Institute
and Faculty
of Actuaries

Protecting defined benefit pension schemes

IFoA response to the Work and Pensions Select Committee

25 May 2018

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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

Rt Hon Frank Field MP
Work and Pensions Committee
House of Commons
London
SW1A 0AA

25 May 2018

Dear Mr Field

IFoA response to Work and Pensions Select Committee's 'Protecting defined benefit pension schemes' inquiry

1. The Institute and Faculty of Actuaries (IFoA) welcomes the Committee's inquiry into the White Paper 'Protecting defined benefit pension schemes'. Overall, we agree with the Department for Work and Pension's (DWP) assertion in its original Green Paper that the current defined benefit (DB) pension system is not broken. However we do agree with the Green and subsequent White Paper that there are areas where improvements can be made to address the small minority of schemes that are experiencing issues.

2. We support the Pensions Regulator (TPR) having greater powers so that it can encourage schemes to reassess their scheme funding valuation if the original valuation assumptions are not prudent or if the recovery plan is not appropriate. However, there are many aspects of the Code of Practice that do not lend themselves to primary legislation, such as integrated risk management. This is a concept rather than a fact, and works well under the current framework, as it allows sufficient flexibility for actuaries to exercise expert judgement and trustees to reflect the specific circumstances of the scheme and sponsor.

3. Therefore, we believe Government needs to be confident that any changes to the Code will achieve the policy objective and it needs to have a clear understanding of the risk of unintended consequences. For example, imposing additional record-keeping and information-sharing burdens on schemes for which the current system works well, as this could have associated costs with no improvements to member protection.
4. There are a number of considerations for Government and TPR as it pursues commercial consolidation for defined benefit (DB) schemes, particularly in ensuring that there are appropriate controls around the proposal. It is crucial that the regulatory framework sufficiently protects members' benefits, not just at the point of consolidation, but also the long-term security of those benefits. It is also crucial that the framework protects the Pension Protection Fund (PPF) (if applicable), so that consolidation does not simply amalgamate existing risks to the PPF.

To what extent is improving TPR's effectiveness a matter of greater powers, better use of resources or cultural change in the organisation?

5. In our view, TPR is operating in the way that was envisaged when it was created. However, we understand the need to review TPR's role and effectiveness in light of

recent events and industry changes. TPR has been using its powers more effectively in recent years, such as with criminal sanctions, but could benefit from using its "larger" powers more frequently and consistently, as well as at a faster pace. Therefore, a combination of small changes to the regulatory regime together with effective resourcing could improve TPR's effectiveness and response to scenarios where its powers might be used. In particular, by making it easier for TPR to get trustees and employers to reconsider a valuation that it believes is inadequate, and to impose civil fines, where appropriate, to encourage positive behaviour. In the current system, if TPR does not consider a funding valuation agreed by both Company and Trustee as 'prudent', it has to undertake an extensive process, including the commissioning of an independent expert report, before it can consider further action.

6. The proposed Chair's Statement could oblige trustees to take more ownership of funding valuations, particularly in the case of smaller schemes. TPR may be able to make more effective use of its resources if the responsibility for reassessment could be passed back to the trustees and employers, with suitable guiding comments. The new smaller schemes proactive valuation questionnaire might be an example of how TPR could achieve greater effectiveness. However, collecting cash-flow information for all schemes seems less likely to be a proportionate solution.

What can be done to strengthen the regime for clearing corporate transactions (like dividend payouts, selloffs, takeovers) that might weaken a pension scheme?

7. We support the proposal in the White Paper for disclosure of pension scheme impacts on corporate transactions and for civil fines for misconduct of directors, but do not believe that otherwise the regime for clearing corporate transactions needs to be strengthened. In our view clearance should remain a voluntary action.

