Security and Sustainability in Defined Benefit Pension Schemes

A Response to The Department of Work and Pensions Consultation

Prepared by: Iain Clacher, Con Keating, and Andrew Slater

May 2017

"It is difficult and probably wrong to caricature Government thinking on regulation. However, if we did, it would be that successive administrations have been cautious, prescriptive, fearful of EU infraction, and possessive of implementation. As a result, in many instances we have become slaves to the process of regulation and lost sight of the outcomes we have been trying to achieve. . ."

Independent Farming Regulation Task Force, May 2011

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Preamble

We welcome this consultation, as we believe that the decline in the provision of new private sector defined benefit (DB) pensions is regrettable. We regret the decline, as we see this form of institutional organisation as highly efficient and substantially superior to substitute arrangements such as individual defined contribution. Much of this superiority arises as a consequence of the risk-sharing and risk-pooling inherent in the design. Box 1 illustrates this advantage in the most general, if abstract, terms. When properly designed, managed and regulated, we think that occupational DB pensions are both sustainable and secure.

We are particularly troubled that much of the pensions industry is now concerned with the closure and wind-up of existing schemes; that occupational DB pensions are widely seen as an expensive historic mistake, to be closed at the earliest practicable opportunity. We do not subscribe to this view, for many reasons, which we will expound in this response.

The demise of DB provision has had many costs. The most important of these costs is the lack of new DB provision to many millions of employees over the past decades. We are certain that occupational DB pensions are both sustainable and secure.

We note that the Green Paper is silent on the question of the taxation of DB pensions and indeed the costs to the Exchequer of the developments which have taken place since 1995. We have not attempted more than a cursory estimation of these costs due to the difficulties associated with data availability. However, with some 'heroic' assumptions, our best guesswork is that these tax costs would total between £45 billion and £95 billion.

We are a little disappointed that the discussion of the purpose of the report (Para 8) should place emphasis on the 11 million current members, rather than focusing on how we might encourage active private sector DB provision once more.

We would also note here that occupational pensions lie technically in the domain of the economic second best, with one of the principal confounding factors being the politics of a situation. With this in mind, we believe it is important to consider things in the round, and that some ideal/non-ideal partition be arbitrary; this extends to the concept of mutual exclusivity. For example, some issues may be both a matter of trust and contract.

We are happy to make ourselves available to discuss any and all aspects of this response.

Note about the structure of this document

Part A offers a commentary on the executive summary of the Green Paper, and Part B contains our responses to the specific questions posed. Part C offers a short summary of the proposals we make, plus a thumbnail outline of our view (or our 'vision') of the framework for a sustainable and secure private sector occupational DB system. Part D contains a detailed review and commentary on the narrative text of the consultation paper.

Sections in bold typeface are verbatim quotations from the Green Paper with only the occasional typo and punctuation corrected.

Box 1

Pensions, insurance, cooperation

Dr Alexander Adamou, London Mathematical Laboratory

This box highlights some recent advances in economics which explain how insurance contracts and cooperative structures benefit their participants. Its aim is to provide a body of theory in which the debate about Defined Contribution (DC) and Defined Benefit (DB) pension schemes can be framed.

Insurance and cooperation make wealth grow faster

Recently (Peters & Adamou, 2015a) showed that both buyers and sellers benefit from insurance contracts. Hitherto the existence of insurance markets was a puzzle in classical economics because contracts are zero-sum games in their effect on the expected wealth of the parties. In this picture, one side, usually the buyer, must accept a reduction in the rate of change of his expected wealth for the contract to be agreed. Traditional explanations for this apparently suboptimal behaviour are that buyers (ordinary people) are more averse to risk and have less accurate information about the insured risk than sellers (insurance companies).

Evaluating insurance contracts instead by their effect on the exponential growth rate of wealth, (Peters & Adamou, 2015a) demonstrated, contrary to classical theory, a range of prices for which insurance is beneficial to both buyer and seller. Put simply, the insurer's and its customers' wealths grow faster when the customer is insured. Business happens because both parties gain.

(Peters & Adamou, 2015b) revealed a similar effect at play in the evolution of cooperation. They imagined a population of agents whose resources follow noisy multiplicative growth. In accounting terms, this means compounding at a randomly-varying rate. Without cooperation, each agent's long-term exponential growth rate is equal to their expected return rate minus half the square of the volatility:

$$g_1 = \mu - \frac{\sigma^2}{2}.$$

The second term is the so-called "volatility drag" in finance. However, when the agents cooperate by pooling and sharing their resources, they all grow at the faster rate,

$$g_N = \mu - \frac{\sigma^2}{2N},$$

where N is the population size. Cooperation multiplies the volatility drag by a factor of $1/N$, which is less than one (so that $g_N > g_1$) and which goes to zero as the population of cooperators increases.

Both findings rely on the same fundamental mechanism. Volatility makes a negative nonlinear contribution to the long-term growth rate of a compounding investment. Resources whose risks are either insured or collectivised grow faster because the volatility is reduced.

Box 1 (continued)

Retirement risk is insurable

A risk is simply a future event that is uncertain to occur. Sometimes the event's magnitude, suitably measured, is also uncertain. The risk that pensions seek to mitigate is retirement or, more specifically, the event of a person living past the age at which he is able to sustain himself financially through labour. Usually in insurance, risks are unpleasant, even catastrophic, events. Not so here. This fortunate person receives a pension to replace his labour income until he eventually expires.

Retirement is a quantifiable risk. Future lifespan distributions can be estimated from public data on births and deaths. Estimates can also be made of the future incomes required by people who live past working age, based on estimates of future inflation rates from historical data. Or they can simply be defined in advance, as is done under DB. Either way, producing the necessary estimates is the work of actuaries, on which we won't dwell here. The point is that the probability and loss associated with the retirement event are quantifiable, which gives us a basis for insuring or otherwise collectivising the risk.

Defined Contribution prohibits insurance

The recent move towards DC schemes is a move towards "self-insurance" – or, more truthfully, non-insurance – of retirement risk. In the DC setup, an individual pays a fraction of his labour income into a pot of money with only his name on it (and possibly those of his beneficiaries, should he die young). The pot is handed over to a financial professional, along with other people's pots, to be invested in risky assets. The hope is that, by the time the individual can no longer sustain himself through work, his pot will contain sufficient resources to provide a replacement income for the rest of his days. Usually this is done through the purchase of an annuity, which converts the lump sum into a series of guaranteed future cash flows.

Annuitisation is a form of insurance, in that it collectivises the longevity risk that still exists after the retirement event has occurred. Annuity sellers, in effect, make retirees cooperate by using the money of those who die sooner after retirement to pay the incomes of those who die later. However, we should be clear that this is only a partial insurance of the retirement risk, since it is contingent on retirement having occurred and on the retiree having accumulated a sufficient lump sum to that point.

Prior to annuitisation, the reservation of pension contributions for the benefit of the individual who made them renders DC a fundamentally non-cooperative method of pension provision. Theory tells us, therefore, that DC must be more expensive than other schemes in which individuals cooperate – through insurance or other types of collectivisation, including general taxation – to provide income in old age. This is because uninsured individuals suffer from larger relative fluctuations than those whose risks are insured or collectivised. With pensions this happens in two ways: individual investments can have large fluctuations because they lack the scale to be diversified well; and individual contributions can fluctuate due to illness and unemployment.

These fluctuations have a negative effect on the long-term growth of resources and, without cooperation, create a population of winners and losers. In the DC setup, there are two types of winner. The first is the retiree who gets lucky with his investments and retires with a very large pot Providing an income exceeding his needs. The second "winner" (in the technical sense only) is the contributor who does not reach retirement and whose funds, therefore, are not needed to cover the

Box 1 (continued)

insured risk. He "wins" because he declined to insure an event that did not occur. In both cases, the individuals or their beneficiaries receive funds surplus to the intended requirements of the scheme, i.e. to provide a replacement for labour income. In a cooperative setup, these funds could have been used to fund the incomes of other participants, reducing the costs for everyone involved.

As for the losers, they belong to the majority who have realised the volatility drag and retire with pots insufficient to sustain them. Since the taxpayer implicitly underwrites a minimum standard of living for its citizens, the maintenance of these retirees is collectivised, albeit in an uncosted and uncontrolled manner.

In theoretical terms, the DC approach by construction prohibits cooperation and leaves individuals largely uninsured with respect to their retirement risk. This is expensive because it increases wealth-depleting fluctuations and fails to allocate efficiently funds that could be shared to reduce overall costs. In effect, there are as many DC schemes as there are individuals, each of whom is reliant on his own fragile financial trajectory.

Defined Benefit allows risk to be collectivised

In the DB setup, future replacement incomes are defined at the outset. This makes the retirement risk particularly easy to quantify, since it depends only on the well-researched lifespan distribution. A DB scheme manager simply calculates the cost to insure the retirement risk and then requests the proportionate share of this cost from the scheme's participants. The greater the number of participants – either in the scheme itself or effectively participating as other customers of an insurer – the closer this cost can approach the minimum expected-value price. This is because, as we saw in the context of cooperation, the effect of fluctuations disappears as the number of co-operators grows large.

Indeed, a well-run DB scheme may not even require the annuitisation step. If sufficiently large, it could collectivise all of its retirement and longevity risk to operate on an ongoing basis, with participants joining as they enter employment and leaving on death. Indeed, since annuity rates are contingent on the uncertain health of the pensioner at retirement age, removing this step would have the additional benefit of collectivising this health risk. For a DB scheme so constituted, the only residual risk would be the bankruptcy of the scheme or its sponsor. There seems no reason why this default risk could not be insured in the re-insurance market.

Framing this in terms of economic theory, the DB approach allows the cost-effective possibilities of insurance and cooperation by defining only the *deliverables* of the scheme. It is agnostic to the contribution levels and the way in which retirement risk is managed. In other words, it does not prescribe how the deliverables are delivered. This is the opposite of DC, where the contributions are defined and effective risk management is hamstrung by the partitioning of funds into personal pots. By allowing risk to be spread, DB can reduce the cost of pension provision to providers, participants, and the taxpayer, who underwrites income in old age.

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Part A

This section discusses the Executive Summary of the Green Paper and is followed by a detailed commentary on that Summary.

