easy to implement and relatively straightforward for members to understand. This approach could have the drawback of encouraging members to accept lump sums as a replacement for retirement income, which is not the purpose of the scheme.

e) Are costs and charges too high in DB schemes?

- **If yes, which regulations and how do they impact on these decisions?**

113. The market for advice and administration of defined benefit schemes has never been more competitive. There are many participants in the market, and short contracts with fixed fee arrangements are now the norm for smaller and larger schemes. This competition has driven increases in efficiency, including the establishment of offshore centres used for the provision of certain services.

f) Should schemes be required to be more transparent about their costs or justify why they do not consolidate? In what circumstances?

114. We agree there is benefit for schemes to be transparent in terms of the fees they are charged. However, there is already a significant degree of transparency given the disclosures in the report and accounts. In most cases, non-investment costs are directly or indirectly met by the employer(s) who already seek and obtain clear information about the costs being incurred.

115. However, we do not consider it would be appropriate for trustees to justify why a scheme has not been consolidated. There is a wide range of options for schemes to increase efficiency and enhance outcomes for members. Such options include data reviews, enhanced funding

arrangements, use of alternative investment strategies and insurance solutions. It is inappropriate to ask the trustees to justify why they have not undertaken one step, while ignoring the alternatives, especially as many of these options are typically, or necessarily, company-led initiatives.

116. As mentioned previously, one approach for encouraging consolidation would be to provide guidance to trustees about how consolidation could take place, if and when they consider that it would be in the best interests of their members (having weighed up the alternative options).

g) Is there a case for mandatory consolidation? In what circumstances?

117. There is no case for mandatory consolidation, other than that which is already in place – the Pension Protection Fund.

h) Should the Government encourage the use of consolidation vehicles, including DB master trusts? If so how might it do so?

118. Companies will use these arrangements if there is a sufficient business case to do so. Trustees will consider these arrangements if they think it is in the best interest of the scheme members to do so. The market currently offers options to consolidate including DB master trusts and we believe it should be left to the market to demonstrate the attractions of consolidation.

119. We do not consider it a beneficial use of Government resources to take an active role in promoting consolidation vehicles. However, there are some 'light touch' measures, as suggested elsewhere in our response (e.g. increased transparency of fees and guidance to trustees considering consolidation) which, if supplemented by the provision of additional education on these vehicles, could be effective and easy to implement.

i) Are further changes needed to the employer debt regime in multi-employer schemes to encourage further consolidation?

121. We set out our views on this topic in our response to the 2015 consultation.[4] The main points of that response remain relevant for multi-employer schemes:

- Section 75 debt legislation is very complex and any further options are likely to increase the complexity;
- There is a delicate balance between paying the debt by means of a lump sum and scheduling a series of regular payments; and
- Introducing some flexibility around the timing of the effective calculation could lead to advisory cost savings but could also lead to variations in debt amounts.

j) Is there a case for consolidation as a cheaper, but more efficient form of buy-out, with the employer and trustees discharged? If so, (a) what should be the requirements for a scheme to enter such a consolidator, especially the level of funding; and (b), should the residual risk be borne by the member, or by the PPF?

[4] https://www.actuaries.org.uk/documents/ifoa-response-dwp-s75-employer-debt-non-associated-multi-employer-defined-benefit-pension

120. There is already a strong market in buy-out solutions, albeit to the extent it is constrained by the cost of providing regulatory capital, which is required to protect members. Any steps to make buy-out more efficient should be undertaken through the insurance regulatory regime.

121. Consolidating schemes that are in a poor financial position has some potential advantages, for example, potentially providing better investment returns and efficiency gains to give the scheme a better chance of recovery. However, all the potential drawbacks of consolidation discussed elsewhere in our response apply equally here. Within the current regulatory framework there is already significant flexibility available to stressed schemes and their sponsoring companies, specifically:

- a funding regime that allows setting of cash contributions taking into account affordability and the future sustainability of the company; and
- a completive market for pension scheme service providers that should enable schemes to manage or reduce their running costs.

122. The key objective of a high-risk scheme is to improve its funding position and reduce reliance on the company's covenant. We are unconvinced that consolidation, a very onerous and costly process, is aligned with this objective, particularly in the case of stressed schemes. Therefore, the IFoA does not consider consolidation to be a high priority. We do not consider a consolidated 'half way house' between the PPF and buy-out to be a realistic option, unless the Government, or PPF (in other words, non-stressed schemes), was willing to bear a significant proportion of the risk and cost. In addition, we do not consider it would be appropriate to pass any material residual risk to the members.

123. There is a case for allowing companies and schemes that are 'high risk' some additional measures to help them recover, for example:

- Switch their inflation index from RPI to CPI, although we do not consider this is an indication of unaffordability.
- Allow additional flexibility in the scheme funding arrangements for high-risk schemes, which actually already exists.
- Extend the small lump sum limit to allow more cashing in of small, although this does not provide income.

124. As we noted previously, it would be very challenging to avoid moral hazard.

k) Should Government encourage creation of consolidation vehicles for stressed schemes?

125. No, there is no need to do so as there is an active services market.

l) Should employer debt legislation for multi-employer schemes require full buy-out and for the actuary to assess liabilities for an employer debt by estimating the cost of purchasing annuities?

126. There should be consistency in the treatment of schemes. Multi-employer schemes should be subject to the same legislative framework.

m) How else could historic orphan liabilities be met if they were not shared between employers?

127. In general, the IFoA recognises that the Section 75 debt legislation functions for most situations, even if it is imperfect. It remains our view that companies should not walk away from schemes without meeting their share of the cost.

128. It is appropriate to assess the debt using a low risk buy-out approach. Any other scenario would encourage a company to depart a scheme and transfer significant risks to the remaining employers. This would be a barrier to consolidation.

129. The buy-out market has become increasingly competitive. Actuaries have become adept at monitoring the market pricing. This ensures the approach used is fair and does not include unnecessary prudence.

130. There is already a range of options available to employers as alternatives to paying the debt, assuming they can collaborate and reach appropriate arrangements with the other participating companies in the scheme.

131. Under the current approach, ‘orphan’ liabilities are shared proportionately between the participating employers in the calculation of any debt. This allocation can considerably inflate the employer debt amount and frustrate employers. However, the orphan liabilities relate to promised benefits to members of the scheme and should have equitable treatment with the other scheme members. Consequently, we would not favour any approach whereby orphan members / benefits are segregated and adversely affected, or if they were to fall into the PPF.