8. Alternatively, it could be more effective for TPR to give clear guidance on its expectations of sponsors and trustees and for them to be answerable to members where they have agreed to transactions. An overhaul of the notifiable events regime would also help - by reassessing the appropriate risk indicators and removing those which do not indicate risk but do use limited trustee and TPR resources.

Will a criminal offence provide a meaningful deterrent?

9. Yes, but the potential for unintended consequences should be considered. For example, there is the potential for a criminal offence to become a deterrent to perfectly legitimate transactions. More widely, we would question the value this move would have in terms of putting additional obligations on company directors who already have responsibilities outlined under company law.

What should "prudent" and "appropriate" scheme funding mean?

10. Trustees must ensure a scheme's funding valuation is both "prudent" and "appropriate" based on their unique knowledge of the current circumstances and prospects for the future for the employer and the scheme. Under the current framework both can be interpreted differently by trustees, actuaries and TPR.

11. Prudence and appropriateness should take into account, inter alia, the nature of the scheme's liabilities, investment strategy, employer covenant and data on the demographic and other experience of the scheme. The technical provisions are calculated using assumptions that are prudent, being more cautious than best-estimate, while recovery plans can be considered on appropriate assumptions, which may be less cautious than prudent assumptions. Our view is that the original policy intention was for recovery plans to be prudent, rather than appropriate. Therefore, whilst reviewing the definitions of these terms it may also be useful to review whether recovery plans should be considered on appropriate or prudent assumptions.

12. There may be helpful frameworks in which prudence could be described consistently – such as the margin between technical provisions and the solvency basis for example. However, Government should remain cognisant that any attempt to define either of these terms in a more prescribed manner, it may undermine the current funding regime, and mean returning to something akin to MFR.

How can consolidation of the fragmented DB landscape be best achieved?

13. Policymakers and the pensions market will need to consider how any measures taken to reduce fragmentation through consolidation arrangements are consistent with the existing options for schemes (i.e. ongoing scheme, buy-out or PPF). In particular, PPF levy payers will expect a comprehensive consultation on the levy terms to apply for arrangements that have no sponsor. In addition, the insurance industry will expect clarity on the consistency between the stated level of security of members' benefits in a consolidation arrangement, compared with the level of security of insured benefits, and the corresponding levels of capital requirements. The Government will also need a framework which deals with the direct conflict between the commercial needs of a commercial provider and the need to protect members (and potentially the PPF). Consolidation is not necessarily a desirable outcome if it simply consolidates, but does not manage, currently diversified PPF risks.

14. There are numerous ways consolidation could be achieved and each model has its own set of considerations:
    a. The PPF
    The PPF already provides consolidation for stressed schemes and, therefore, we recommend that the Government does not seek alternative means of consolidation for stressed schemes as this could undermine the PPF and the PPF levy. It is conceivable that the creation of a new regime could enable sponsor-less schemes to become eligible for the PPF under the guise of "consolidation", therefore Government should be alert to this eventuality. We are also concerned that consolidation for stressed schemes outside the already well-established PPF regime would need to be negotiated on a case-by-case basis and this would add unnecessary complexity and cost, resulting in difficult compromises, and ultimately unsatisfactory outcomes for members.

    b. Master trusts

Consolidation within master trusts is already happening under the current framework. This form of consolidation can achieve the benefits of scale from an administrative, governance and investment perspective, but maintains the link to the sponsoring employer. This enables each scheme in the master trust to maintain its benefit structure. The benefits in administration, governance and investment are often marginal compared with other available alternatives, and so the DB master-trust model has not been very successful to date. In addition, it is not possible to pool longevity risk between schemes. Simplification of benefits to pool longevity risk can be attained, but this is often costly and could outweigh any potential benefits. It also involves there being "winners and losers" (in the absence of additional finance) and therefore trustees are understandably reluctant to implement benefit simplification.

c. "Superfunds"
Bulk buy-outs are already offered by insurers and available to those employers who have sufficient resources to insure their pension liabilities. We understand that the model for commercial consolidation set out in the White Paper would allow sponsoring employers to transfer their pension liabilities to a commercial consolidation vehicle. These vehicles would not be subject to the same capital reserving requirements as life insurers that are subject to Solvency II, nor would they be subject to the same level of governance as buy-outs by life insurers which require an actuarial certificate. This means an 'insurance-lite' model could be beneficial for employers, as this option could be less expensive owing to reduced capital and governance requirements. However it would also have a higher risk of failure and this risk would sit with members, or potentially the PPF, not the employer.