Executive Summary

In reading through the Green Paper's Executive Summary, the first issue that has to be drawn out and emphasised is the size of the average pension pot at just £7,000 per annum. However, in listening to the debates and discussions that have plagued the DB pension question for the past 15 years and more, the pensions that people think are being paid out are considerably greater. It is often the case that the debate focuses on a small part of the distribution of retirees, who will be receiving a much larger pension than this, and so it creates the myth of the monetary value of the pension received: the 'gold-plated' pension. There are many people who are or will be receiving large pensions from a defined benefit scheme. However, in terms of the cross-section of those in defined benefit pensions, they will be a tiny fraction of the 11m people in schemes. It is the presence of these people who receive the largest pay-outs that has coloured the debate and leads to the majority, who receive just the average pension, losing out on a modest, secure income in retirement.

The discussion of deficits and recent high profile cases is to conflate two very separate issues. Looking at events since 2008, developments in the gilt market as a result of quantitative easing (QE) and the skewing of investment, is one issue that needs careful consideration. The second is of high profile failures (eg BHS). This is simply one of excess and dubious transactions which should be dealt with properly for what they are: bad management. Suffice to say, however, bad management and excess will occur again, but this is not the issue here and is outside the course of this response.

Returning to the first issue, there is an intellectual dishonesty in the defined benefit pension debate. The current approach is underpinned by financial economics, with rationality, *homo economicus*, utility wealth maximization, and more as elements. All of these things have been hugely criticised post-2008 as being flawed and misapplied. However, there has been no reappraisal of the use and application in financial economics in the pension arena. There is a range of different approaches to the funding and valuation of pensions, and consequently, how risk is viewed and managed. It would be fallacious to assume that any of these approaches gives a 'correct' number;

all they do is provide some estimate that is then used to direct investment and funding. Any of these approaches can be criticised and found wanting, depending on perspective. Understanding

these differing views and approaches is crucial to setting the way forward as well as being aware of the consequences of adopting a particular approach.

We agree that there is no structural problem with the regulation per se; however, the application of the regulation and behaviour resulting from the current regimes of accounting, valuation and solvency has led to structural problems. Moreover, the move towards a goal of self-sufficiency has resulted in bad outcomes and decision-making.

We are pleased to see that, in the executive summary background and key statistics, the view is that defined pensions are affordable and they are not pushing companies into insolvency. While, this is not the case for all schemes, for the majority we agree that this is the case.

Funding and Investment

It is good to see that the Green Paper does not think that the purpose of UK pensions legislation is to remove all risk from the system. However, there are a number of instances where the application of the regulation or the shifts in regulatory behaviour would suggest otherwise.

First, the desire for companies to 'de-risk' and hold matching assets is problematic. In switching to bond-like investments that match the projected liabilities of the scheme, investment behaviour is skewed. Consequently, there is an excessive demand for 'matching' assets, which make them ruinously expensive, and offers no upside to the sponsor, making the cost of meeting the liability more expensive.

Second, the current regulatory regime does allow risk-taking. However, the behaviour of a range of market actors, including trustees, sponsors, consultants and actuaries, has focused on the 'low-risk' valuation metric and this has driven investment strategy since 2005, with some significant consequences. Latterly, the lack of take-up of the flexibilities afforded in scheme valuation is now down to the desire for self-sufficiency, which is a wholly unsuitable objective.

Employer Contributions and Affordability

We are pleased that the view is there is no wide-ranging problem of affordability and there is no need to increase the risk of members. While we acknowledge that there are a small number of schemes that have significant issues with respect to meeting deficit recovery contributions, the discussions around easement for schemes that are struggling are a matter of concern. First, the underlying target for many of these sponsors is buy-out. As such, they are seeking to fund the scheme to a level where an insurer will take the scheme onto its books. This is clearly inappropriate for such a scheme, as it is the most expensive route possible to trying to resolve whatever solvency issues exist.

Second, the Pension Protection Fund is well capitalised and its role is to provide a safety net for such circumstances. The push towards buy-out and self-sufficiency does nothing for sponsors or members but minimises the risk to the Pension Protection Fund (PPF) to such an extent that there is little risk being transferred, particularly in light of the ability of the PPF to reduce member benefits. This cannot be the correct set of incentives as firms are trying to fund on a buy-out basis, far in excess of the level of funding required to pay pensions, into a fund that has the power to also reduce member benefits.

Member Protection

The idea of increasing the powers of the Pensions Regulator (tPR) to ensure member protection is worrying. Simply put, if we look at the decline of defined benefit pensions and some recent high-profile cases in 2016, the Regulator has done nothing of substance to ensure member protection. There is, as it stands, a system of limited approval for certain types of corporate transactions. However, it not clear that the current system has done anything of note here given recent scandals such as BHS, so giving more powers to tPR to enable it to protect member benefits is without foundation. As it stands, the overarching goal of tPR is to protect the PPF and this is not compatible with protecting member benefits.

Consolidation

We welcome the chance to comment on consolidation, and this is a necessary debate. However, while the debate is welcome, the analysis to date is not compelling. To our mind, it is not clear where the cost savings for consolidation will come from given that the underlying schemes and sponsors are not equal in any regard. Moreover, while there is a rationale for consolidation in the Local Government Pension Schemes (LGPS), the same logic does not transfer to the private sector. The pooling of LGPS assets makes sense and cost efficiencies should result from scale and scope. However, the individual local authorities will still exist and be liable for shortfalls. This is not likely to be the case in the private sector given the rate of corporate failure that we see and the rate of corporate transactions that occur. Consolidation may ultimately create some short-run gains (although it is not clear that the cost of consolidation is less than the cost savings) but result in a significant burden at some point in the future when the sponsor no longer exists.

Detailed Discussion of the Green Paper Executive Summary

In the private sector, Defined Benefit (DB) pension schemes provide an important source of income in the retirement plans of millions of people. Around £1.5 trillion is held under management by these schemes. They help to fuel the UK economy through investment in UK government bonds, corporate bonds and equities.

We note that most private sector occupational schemes are now closed to new members and also future accrual. This is not immediately evident from the ONS MQ5 statistics which show member contributions of £3.6 billion and employer contributions of £20.3 billion. While much of this reflects the presence of some local authority schemes, which are still open, it does illustrate a recurrent problem of poor aggregate data. The annual Purple Book is a good start, if inconsistent in coverage, which leads us to believe that the Pensions Regulator should have a responsibility to compile and publish far more of the data it possesses.

The pensions provided by these schemes are on average a modest (just under £7,000 per annum) but nonetheless vital source of income for around 11 million members (current and future pensioners).

The most relevant statistic is the number of members still accruing new pension awards. It is hardly meaningful to be discussing the sustainability of DB pensions, a titular objective of the consultation, when they are largely closed and beginning to run off. The decline in provision, and its causes, should have been the prime focus of this consultation. It is not as if cautions of unintended consequences have not previously been advanced. As long ago as the Goode report, we have: "I know of one very large plc where the view has been expressed privately to me that further legislation and the imposition of costs due to solvency may cause it to abandon final salary pension arrangements and move over to low-cost money purchase schemes. I feel that it will only take one very large company to take that step to start the bandwagon rolling." This bandwagon has almost run its entire course; private sector DB pensions have only the momentum of previous provision to wind down.

For those employers providing DB pensions and the trustees responsible for running these schemes, the years following the financial crash of 2008 have been particularly challenging, with record low interest and gilt rates driving up the cost of scheme liabilities compared to the increases in assets, thereby leading to increases in funding deficits.

There are issues with this narrative. Firstly, with the significance of deficits, which are probabilistic estimates. They should be treated with the same scepticism that Goode reserved for surpluses. The legalistic opinion, expressed by the Goode Report, is that a surplus only arises when a scheme is wound up. At that point, all the liabilities and assets have crystalised, and a surplus (or deficit) can be confidently measured. The cost of the ultimate liabilities has risen, due to increasing longevity, and wage and inflation indexation, but overwhelmingly the increase in estimates of liabilities has been caused by declines in the discount rate used to measure these liabilities in (discounted

present value terms. Secondly, there are issues with the suitability of discounted present values for valuation of pre-existing liabilities. (See later)

News of these increased deficits, combined with a number of high profile cases during 2016, have led some commentators to declare that there is a fundamental problem with the funding and regulation of these schemes.

There are serious problems with current regulation. These greatly distort the true position of DB schemes and their funds, creating both the impression of severe difficulties and introducing significant and unwarranted costs into the financing of DB schemes.

This Green Paper therefore explores those concerns and sets out the current key data available on the funding of these schemes and how they are regulated. While recognising that the system may not be operating optimally in all areas, our main conclusion is that there is not a significant structural problem with the regulatory and legislative framework.

We disagree most strongly. We believe that the principal causes of the decline in DB provision have been rooted in the regulation of DB pensions. In our view, it is most definitely a structural problem with the regulatory and legislative framework. Having said this, we feel that we should be absolutely clear that we believe good quality DB provision is both feasible and affordable for the private sector.

However, this Green Paper draws together a number of suggestions from commentators (including the Work and Pensions Select Committee) on how the system could be changed to potentially deliver better outcomes.

We are very concerned by the role of the Work and Pensions Committee. We see it as little more than a "bully-pulpit", with the consequence that it may engender resentment rather than active collaboration. We believe that many of its findings, recommendations and pronouncements are poorly founded and likely to prove counterproductive. We note, from the foreword of the 2017 corporate plan, that the Pensions Regulator appears to be influenced by them in the manner in which it applies and enforces legislation.

It seeks to identify where there may be particular problems or issues in order to start an informed discussion on the best way to improve the management and oversight of the risks inherent in providing DB pensions.

We were disappointed by the narrowness of the consultation. We believe that the multitude of problems we observe with DB pensions are in very large part caused by inappropriate regulation which is based upon an inappropriate model of them. If the costs of provision have risen by as much as valuations imply, how can it be that the pensions payable have not risen by anything like as much?

Background & Key Statistics

Whilst almost all DB schemes currently have a funding deficit, our modelling suggests that these deficits are likely to shrink for the majority of schemes if employers continue to pay into schemes at current/ promised levels.

We agree with this result. It would be expected from the simple fact that only 15% of schemes remain open and the majority are therefore shrinking as liabilities are discharged. It does not require further employer contributions, though they will accelerate the process.

The available evidence does not appear to support the view that these pensions are generally 'unaffordable' for employers. While DB pensions are more expensive than they were when they were originally set up, many employers could clear their pension deficit if required.

We agree that pensions are not unaffordable. However, they do represent a material call on resources – one which is not merited relative to other calls. There have been many sources of real increases in costs over the years. These divide into two types; real and compliance. Real cost increases are mirrored in increased benefits for pensioners; these include indexation and increasing longevity. The category compliance has no improved pension counterpart and may be itself divided into two sub-categories: illusory and tangible. The valuation of liabilities using gilt rates is an example of the illusory category. In and of itself, it produces no cost. Other things being equal, these can be expected to revert to reality with the passage of time. However, actions based upon these illusory aspects may generate expenses; these include deficit repair schedules, overly cautious asset allocations and cash equivalent transfer values. This is money squandered and it is correct for sponsors to attempt to minimise and avoid such expense.

There is also little evidence that scheme funding deficits are driving companies to insolvency, and it seems clear that the majority of employers should be able to continue to fund their schemes

and manage the risk their schemes are running.

We agree with this. There are occasional exceptions but overwhelmingly the exceptions are companies with failing business models. We are concerned that hard cases make bad law. The greater problem is that the level of expense introduced has resulted in an unwillingness on the part of sponsors to continue with this form of provision. If companies are not prepared to offer such rewards for employment, the system cannot really be described as sustainable.

The single biggest risk to the members of these schemes is the collapse of the sponsoring employer.

We agree. We feel that it is concern with this aspect that has led to the current situation. It is regrettable that inefficient and incorrect solutions to the issue have been sought. However, there are some employers who are finding that their pension scheme deficit is having a significant impact and where the level of Deficit Repair Contributions may become unsustainable.

We agree. However, we would note that a large part of this problem is one of illusory deficits being converted into tangible costs.

Issues and Options

In considering the current position of these schemes and their sponsors, the Department for Work and Pensions undertook an informal consultation with a range of stakeholders in the summer of 2016. The overarching view of virtually all those contacted is that on the whole the regulatory regime for DB schemes is satisfactory and that the funding regime sets a fair balance between the interests of the members and those of the sponsoring employers.

We do not share this view. We note that many stakeholders have vested interests in the continuation of the status quo. If the regime is satisfactory, why is the emphasis now almost entirely upon the decommissioning of occupational DB? Existing members have seen no improvement in the amounts of their pensions though they may have seen minor improvements in their security. It is sponsor employers who have borne massive costs, with little being reflected in the benefits payable to members, and no commercial gain.

There was a clear view that experiences differ from scheme to scheme, that some schemes and employers are struggling, and that some changes may be beneficial. However, there was no consensus on whether or how to adjust the current balance between protecting members and supporting employers.

In the course of this response, we make recommendations based upon our viewpoint. We also respond to many questions on the basis of the status quo continuing. Our view, if fully implemented, would see a massive reduction and simplification of pensions legislation; parts or all of the many Pensions Acts and statutory instruments introduced since 1993 would be repealed and replaced by one short act.

We have examined the evidence and the various changes that have been suggested in four broad areas and discussed their pros and cons. These are:

- **Funding and Investment;**
- **Employer Contributions and Affordability;**
- **Member Protection; and**
- **Consolidation of Schemes.**

Funding and Investment

Some commentators believe that the current valuation and funding arrangements influence schemes to make overly cautious and short term investment decisions.

It is clear that this is true. The evidence for it is overwhelming. Much is based on a complete misunderstanding of probability. A recent roundtable discussion of DB scheme funding among senior, and illustrious industry figures contained, when promoting a full or buy-out funding objective, the statement “I would not want to tell members that they have a 30% chance of not getting their pension”. This was referring to a scheme which was funded at 70% of full buy-out values.

The errors are profound and alarming, but as they recur in the PLSA “Consolidation” paper, they appear to be widely believed. Obviously, what matters first is whether the scheme sponsor is solvent, so the likelihood of pensions being unpaid is conditional on sponsor failure. If we assume that this is an average sponsor, though such thing really does not exist, its insolvency likelihood is around 0.4% per annum – over ten years 4%. In fact the conditional likelihood, over the next decade, of members not receiving all of their pensions is 1.2%.

But the alternate presentation would not grab headlines. ‘Our scheme is capitalised at 140% of the best estimate of pension liabilities; this is better than any major bank or insurance company in the world’ just does not grab an editor’s or politician’s attention. This is discussed further in Box 3.

The UK DB funding regime is not designed to eliminate all risk to members’ benefits. Rather it seeks to strike a reasonable balance between the demands on the employer and the security of member benefits, recognising that a strong, sustainable sponsoring employer is the best

protection for a DB scheme.

We do not agree that a strong, sustainable sponsoring employer is necessarily the best protection for a DB scheme. A strong sustainable employer makes the likelihood of sponsor failure more remote. However, the problems arise after that event. It is the manner in which the problem of post-insolvency is handled by current legislation and practice that creates many of the issues we observe.

If we wish to guarantee post-insolvency benefits, this may be simply achieved by increasing PPF compensation to the level of full member benefits. Put another way, if the loss post event is zero,

then the likelihood of the occurrence of that event is immaterial as the risk is the product of the loss and its likelihood.

We have suggested that more might be done by both government and those in the pensions industry to help people and commentators better understand scheme valuations and 'scheme deficits', in order to provide a better sense of the risks to members.

We agree that there is much confusion and misunderstanding. However, we do not see the suggestions made in this consultation paper as addressing the central issues of valuations.

We have also considered comments made that schemes are not using the available flexibilities when deciding what assumptions to use about future investment growth, and that this is leading to scheme deficits being overstated.

We see this as a problem created by the Pensions Regulator. Notwithstanding their protestations to the contrary over matters such as the utilisation of 'flexibilities', perceptions of the Pensions Regulator in the market place differ. Two quotations from seasoned professionals participating in a roundtable illustrate this well: "On funding the Pensions Regulator's code basically says trustees should start from the yield on gilts in framing their valuation assumptions and there are then about 20 paragraphs amplifying that. Including one saying that if you are invested in equities you might wish to allow something for the expected returns over gilt but you must be very prudent about it. That was what pushed us into gilts plus." And, "I sign off about 20 valuations a year as chairman of trustees, and I know the first thing the regulator is going to say to me is: 'Why did you move from gilts plus a half a percent and make the assumptions less prudent?'"

We note the change of tone in the most recent Corporate Plan of the Pensions Regulator, and feel that it is likely to prove counter-productive. In 2017, this reads:

"We work with trustees and employers, but we are prepared to use our enforcement powers where necessary. We have a range of powers that we use flexibly, reasonably and appropriately to put things right and keep schemes and employers on the right track.

We have been moving towards an approach that prioritises quicker and more efficient enforcement over the past year, and we will continue to adjust our approach where necessary.

We may take enforcement action where we encounter wilful or persistent non-compliance, where our earlier efforts to encourage compliance with the law have not had the desired effect, or where we uncover evidence of malpractice."

This contrasts sharply with the previous year's comment: "Our approach is to educate, enable and enforce where appropriate. This principle informs our responses to the risks that we see in the market, and the interactions we have with our regulated community. As we will seek to educate in the first instance, the majority of our activities are focused on setting out the legislative requirements and best practice for our regulated community via a comprehensive and tailored programme of communications."

Our conclusion is that it is not clear that in general discount rates being used are overly pessimistic, and that there is not strong evidence to demonstrate a systemic issue with the current flexibilities available.

Our disagreement here is most profound. We feel that the entire prospective approach to liability valuations and their comparison to market prices in a 'solvency' test is malfounded. Both the use of gilt yields and expected returns on assets are incorrect. As we discuss these issues at many other points in our response, we shall not restate our objections here.

In considering DB scheme investment strategies and asset classes, we would like to explore whether there is scope to encourage or facilitate some schemes to make more optimal investment decisions, and to mitigate any barriers to the greater use of alternative asset classes.

We believe that the emphasis, since Goode, on the trustees as the decision-makers and managers of scheme assets is misplaced. It would be appropriate if the scheme were truly an independent (insurance) entity expected to continue beyond the insolvency of the sponsor. However, for open schemes, with the sponsor employer responsible for the costs of the scheme, it seems to us that the appropriate decision-maker is that employer. This means, in turn, that if the appropriate decision-maker is the sponsor employer, then we would expect the resulting asset allocation to reflect the risk profile of the sponsor employer. Member security is best achieved by consideration of the whole entity, sponsor and scheme.

We note that much hedging activity, which is often achieved through asset allocation, is presently undertaken to lower the volatility of scheme valuation results in the sponsor balance sheet, which of course are derived under the UK accounting standards. These involve discounting using bond rates.

We note even though UK equities have constituted a reliable hedge of retail price inflation in the period since 1995, in both price and dividend, their use has fallen markedly.

On the issue of the quality of scheme trustees' investment decision making, we do not feel that there is sufficient evidence on which any firm conclusions can be reached, and therefore intend to commission further research on this and to further investigate the factors that influence investment strategies and the choice of asset classes.

We have conducted research on this subject and find that trustees possess inherently sound judgement. See later in this response for further details. In our viewpoint, the requirements of trustees would be much less onerous than they are under the Regulator's prospective view. They would not require any long-term consideration of sponsor covenant, or integrated risk management.

Employer Contributions and Affordability

We are not persuaded that there is a general 'affordability' problem for the majority of employers running a DB scheme. Consequently, we do not agree that across the board action is needed to transfer more risk to members, or indeed to reduce members' benefits in order to relieve financial pressure on employers.

We agree. The idea of reducing members' benefits based on a prospective, poorly constructed probabilistic viewpoint, is simply anathema. It could and doubtless would be challenged in the courts.

However, we do recognise that there are some companies who are paying very substantial Deficit Repair Contributions which may not be sustainable in the long term. We have therefore considered what might be done for these 'stressed' schemes and their sponsoring employers, and the difficulties in doing so.

It would help no end if valuations and actions based upon them were correctly derived. We would advocate most strongly the use of multiple viewpoints for such employers and their schemes.

A number of people have put forward options including allowing a struggling business to more easily separate from their pension scheme, renegotiating benefits, providing more intensive

support from the Pensions Regulator and enhancing the powers of the Regulator so that it could separate the scheme from the employer or wind up the scheme in specific circumstances.

As we believe the Regulator to be part of the problem, we do not see that it can be the seat of a solution. It certainly cannot be as long as it has a duty protect the Pension Protection Fund. We would oppose any increase in the powers of the Regulator.

All of these options have significant drawbacks and could raise 'moral hazard' issues, where sponsors might be tempted to look to reduce their liabilities by taking advantage of any easement available for 'stressed' schemes or employers.

The problems being described are not "moral hazard"; they are problems of perverse incentive arising from legislation and practice. See Box 2.