If a commercial consolidation vehicle is used for employers with a weak covenant there is a risk that this will be seen as a means for such employers to transfer risk to scheme members, despite them being sufficiently well-funded to secure benefits above the PPF level of benefits. Therefore, before a well-funded scheme is able to enter the consolidation vehicle, we recommend that the framework must ensure member benefits will not be reduced at the point of consolidation and that there is no increased risk to the long-term security of their benefits. If the framework does not ensure security of member benefits it will introduce moral hazard.

This level of protection could reduce the number of schemes that would use a commercial consolidation vehicle and they may instead try to gain efficiencies via a master trust. This trade-off will need to be understood by trustees when they are considering commercial consolidation and this could require costly advice from a number of specialists, including actuaries, covenant specialists and lawyers. This would mean this vehicle is likely to be less available to smaller schemes – perhaps even a majority of schemes by number. If the Government wants to address the perceived inefficiency associated with large numbers of small schemes, the superfund model will not necessarily be the solution.

The Government will also have to address the question of whether a commercial consolidator would be eligible for the PPF and if so what levies it would pay and how moral hazard would be mitigated. Conveying the complex trade-off between cost and risk to trustees will be difficult and if the regime requires member consent we suggest that explaining this to members, and expecting them to engage, will be an even bigger barrier.

15. These considerations mean we are uncertain that implementing a regime for commercial consolidation would lead to a meaningful reduction in fragmentation. We recommend that more analysis is needed to assess the potential size of the market, before pursuing this additional regime is concluding that it will be of sufficient benefit to outweigh the potential increase in moral hazard. We would also recommend that the Committee considers the recent activity of commercial consolidators which are already being set up under the current regulatory framework and what additional controls need to be put in place within the current regime to protect members in light of these developments.

16. In considering the Government's approach to the regulation of commercial consolidation, it is helpful to note that the main consideration for trustees before any scheme enters a commercial consolidation vehicle must be whether this will be in the scheme members' best interests. Assessing this will require trustees to grapple with a number of complex questions:
    a. Will changes to the structure for member benefits mean members will be no worse off at the time of consolidation and that they will have security for the duration of time they are likely to be in receipt of their pension (this needs to be considered both from the point of view of value of member benefits and any potential change to the incidence of benefit payment)?
    b. How does the level of security of benefits in the consolidation arrangement compare with the level of security currently (scheme assets plus employer support)?
    c. How does the level of security of benefits in the consolidation arrangement compare with the level of security available through the existing insured annuity market?
    d. How do these levels of security vary over the future period during which members' benefits are dependent on the arrangement?
    e. What is the current and projected solvency of the employer?
    f. What are the consolidator's commitments regarding its long-term future solvency (including clarity on how value can be extracted by investors in the consolidator)?
    g. What is the weighting between the initial costs of consolidation, which could be significant owing to the level of advice that will be needed by all parties (employer, trustees and consolidation provider), and the overall cost savings for employers from efficiency gains in respect of administration and governance?

Given the difficulties facing DB schemes, is a faster legislative timetable warranted?

17. We recommend that it is more important to ensure the legislation does not create any unintended consequences than to push for a faster legislative timetable.

Should you wish to discuss any of the points raised please contact Henry Thompson (Henry.Thompson@actuaries.org.uk) in the first instance.

Yours sincerely,

Marjorie Ngwenya
President, Institute and Faculty of Actuaries