Member Protection

Protecting members' interests is at the heart of our policy. The Regulator exists to ensure that members are protected. Many commentators have argued that its powers should be extended.

We do not believe that the case for placing members into a position of super security, beyond even the insolvency of the sponsor has ever been made. If attempted through the pension scheme, it is massively expensive and economically inefficient. It also has significant costs for society at large through the cessation of DB provision and for tax-payers in particular through the loss of revenues that would otherwise arise. It is not at all obvious that members should have such a status. If they should, then it is equally obvious that the way to achieve this efficiently is not through scheme funding but through insurance.

We have examined a number of options put forward to us covering scheme funding, corporate restructuring and information gathering powers, although in taking forward any changes to existing powers, we would need to be certain that any new powers are proportionate, and take into account the impact on the Regulator's resources and the levy on pension schemes which funds its activities.

As there are none with which we agree, we shall note only that the cost of the Regulator over its short lifespan has already risen from £10 million to more than £80 million.

The paper considers whether the Regulator should take a more proactive role in scheme funding and be more explicit about the level of risk it is appropriate for a scheme to take.

The appropriate level of risk in a scheme is rightly a concern for the sponsor employer. The Regulator is in no position to make judgements about this, and nor should it be.

Box 2

Moral Hazard and Blame Shifting

Pre-pack resolutions of distressed companies have received an extremely bad press in recent weeks; morally righteous rent-a-pension-quote politicians and regulatory authorities have queued to express their indignation at this “moral hazard”.

There is a problem here; what we are seeing is not moral hazard; that is a term of art in the realm of insurance. It refers to the situation where, once insured, we may cease to show proper care in avoiding the incident covered by the insurance. For example, we may fail to check, as diligently as when uninsured, that all windows are closed and locked after we have taken out household contents cover. Policies contain a number of mechanisms to limit this possible increased risk exposure, such as a deductible. Moral hazard is seated purely in the behaviour of the insured.

Although the reductions in pensioner benefits imposed by the Pension Protection Fund have often been presented in these moral hazard terms, they are not warranted as such. The member does not have control over the behaviour of the scheme, fund or sponsor employer. The reductions in benefits are analogous to reducing the compensation awarded to the injured third-party in motor insurance; the little old granny we ran down on the zebra crossing.

Pre-pack behaviour has similarly been described, incorrectly, as a problem of moral hazard; the issue here is actually one of incentives. The actions that offend with pre-pack resolutions is the award of senior or secured status (or both) to other debt obligations; in insolvency this may leave little, if anything, for general unsecured creditors after repayment of those debts.

It is worth noting that pension deficits are qualitatively different from other debts. Pension deficits arise from the accounting convention, while the other debts arise from the advance of funds, for operating or investment purposes. Deficits are inherently more nebulous than ordinary debts.

The perverse incentive is rooted in the section 75 valuation, which is the estimated cost of full buy-out. This determines the amount of the scheme’s claim; the shortfall of assets from this value. This is a major breach of the elementary concepts of equity and fairness.

The equivalent valuation to an advance made, for a pension liability is the best estimate of that pension liability. It is not even the technical provisions level, let alone the section 75, full buy out value. The claim in insolvency is massively overstated.

This overstatement cannot even be justified by reference to the risk faced by the PPF. Because of the haircuts, the payment of reduced benefits, that is typically 80% or less than the best estimate of liabilities. Indeed, the PPF only faces loss if the scheme is funded below this level. By contrast, under current conditions, the average section 75 value is close to twice the best estimate of liabilities. Suppose the scheme is funded (has assets) to the level of best estimate, and the majority of schemes are actually now better funded than this, then the PPF will profit to the tune of 25% of its liabilities. However, the section 75 claim will be 100% of best estimate.

If you were another general unsecured creditor, you would be rightly indignant at this. This is the perverse incentive. As a creditor, if faced by such a massive dilution of your valid general unsecured claim, you would and should, out of prudent self-interest and not exploitation, take steps to ensure that your claim has higher priority or superior security.

Box 2 (Continued)

The incentive is perverse and substantial. By contrast, in one view, the misdescription as moral hazard is not; that misdescription facilitates blame shifting by the creators and enforcers of the incentive to the directors of the distressed company.

The solution does not lie with further powers for the Pensions Regulator, nor draconian legislation; that would simply make finance for distressed companies more expensive and less available. It would exacerbate their difficulties and increase insolvency rates. The correct solution requires twofold action: elimination of the section 75 debt fiction, and the introduction of negative pledge clauses with respect to real scheme deficits. A negative pledge clause is a standard term in commercial lending; it would require the company to offer similar security and status terms to trustees as offered to other, usually new, creditors. As the trustee does have to accept this, there is flexibility to recognise the realities of commercial life, when necessary.

If corporate actions really have been too egregious, it should not be forgotten that the insolvency practitioner may be held accountable.

But don't hold your breath, demonising the individuals involved is just far too much fun, and advances political careers; particularly so when absolutely no blame is attached.

On the issue of corporate restructuring, it has been suggested that the Regulator would be more effective if it had powers to act proactively in order to prevent certain corporate activities.

This is a ridiculous argument. How would the Regulator compensate those where it had intervened and this intervention was subsequently shown to be unwarranted? Proactive intervention raises the "Minority Report" question: can you really prosecute someone before the event has occurred?

There are already mechanisms for redress if it is subsequently proven that actions were taken in bad faith, and had deleterious effects.

Our view is that a blanket requirement on parties to obtain clearance from the Regulator ahead of any planned corporate actions would be disproportionate.

We agree.

We have, however, considered the case for the Regulator to have a clearance regime in certain specified circumstances, although we note the very significant difficulties that would need to be overcome before such an approach could be considered.

In our view, such a regime will only serve to ensure that DB schemes are not offered in future.

It would need to be very narrowly limited to avoid potentially significant disadvantages to business, and a high threshold would need to be set for the circumstances where seeking clearance would be required.

We feel that the effect would be for schemes to convert themselves into insurance companies – that is to say that the employer would create an insurance company and the scheme would buy out with it and then wind up. There would of course be no obstacle to these being incorporated overseas.

In looking at current information gathering powers, options for change include the creation of a duty, applicable to all parties responsible for a scheme, to co-operate with the Regulator, and providing the Regulator with a power to interview relevant parties supported by a sanction for non-compliance.

This is nonsensical. It is a license to go fishing. It is further cost for no employer gain. There is already such a power in s72 of PA 2004; the use of which is highly contentious.

Consolidation of Schemes

The final section of this paper considers the issue of scheme consolidation. Most DB schemes are small, and the data suggests that small schemes have higher administrative costs, are unable to benefit from the economies of scale available to larger schemes, and tend to have less effective governance.

We see the costs of a scheme as a matter for the employer sponsor. If the concern is member security, that is simply resolved by requiring the PPF to pay full benefits.

This section considers the arguments for and against the aggregation of smaller schemes into one or more consolidation vehicles in order to reduce costs, improve investment options and governance. A number of consolidation models and their pros and cons are considered, together with the question of whether a move to greater consolidation should be a voluntary or compulsory act and, if a compulsory approach were taken, how this might work. Our view is that there appears to be a strong case supporting greater voluntary consolidation.

Voluntary consolidation arrangements have existed for a long time; there has been very little take-up.

Some commentators have argued that, in certain circumstances, schemes might be required to consolidate, but we are not convinced that compulsion would be a proportionate response.

This is entirely ridiculous. The problem of member security can be fully resolved by requiring schemes to have pension indemnity insurance cover.

In considering the design of “Superfund” consolidation vehicles, one option raised is for

government to design and run them through an arm's length body. We have considered the case for and against this approach, and have concluded that it would not be appropriate to take this option forward, but we have asked whether it would be appropriate for government to provide some structures or incentives to encourage the pensions industry to innovate and to provide new consolidation vehicles.

We agree that government should not get involved in the management of any superfund. We have suggested, at many points in this response, change which would permit innovation and hold the prospect of reinvigorating defined benefit provision.

Box 3

Moral Hazard

A recent roundtable discussion of DB scheme funding among senior, and illustrious industry figures contained, when promoting a full or buy-out funding objective, the statement “I would not want to tell members that they have a 30% chance of not getting their pension”. This was referring to a scheme which was funded at 70% of full buy-out values.

The errors are profound and alarming, but as they recur in the PLSA “Consolidation” paper, they appear to be widely believed. Obviously, what matters first is whether the scheme sponsor is solvent, so the likelihood of pensions being unpaid is conditional on sponsor failure. If we assume that this is an average sponsor, though such thing really does not exist, its insolvency likelihood is around 0.4% per annum – over ten years 4%. If fact the conditional likelihood, over the next decade, of members not receiving all of their pensions is 1.2%.

But the alternate presentation would not grab headlines. ‘Our scheme is capitalised at 140% of the best estimate of pension liabilities; this is better than any major bank or insurance company in the world’ just does not grab an editor’s attention. In 70% of outcomes we already have far more than is needed.

The PLSA “Consolidation” paper tells us that schemes holding 42% of all benefits of schemes in deficit “have just a 50:50 chance of having them paid in full” and subsequently refers to schemes “limping along for the next 20 to 30 years – posing high risk to employees hard-earned benefits.

Let’s unpack this: half of schemes failing over 30 years – that is an annual rate of sponsor insolvency of 1.36%. These must indeed be true basket cases, when the overall corporate population insolvency rate is around 0.4% and that is heavily distorted by the high failure rates of recently created firms (which don’t have DB schemes). It is higher, as both the Regulator and PPF have noted, than their projections.

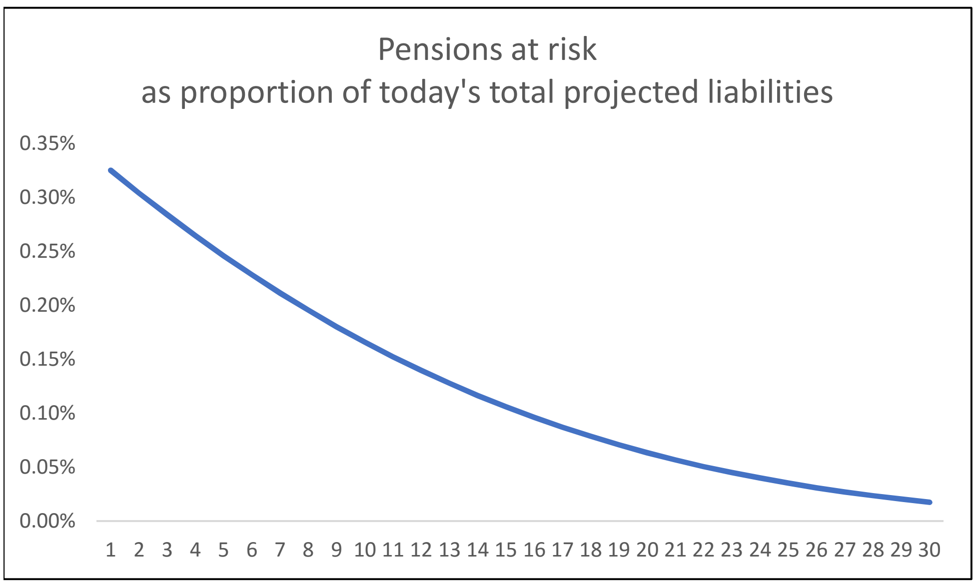
The risk to members is of course the loss that they would experience as a result of entering the PPF. Those PPF haircuts are unwarranted, but that is a separate subject, even though also often another misrepresentation of moral hazard.

Box 3 (continued)

These schemes are by and large closed to new members and future accrual; they are in run-off. Pensions get paid and this means that the total amounts of pensions payable decline over time – for a fairly typical scheme, the liabilities 30 years from now are just 18% of those prevailing today.

Moreover, as time passes, more and more of the membership are pensioners in payment. Schemes that closed ten years or more ago will have only pensioners in payment thirty years from now, and of course the risk to these pensioners in payment exists only for the members of those schemes which are still using RPI rather than the PPF's CPI for indexation. The illustration below shows the amount of pension at risk, year by year, as a proportion of today's total benefits projected. It is cumulatively less than 4%.

This is small and rapidly declining; it gives the lie to the many assertions that the risk is huge, imminent and that doing nothing is not an option.



The PLSA paper drives relentlessly towards their consolidation and superfund model, when there is a far simpler way in which to manage the risk that the PLSA study is concerned by: increase the PPF compensation to full benefits.

There's something very macho about a superfund, a form of sovereign wealth fund envy perhaps. The entry requirements envisaged would be 90% of full buy-out values. Quite how these basket case companies would afford that is a problem glossed over. The cost to these companies is astronomic. It is a near doubling of the best estimate cost under current conditions.

Box 3 (continued)

There is a further issue with buy-out estimates. Under current practice, they are stand-alone valuations, when bulk annuity insurers should and do price schemes on the basis of their marginal contribution to the risk of their books of business. For the obvious commercial reasons, no external party has knowledge of that position. The differences can be quite stark. For one scheme recently, the stand-alone valuation was 117% of the transaction quotation.

Two quotations from Schumacher's "Small is Beautiful" are immediately relevant: "Any intelligent fool can make things bigger, more complex, and ... It takes a touch of genius — and a lot of courage to move in the opposite direction." and "Even today, we are generally told that gigantic organizations are inescapably necessary; but when we look closely we can notice that as soon as great size has been created there is often a strenuous attempt to attain smallness within bigness."

As the motivation for the PLSA consolidated superfund is risk reduction, another: "You do not make non-viable people viable by putting large numbers of them into one huge community, and you do not make viable people non-viable by splitting a large community into a number of smaller, more intimate, more coherent and more manageable groups".

It is obvious that some basic education on statistics and probability theory is necessary. As for the PLSA report: is it just a solution (life insurance consolidation) in search of an application or is it just that it is simply of consultant quality, where the iron first law of consultancy applies: there can be no solution that we are not part of.

Part B

This section contains our responses to the specific questions posed in the Green Paper.

Questions and Answers

This section considers and responds to the specific questions posed in the Green Paper. **Extracts from the Green Paper are in bold, with responses in italics**; and, as there are two frameworks informing our responses, we show those **applicable under our vision in dark grey plain text**.

Question 1

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

No. Both measures are prospective, meaning that they bring the projected future values of benefits accrued to the present by discounting, and this discounted present value is then compared with the market value of assets to estimate the solvency position of the scheme. This is inappropriate for liabilities which have already been incurred, but would be appropriate if we were pricing the acquisition of new liabilities today. In other words, the prospective approach is suitable for an insurance-type institution such as the PPF, when pricing new business. However, even for such institutions, it is inappropriate to value the accumulated book of business in this manner.

There are also issues associated with the solvency approach. The measures being used for assets and liabilities differ. Using different measures constitutes a fundamental measurement error. It introduces the possibility of bias and error into the resultant solvency estimation. It is clear that this has been substantial in recent years. The discussions among European regulators over the ultimate forward rate applicable to insurers is a reflection of this, though the 'solution' of that issue is a compromise which addresses symptoms rather than cause.

Basing cash equivalent transfer values on valuations derived in this way introduces a real cost to the scheme. In essence, the member has been awarded an option (for free) on the long-term performance of discount rates, with a lesser, and regulatorily discouraged dependency upon the accumulated value of the scheme asset portfolio, and this is extremely costly to the scheme. Not the least aspect of this is the extent to which it will shorten the investment time horizon of the fund.

Both methods are time inconsistent. This introduces material costs into the management. Portfolios *of assets and liabilities are acquired over time on terms which remain largely fixed; these are intrinsically smooth processes, with only marginal changes arising from actions at points in time. However, it should be recognised that the aggregated change(s) may be substantial. However, the smoothness is a symptom, or feature, rather than cause, and for this reason we do not support the use of smoothed discount rates in valuation.*

There are alternate measures and approaches. For example, we may estimate the required rate of return on scheme assets necessary to achieve payment of the benefits projected. This is a form of solvency measure.

Another method would be cash-flow based and rely not on today's market prices, but on the adequacy of the asset portfolio (and any other contracted contributions) to generate sufficient cash to pay benefits as they fall due. This was in fact the standard actuarial method prior to the millennium. From around 2000 until 2006, there was an ever-increasing move towards the FRS17 'market consistent' approach. The Inland Revenue excessive surplus requirements still smoothed the assets until March 2006, and market consistent became obligatory from the end of 2006. It should be recognised that corporate cash flow projections are inherently an order of magnitude more stable (and therefore simpler) than market return projections. Indeed, cash flows and cash flow projections are the most powerful predictor (factor) of listed equity returns.

Let us emphasise this point: the existing methods are appropriate for pricing new business. This means that they are suitable for pricing new awards, though very few schemes remain open to further accrual. However, as contributions are usually fixed for long periods of time, this is largely academic. The value of the discount rate used is also material. When this is based upon gilts or similar bonds it can result in grossly exaggerated apparent costs to new awards.

The framework in use is implicitly one of scheme primacy, with the sponsor a remote adjunct. As these are occupational schemes, this is a strange and significant transposition of responsibility.

[Applicable under our response] The question unasked in all of this is that which is relevant in a broader context: has the company performed in accordance with its contractual promises? This would be the test applied in securities markets. These are a useful counterfactual; a world in which owner security is a material concern but without any pension legislation applying. The valuation is simply a matter of determining the degree of progress expected to have been achieved at the point in time of the valuation. This looks backwards. It considers the terms on which the security or pension promise was made by the company.

In the case of a security, say, a secured ten year zero coupon bond issued five years previously at a

5% compound yield, the calculation is the sum of the amount originally advanced plus the accrued five years of compound interest (£61.39 plus £16.96) and the total security required would be £78.35. Note that this valuation process is time consistent. If the company continues to perform as required in this manner then the bond will be fully discharged at maturity. It is worth noting that similar maturity proceeds will, if they were issued on differing terms, have different values today. If the ten-year bond, above had been issued yielding 10%, then its value (and security) at year five would be £62.09 – (£38.54 plus £25.53). This would constitute the distribution available in a voluntary liquidation of the enterprise and the admitted claim in insolvency. It would also be the basis of taxation by HMRC as to income and capital gains.

As we note elsewhere, the s75 (section 75, PA 1995) debt is profoundly problematic in this regard.

The methods specified in pensions legislation do not recognise these differences. The contractual accrual rate for a DB pension award should be no different. The contribution and the projected benefits determine a unique rate of accrual. The scheme is simply the accumulated aggregate of these awards. The rate is time consistent. It is the rate of return on investment promised to the employee on their voluntary contributions. It is the gross cost of the award and scheme to the sponsor employer; the income of the fund simply serves to defray or defease this gross cost.

It is this gross cost which is the prime determinant of the cost of the scheme, and with that the sustainability of the scheme and employer.

In our opinion, many of those who complain that pensions used to be provided on a “best endeavours” basis are reflecting in part, and somewhat inchoately, this shift from performance due to performance expected.

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

[Applicable under our vision] No.

[Applicable under our vision] And this question would not arise in our contractual accrual rate view.

- If not, why, and in which way are they not being used appropriately?

The bond discount rate basis is still being widely used even though these rates are extrinsic random variables. Somehow, but inexplicably, the myth persists that these represent the use of a ‘risk-free’ discount rate.

The expected return on assets is in all too many cases being based upon a ‘gilts plus’ vision of the *future world. This apparently relies upon a totally discredited academic hypothesis. To quote Hyun Shin of the Bank for International Settlements (BIS): "Long-dated yields may be overrated as a forward indicator of economic conditions. Far from being a window on the future that reveals insights that no individual market participant has, low yields may, instead, reflect very ordinary motives of individual investors that have only a limited bearing on forecasts of the distant future." This is hardly new: in 1983, Bob Shiller, John Campbell and Kim Schoenholtz noted: "The simple expectations theory, in combination with the hypothesis of rational expectations, has been rejected many times in careful econometric studies. But the theory seems to reappear perennially in policy discussions as if nothing had happened to it...*

We are reminded of Tom and Jerry cartoons that precede feature films at movie theatres. The villain, Tom the cat, may be buried under a ton of boulders, blasted through a brick wall (leaving a cat-shaped hole), or flattened by a steamroller. Yet seconds later he is up again plotting his evil deeds." It reappears yet again in UK pension valuation.

Until recently the Pensions Regulator promoted gilt type approaches, presumably in support of its objective of protecting the PPF. In addition, the use of similar bond-based approaches in accounting standards may weigh on particular trustee choices.

- **What evidence is there to support this view?**

The most obvious is the prevalence of liability-driven investment. Invariably this involves the hedging of interest rates, when these discount rates are irrelevant to the risks of a scheme. This is a case of hedging the measure, not the substance. Obviously hedging may be effected by use of either derivatives or bonds – the increase in bond holdings by pension funds is well-known.

It is intrinsically short-term in nature. The consequence has been a marked decline in the income and return performances of funds. Indeed, the activity has been sufficiently great that index-linked gilts now offer RPI minus 1.85% when they are owned as to more than 80% by UK pension funds.

- **How could sponsors and trustees be better encouraged to use them?**

We believe that it is necessary to first remove the Pensions Regulator's statutory obligation to protect the PPF. The flexibilities are quite limited. If a scheme is invested in gilts, it will have only the expected return of gilts as a basis for its discount rate.

We wonder as to the extent that accounting standards and the company position are driving this lack of take-up. We recommend that a research survey be conducted to resolve this question.

[Applicable under our vision] These flexibilities are irrelevant in our view.

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?**

We do not believe that there is evidence to support any change to the valuation cycle. We note that many schemes in fact operate systems which extrapolate earlier results between valuations.

Moving to a shorter cycle will tend to exacerbate problems of short-termism. We do not believe there is any reliable method of identifying the riskiness of company or scheme. We would also be greatly concerned that this is then subject to the Minority Report critique. Would it really be possible for regulatory interventions to be based upon probabilistic assessments, and indeed, where wrong, if that ever becomes evident, without liability?

Risk based regulation brings with it further concerns. To quote Roger King: "While at the level of abstract general principles it is hard to cavil with a regulatory approach that seeks to be selective, focused, and proportionate, and which promises to relieve a number of institutions of unnecessary central control and bureaucratic impositions, risk based regulation can be a risky business, not least for the regulators. Risk based regulation principles are set to provide major operational challenges … Nor is it clear that the principles … sit easily with established democratic beliefs of equality before the law and associated ideas of fair treatment and accountability, based on bureaucratic impersonality, the application of the same rules and processes to all…"

As risk simply means that more things may happen than will, we are much exercised by the possibility that trustee concern with prudence will result in expensive and unnecessary 'risk' interventions. There would doubtless be an army of advisors recommending just this.

We do not believe that any part of this question should be pursued.

[Applicable under our vision] Risk concerns are self-evidently a prospective view. In ours, such concerns would arise only if the sponsor was delinquent, that is to say that scheme funding was below best estimate. It is a matter of fact, not guesswork, no matter how sophisticated that guesswork is. The only significant source of uncertainty here is variability of the asset portfolio. Deficits tend to become smaller and are more foreseeable.

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

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

We have no experience of the 15-month term being problematic. Where we have seen time-scales *challenged, it has been because of the complexity of the situation combined with a need to investigate options and approaches to resolution fully. We are not convinced that there is an issue in general.*

[Applicable under our vision] In our view, the valuation process is far simpler. The (contractual accrual rate) discount rate and liability valuations are matters of fact. Trustee debate reduces to consideration of the required degree of prudence to be exhibited in technical provisions.

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

- If so, which ones and for what purpose?

We believe that a range of approaches, of different viewpoints, would serve to break the tyranny of the current mixed attribute prospective solvency regime. Accordingly, we would like to see additional techniques utilised. These would include:

1) cash flow projection for both assets and liabilities – this would, among other things, deliver a time to failure metric, for those schemes in deficit.

2) the required rate of return on assets – the likelihood of this return being achieved may also be estimated.

3) a solvency approach using the contractual accrual rate – this may be reported to scheme members as the rate of return on their investments.

4) publication of the best estimate of scheme liabilities.

We are not convinced that stochastic modelling of assets and liabilities would add to our comprehension. Stochastic modelling is complex and usually expensive to undertake, and very difficult to do well. For example, with the prices of assets and liabilities modelled as log-normal processes, their ratio, the surplus or deficit, would be Cauchy distributed, a process which lacks even a defined mean. A further issue with many such models is that, as iterations are increased in number, the results merely converge to the properties of the original assumptions.

The further risk with stochastic modelling (indeed, for any complex model) is that it throws out results which are not likely to happen in the real world, and may even be impossible. This is especially true at the tails of a distribution, which is the very area of most interest. It is the tails of a distribution which are information-rich. A major issue for such models is that they are not adaptive, in the sense that they tend not to recognise that the authorities and other market participants will change their behaviour, and with that, the observed behaviour of market processes in extreme *circumstances.*

One can be misled into thinking the problems of the scheme are greater than they really are; becoming fixated with risk and losing sight of the fact that more things may occur than will. One can end up managing the problematic output of a model, rather than managing real world problems of the scheme. The use of stochastic modelling should neither be mandated nor encouraged.

[Applicable under our vision] Modelling of the scheme is in our view, modelling of the wrong institution. The primary risk to pensions is not scheme failure, but sponsor failure, which carries the consequence that it should be the sponsor being modelled. Under the contractual accrual rate approach cure of deficits may be achieved in relatively short time frames. Such short periods do not lend themselves well to stochastic modelling approaches.

- **How would the information provided to the Regulator to explain the agreed recovery plan differ from that at present?**

With a range of viewpoints, the Regulator would be far better informed. For example, cash flow modelling delivers a time to failure metric. The required rate of return on assets is a metric which may be assessed as to feasibility by the Regulator. The Best Estimate valuation immediately reveals the degree of prudence baked into technical provisions. Further, with publication of the best estimate, alongside the already published buy-out and s179 (Section 179 PA 2004) valuations, the true level of risk of a scheme to the PPF may be estimated. The contractual valuation is a baseline measure, from which the load on the sponsor due to regulation may be estimated. It is a measure of the relative efficiency of the regime in force.

- **What would the costs be, and would they outweigh the benefits?**

The benefits would far outweigh costs. The most important costs are indirect, the pursuit of inappropriate investment strategies under existing approaches. This is likely to be compounded by the one-way nature of contributions made into schemes which are closed to new members and future accrual.

The direct costs of estimation of the required rate of return are trivial. Publication of the best estimate would require some minor systems modification, but the ongoing costs would be trivial. Cash flow projection would be somewhat more challenging from a systems standpoint, but is again a one-off cost.

However, we believe that these changes would reinvigorate competition among actuarial advisors and be absorbed by them. Their one-off systems costs would be spread across all clients.

[Applicable under our vision] The contractual accrual approach requires, as an input, the contribution histories of members. This may be difficult and expensive, or even impossible to extract from poor prior records. In the one instance, where we have conducted the exercise, a scheme with reasonable records, albeit in paper form prior to 1973, and with just 3,700 members, the one-off cost was approximately £250,000. However, there are approximations which may be applied that obviate the need for prior records to be compiled, and have trivial costs.

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?

With the advent of widespread defined contribution (DC), a tendency has developed to believe that investment performance (together with cost and fee disclosure) is a prime and relevant concern, when defined benefit (DB) scheme members actually have fixed claims.

Members should understand that:

a) As long as their employer remains solvent, their benefits will be paid in full.

b) In the event of their employer's insolvency, their benefits may be reduced to PPF levels and this is not, for the majority of members, a disaster.

The contractual accrual rate of contributions made to the scheme should be quoted to members. This is a value for money statistic, and its publication would allow comparison with DC and other investment opportunities.

[Applicable under our vision] In our view, there are two possible scenarios. If we adopt the view that the protection of members should not be different from that of a secured creditor or DC investor, then it should be made clear to members that all they will receive is the value accrued to the date of sponsor insolvency, and that this may or may not be sufficient to purchase equivalent benefits at that time. It should also be pointed out to them that this was due performance by the sponsor of the promise made. In the second scenario, where the PPF or private sector insurers step in and pay full benefits, there is no need for any caution over sponsor insolvency.

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?**

We do not believe there is a role for Government here. Such communications would run the risk of creating a liability for Government, in much the same way as trustee statements that lead to or encourage particular expectations may lead to the trustees being held by members to delivery of those expectations.

Members receive scheme information but often do not read it. Any campaign targeted at DB members would be open to the criticism that these are the people already best provided for and could easily become a focus of discontent among DC scheme members and the entirely un-pensioned.

[Applicable under our vision] If on the other hand, Government wishes to resurrect DB pensions from their near-death, and is prepared to undertake the revisions to pensions and accounting regulation necessary, a campaign of communication to employees and their sponsor employers would be appropriate. This would be particularly relevant if defined ambition and collective defined contribution arrangements are to be facilitated.

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?

There is overwhelming evidence of the sub-optimality of investment choices and asset allocations. An entire industry has sprung up promoting liability-driven investment and 'solutions'. Portfolios are heavily driven by the hedging of the so-called 'risk' arising from the discount rate measure. This is a direct consequence of the pension and accounting regulation. Pensions 'Freedoms' and cash equivalent transfer values have added to these pressures. As noted earlier, index-linked gilts, which are owned as to greater than 80% of the outstanding, now offer returns of RPI minus 1.85%.

The performative nature of such large-scale asset allocation shifts has to an extent mitigated the immediate cost of these actions; bonds and interest rate derivatives have performed as well as they have in recent years precisely because of the purchases by pension funds and insurance companies. Such herding typically ends in tears, with a systemic issue. Equivalents of the "taper tantrum" become likely endings.

Not only have falling gilt yields resulted in higher present values of liabilities on all current measures, but the more conservative, less volatile strategies being followed have lowered the volatility of published results. This would imply that technical provisions should now be lower *relative to best estimate than previously under equity dominated strategies. But we have in fact seen the reverse of this; technical provisions are larger not smaller.*

In addition, portfolios are overwhelmingly invested in highly liquid marketable securities, when the timescales to which they operate and generate liability cash flow payments are far longer and smaller.

The use of a wider range of valuation metrics will moderate this.

[Applicable under our vision] In our view, the asset allocation followed by a fund would reflect the sponsor employer's needs and desires for income or cash flow to offset their payment liabilities, in the context of their business capacities and expectations. It seems highly unlikely that, in the absence of the pressures of the current prospective 'market-consistent' standard, this would approach that allocation now seen.

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

In general, it is true that trustees have too many rather than too few options choices. We are, though, concerned that the almost universal advice from investment consultants is intrinsically short-term in nature – 'risk' hedging and the Beebower, Brinson result that asset allocation dominates all other return properties. This result derives from the simple fact that in the short-term returns are dominated by changes in price, while in the long-term, it is income and to a lesser extent changes in income which dominate returns. We are hopeful that the current FCA work on asset management will address this issue.

There are issues in the government bond markets.

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

Yes. The Debt Management Office should issue a higher proportion of debt in index-linked form. It should also undertake debt maturity extension operations, retiring issues with five years or less to redemption while issuing actively in the twenty- to fifty-year range. It may also make sense for the Government to issue term annuities, though this may be better organised through NSI for individuals.

It is also currently the case that fund managers may contract around all but the most egregious examples of breach of fiduciary duty in the investment management agreements for segregated mandates. Government could intervene to limit and restrict the possibility of such behaviour.

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

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

No, they do not. The DB pension claim is a fixed claim in the sense that it would not participate in the upside of strong investment returns.

[Applicable under our vision] If the PPF coverage is extended to full benefits, the investment aspect of DB is entirely immaterial. In any event, in our view, this is relevant only to the sponsor company. There is value to members in disclosing the contractual accrual rate as this is the return they are being promised on their investments.

c) 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?

As long as the Regulator has a statutory obligation to protect the Pension Protection Fund, absolutely not. The result would be 'Regulator's quality' schemes, and further damage to the use of DB by sponsor employers in recruiting, retaining and rewarding staff.

[Applicable under our vision] In our view, if schemes are fully insured, by the PPF or private sector coverage, there is no need for the Regulator to intervene in any way. This is a matter of private contract. In general, the question of the overall risk of the scheme is one for the sponsor to assess in the context of their operations and planned development.

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

Asset pooling may lower the costs of particular segregated mandates. It may also allow some further economies of scope. However, the case for these advantages is still very far from proven. There is also the potential problem, commonly seen, that large schemes or pools tend to underperform small ones. Schemes already have access to a very wide range of pooled products. It is already feasible but not widely used. It may be that the preferences of sponsors are sufficiently diverse or that other asset allocations are sufficiently scheme specific, that common funds are not an efficient solution.

[Applicable under our vision] We see asset pooling as being driven by the capacity and preferences of the scheme sponsor.

[Applicable under our vision] We do not see consolidation as being either necessary or desirable.

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

Yes.

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

[Applicable under our vision] There are numerous examples, but to pick just one: the Regulator's duty to protect the PPF. We would like to see this repealed and an obligation to promote the provision of high quality pensions substituted. Many others, such as the prospective mixed attribute solvency nature of the valuation rules, are discussed elsewhere in this response.

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

Yes. The use of gilts plus under the expected return valuation variant is one example. The use of model portfolios which derive from the Beebower asset allocation result and the promotion of Liability Driven Investment are further examples.

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

No. Our research suggests that trustees are sensible decision makers. Guidance and professionalisation will merely serve to embed and spread the Regulator's narrative. We should not forget that the risk to any Regulator lies in failure of its regime to prevent disaster; it will therefore be conservatively, and expensively, biased.

[Applicable under our vision] In our view, most of the complexities advocated and advanced by the Regulator, such as integrated risk management, are unnecessary; it is these aspects which trouble many trustees. With full insurance coverage, this is an entirely redundant set of obligations. We are also troubled that the Regulator has not intervened when many schemes are using derivatives which are structurally leveraged, when the 2003 European Directive expressly prohibits schemes from borrowing other than for short term cash management purposes. We also worry that when investment banks construct instruments designed specifically to circumvent regulations, to follow the letter rather than the spirit of the law, investors will usually be compromised and disadvantaged by their complicity and connivance.

We are concerned that the Regulator is seen as being supportive of funding to self-sufficiency or buy-out. This has merit only in terms of their obligation to protect the PPF. It is clearly not in the broader interests of the workforce, or population more generally. It is tantamount to assisted suicide.

In our view, trustee duties are rather light; they consist of ensuring that the scheme liabilities are adequately secured under the terms of award at the valuation.

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?

We believe that there is a case for greater flexibility in the options available for schemes where the sponsor employer is in distress; these would not though be 'special' arrangements, merely an extended range of ways in which the pension scheme position may be resolved. For example, members might be allowed to transfer their rights under a particular DB scheme to a DC scheme; the assets transferred would be proportional to the member's share in the present value of liabilities. We also feel that arrangements such as Defined Ambition and Collective DC would have a role to play here. It is clear that there are many circumstances where modification of the member's rights, alterations to the structure of risk-sharing and risk-pooling may permit continuation of the scheme after sponsor insolvency. These would be sponsor-less, independent schemes standing alone. If we take the instance of British Steel, changing inflation indexation from RPI to CPI lowers the liability values by sufficient that the existing assets held provide a capital buffer. There are a range of modifications that may be possible; in one such increasing order, these may be lowering of indexation on new awards, lowering of future indexation, and lowering of benefits. It is also possible to see instances where sponsor support might be partial or limited; for example, the sponsor may commit to providing support up to but not higher than some fixed sum.

These DA or CDC schemes would need to be managed in similar fashion to an independent insurance company, but without many of the regulatory constraints that insurance companies are subject to. These are in many regards mutual societies not open to the general public. With such institutions, the degree of risk they are prepared to bear and the consequences of failure are a matter for their members and their members alone; scheme rules will define precisely what may be undertaken. In general, we do not support the idea that either scheme trustees or the Regulator may unilaterally alter a scheme member's rights; we do not favour any over-ride of the scheme rules. Section 67 of the Pensions Act 1995 clearly allows trustees to alter scheme rules with member consent.

We would note here that the s75 valuation, the cost of full buy-out in an insurance market, and the definition of the employer debt may be a problematic obstruction.

[Applicable under our vision] With full coverage of the benefits by insurance, for example, by increasing the PPF pay outs to full benefits, none of these issues arise. As we note elsewhere, insurance is a far more efficient solution to the problem of sponsor distress and insolvency than any funding variant.

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

No. A collection of anecdotes may constitute data, but we agree with the Green Paper that there is no widespread issue. There have been and are instances where affordability was or is a problem. However, there is a separate issue as to whether sponsors should make such contributions in a timely manner.

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

No. The issue here is that most schemes are now closed to new members and future accrual. This means that contributions may not be recovered when the scheme returns to surplus. The surplus is recoverable only on complete discharge of the pension liabilities. The usual method previously was for the sponsor to reduce ordinary contributions. We would also make the point that over and above the increase in present value of liabilities due to falling discount rates, we have seen increases in technical provisions relative the best estimate of liabilities. With deficit repair contributions based upon technical provisions, the demands made upon sponsors are inflated relative to their true contractual exposure, the best estimate expectation.

[Applicable under our vision] The level of scheme funding under full insurance is a matter of the contractual terms between insurer and sponsor. It is perfectly possible for a scheme to be insured and even to be entirely unfunded, as is evident from Germany and Sweden.

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

While we do believe that measures should be taken, it is possible to envisage a situation where it makes sense for the well-resourced sponsor to repair deficits. If the returns to capital employed in the sponsor business are lower than those expected from financial investment markets, then simple efficiency would suggest that priority should be given to the pension deficit.

- **Should a general metric be used, or should this be decided on a case by case basis?**

No. This should not be a matter for the Regulator. The deficit repair schedule which has been agreed with the trustees is a case by case basis.

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?

Yes. In fact, there already is. This is full buy-out. Of course, stressed employers are unlikely to be able or be willing to pay this price. The problem which currently arises is that in the absence of such *funding, and insolvency, separation of the sponsor from the scheme is not permitted. We believe that schemes should be allowed to separate under independent stand-alone arrangements, under DA and CDC type arrangements, with the consent of scheme members. In these circumstances, we would expect the scheme to be granted a stake in the ongoing firm in consideration of the relief granted by it to the employer; this may take the form of equity or debt, secured or other, on a case by case basis.*

[Applicable under our vision] With a system based upon full insurance, such situations may be handled by negotiation between the insurer and the sponsor. There are many circumstances where the insurer may even choose to support the sponsor employer rather than exercise its right of subrogation and take on the scheme. There may even be situations in which the insurer may choose to insure the ongoing separated and independent scheme. For example, where an independent scheme capitalises itself by changes in future indexation and is otherwise marginal, it would make sense to the insurer to accommodate the separation.

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

Manipulation of the system is not moral hazard. It may or may not be fraudulent behaviour; it arises from the incentives to sponsor employers and other stakeholder groups. We would note that these stakeholder incentives may differ, even among members of a scheme. Employees have the strong incentive of continuing employment, which of course is irrelevant to pensioners or deferred former employees.

It is worth explaining the relationship here. The scheme is a general unsecured creditor of the sponsor employer. There may be other creditors of the sponsor who are preferential or secured. These arrangements came about by virtue of capital or operating finance made available to the sponsor employer. There are already within the insolvency regulations procedures and sanctions for abuse in this regard. The scheme member's benefits are secured to the extent of assets within the fund, and these are 'bankruptcy-remote' in insolvency. There is perhaps a case for the scheme to have the benefit of a 'negative pledge' to the effect that no borrowings will be undertaken which are of higher priority or otherwise secured, without the scheme being offered similar status or other compensation. That said however, we feel that this would merely serve to limit the finance, in cost or amount or both, available to the sponsor firm. There will, of course, always be some cases of abuse, but we take the attitude that hard cases make bad law.

A large part of the problem stems from the s75 debt calculation, full buy out value. The expected *cost, the best estimate, of scheme liabilities is approximately 50% of the full buy out value. Funding to this 50% level would be the same as securing a commercial debt fully. The PPF coverage is far lower than the best estimate; in one case recently, just 50% of the best estimate. The debt on the employer claim of the PPF would be the s75 value, some four times its proper exposure. The s75 debt severely disadvantages other creditors of the same general unsecured class. Their rate of recovery could be just one quarter of that of the PPF. This is a strong incentive to ensure that a stakeholder is, as a creditor in a preferential and secured position.*

The level of inequity implicit in these arrangements is sufficiently great that we would not be surprised to see the legislation promoting and enabling it challenged in the courts. A wider range of options for separation would reduce the power of the incentive, but it is clear that the s75 value as a backdoor method of achieving preferential status for schemes is badly flawed. It is rooted in the view that continuity of the scheme beyond the insolvency of the sponsor is desirable.

[Applicable under our view] In our view, with full insurance these issues are a matter of private contract, with the courts as the ultimate arbiter. In the case where continuity is not a social preference, scheme members, through the scheme, would be secured to and receive the best estimate value, or where there is a deficit to this value, the asset security available, and be a general unsecured creditor as to that deficit.

- **Would some sort of 'quid pro quo' be appropriate to ensure the scheme is not disadvantaged relative to other creditors of the employer/stakeholders?**

No. No 'quid pro quo' is appropriate. It is the current arrangements which disadvantage other creditors of the same class.

- **What could this look like?**

This would be a case of giving the scheme preferential status or additional security. It would be difficult to justify such status in any amount exceeding the best estimate of liabilities. It might take the form of or be complemented by a negative pledge in order to maintain the relative status of the scheme. This is yet another problem which arises from the narrative that schemes exist to pay benefits even after the insolvency of the sponsor, while the social desirability and cost of that has not been publicly debated.

[Applicable under our vision] With full insurance, the issue is a matter of private contract, in the same manner as creditors, with disputes being resolved in accordance with the terms of those contracts.

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

reduce accrued benefits?

No. There are no circumstances where such changes should be unilaterally altered by an employer, other than upward revisions.

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

Benefits should only be altered with the consent of members. We would also note that consensual alteration need not be uniform, and active members may benefit from continuing employment.

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?

No.

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?

No.

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

It should not be allowed for either without member consent.

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

Such actions should not be permitted unless they are expressly allowed by scheme rules. Otherwise only with the express consent of scheme members.

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

The ability to vary and suspend indexation is a critical element in the design of defined ambition and collective defined contribution arrangements as these are broadly envisaged. Scheme rules should define the circumstances in which these powers can be invoked. Broadly speaking, these would be defined by trigger metrics reflecting degrees of distress in the scheme. The Dutch arrangement is that the present value of liabilities must be lowered by such reductions of pensions as are needed to leave the assets and liabilities of the scheme in balance.

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?

As we would not allow this as a universal right, the question is moot.

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

Yes.

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

See the earlier answer to Question 4b. Our basic position would be that in the absence of an ability for the sponsor to remove excess funding from the scheme then deficit repair contributions should be as remote as feasible. These schedules should also be, in part, determined by the level of the discount rate employed. When low rates are employed, the repair period should and could be longer or more remote.

[Applicable under our vision] With full insurance, this is a matter of private contract, as might be the level of funding required.

- **Should other changes be considered, such as the valuation method of Technical Provisions?**

Yes. With publication of the Best Estimate, the embedded prudence of the Technical Provisions level will be evident. As funding is required to the level of technical provisions, and as noted elsewhere these have become more conservative, there is a case for limiting this Technical Provisions less Best Estimate buffer. At present, it appears that many of the deficit repair contributions being demanded are simply the result of excessive prudence in the valuation. We would note that prudent provisions would decline as the volatility of the funding result is lowered and as the level of the discount rate declines.

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

Yes – This is a simple matter of administrative efficiency. Given the difficulties associated with valuation and the discount rate applied, it might be better for the trivial commutation limits in DB schemes to be based on the level of benefit rather than as a cash amount as currently.

Question 5

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

We do not believe that members need further protection. Indeed, many of the issues and problems we now see arise from the attempt to enhance member protection over and above the protections of ordinary investors or creditors, such that schemes are expected to service corporate promises after the sponsor company has failed. A further difficulty arises when this is attempted through the scheme funding mechanism; this is both extremely expensive and in limiting cases may not even be feasible. If this extension of security to DB pensions is warranted as socially desirable, even though it *conflicts with the treatment of other creditors, including DC pensioners, then the efficient manner in which to deliver it is through insurance of full member benefits, not funding.*

[Applicable under our vision] If there is a single action that might protect members and be warranted, it is the extension of PPF coverage to the full benefits of members. Trustees do not need further powers.

[Applicable under our vision] Member benefits would best be protected by allowing the development of a private sector insurance market for members, opening the PPF to competition.

We see the Pensions Regulator as a major part of the problem, not part of any solution. We note that the cost of running the Pensions Regulator has increased from an original annual £10 million to be now above £80 million; evidence of run-away mission creep. It specialises in creating ever more convoluted codes and guidance in pursuit of its narrative; the recently published guidance on DB investment is a prime example of this. As long as the Pensions Regulator has a statutory objective to protect the Pension Protection Fund it will be grossly conflicted. Thus far, in pursuit of this objective, its actions have largely been directed at pension schemes and their funds. The cost has been evident in the closure of DB to new members and even future accrual. It is further evidenced by the perverse investment and valuation practices which have become commonplace. Enhanced powers over corporate sponsors would simply compound the issues. The very idea that a scheme should survive its sponsor employer rather than be liquidated as any other corporate security would be is one which is intrinsically protective of the PPF. Enhanced powers would exacerbate the adverse

incentives already arising from s75 claims, and aggravate conflicts among corporate creditors as well as with the management and shareholders of sponsor employers.

[Applicable under our vision] We believe that the PPF should be required to pay full benefits to members, that it should be privatised, and the market for pension indemnity insurance should be opened to competition. Further we believe that the objective of the Pension Regulator to protect the PPF should be repealed and that it should have an explicit new objective to promote the provision of high quality occupational pensions. In common with many other insurances, if it is decided that it is socially desirable to have this preferential status, then it should be compulsory. In such a world, the role of the Pension Regulator reduces to little more than verifying that schemes have insurance coverage in force. All else is a matter of private contract between insurer, employer and scheme.

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

We believe that scheme sponsors understand the funding requirements well and we think that this is unnecessary for scheme members.

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

As this is unnecessary, this sub-question is redundant.

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?

Even if it were, this is a totally disproportionate solution to the problem. The definitions of corporate transactions would immediately become the target of ambitious corporate financiers and the usual regulatory arms race would ensue. It would also involve many in a costly but entirely unnecessary clearance process.

- **If so how?**

The optimal solution to the issue would lie in a broader negative pledge, applying to changes of ownership and management, dividend distributions, sales of assets (including subsidiaries), and prepayment of debts as well as the usual priority and security of debt instruments. It should be emphasised that a negative pledge would give the trustees the power to demand further contributions but not require them to exercise this power. This would not necessarily involve the Pensions Regulator. Trustees are most unlikely to be complicit in avoidance and abandonment of schemes as this would create personal liability. Moreover, they are best suited and positioned to understand what degree of forbearance, if any, is appropriate.

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

The risks of giving powers in this regard to the Regulator are enormous. Their exercise would doubtless open them to litigation. More importantly, as long as the Regulator is conflicted by the PPF protection objective, this would be grossly unsound. The principal risk of course would be that not only would DB provision be unlikely to be offered by any corporate sponsor, but its close kin, defined ambition and Collective Defined Contribution (CDC) pensions would also be unlikely to be entertained by them.

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

No. There are many valid corporate transactions which are or may be detrimental to a firm, and, by association, the scheme. Just think of research and development expenditure; most of this is money wasted; or advertising - and that part is detrimental to the firm.

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

This should require initiation of the complaint by scheme trustees and the fine should accrue to the benefit of the scheme. The fine should fall on the directors and officers and not be indemnifiable or otherwise reimbursable by either the company or an indemnity insurer. The critical element would be proof of intent.

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

Any and all such powers would lower the competitiveness of UK businesses with defined benefit schemes. The fact that Government is willing to grant such powers to a Regulator would detract from the overall attractiveness of the UK market – if here why not anywhere else when it suits? Unilateral modification of pensioner benefits would have a similar but much wider effect. The position would be greatly inflated by any ongoing requirement to protect the PPF, which is widely seen as an arm of Government. The only effective safeguard is not to grant these powers.

e) Should the Regulator have new information gathering powers?

No. Neither the employer covenant nor integrated risk management receive as much as a passing mention in any of the volumes of pension legislation. They are inventions of the Pensions Regulator and lack the force of statute law, but as a trustee, God help you if you stray from the Regulator's narrative, because there is little or no recourse available through the courts.

We have seen instances where the behaviour of the Regulator has been arrogant, capricious and abusive; instances where their actions have been totally disproportionate, such as the issuance of section 72 (PA 2004) notices, so much so that the costs of compliance have been materially deleterious to the security of member benefits, a clear breach of the Regulator's prime statutory objective to protect members' benefits.

Since its inception, the responsibilities and powers of the Regulator have grown seemingly unceasingly. The Regulator has proved remarkably adept at capturing the ire and indignation of politicians to its gain. Its track record in discharging these responsibilities has been far from illustrious; its accountability almost non-existent.

Rather than granting additional powers, a further dose of a failed medication, we recommend that a Royal Commission be established to investigate and report on the operations, accountability and role of the Pensions Regulator.

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

No

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

No Quite the opposite. If it is socially desirable to protect member benefits beyond the point of sponsor insolvency, this is best achieved by private sector insurance. The role of the Regulator reduces to verification that a scheme has such insurance.

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

Yes. This would sit well with a negative pledge.

[Applicable under our vision] We would expect private sector insurers to demand such information rights as a policy condition.

- **If so, what extra powers might be helpful?**

See above.

i) Should trustees be consulted when the employer plans to pay dividends if the scheme is underfunded – and if so, at what level of funding?

No. But they should be advised as a matter of common courtesy and sound internal information flows. When considering deficit repair contributions, trustees should certainly consider the dividend policy in effect.

j) Is action needed to ensure that members are aware of the value of and risks to their DB pensions?

No. This is a matter for the scheme trustees. If, as should be the case, variants such as defined ambition and collective defined contribution are permitted and introduced, it will be incumbent on trustees to explain these elements in detail.

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?

No. No-one could really disagree with the concept of better governed pension schemes but there no evidence that this must or will result. Similarly, it would be churlish to dispute risk reduction, but the *unaddressed question is: at what cost?*

[Applicable under our vision] The issue driving this initiative is the haircuts applied to member benefits by the PPF. The most direct and simple solution to this is for the PPF to pay the full benefits of members.

a) Is there anything in the existing legislative or regulatory system preventing schemes for consolidating?

No. We already have multi-employer schemes and indeed a number bodies already operate consolidation arrangements. None have proved terribly successful. Existing multi-employer schemes are widely seen as inefficient, unresponsive and as meeting the needs of neither members nor sponsors. The s75 value has proved problematic in some multi-employer schemes. One barrier for ongoing schemes is the triggering of a Section 75 debt on a cessation event which include an employer not having any active members. It is not necessary for this debt to be triggered if the employer remains associated with the scheme and liable for this debt in the long term.

- **How might such barriers be overcome?**

As discussed earlier, substitution of Technical Provisions value for the s75 value would remove or diminish many of the perverse incentives. Removal of the one-person cessation event would be another.

b) What other barriers are there which are preventing schemes from consolidating?

There are other barriers. Pride of ownership is evident among many trustees and these schemes are part of the overall human resources management of the sponsor company. Employers, trustees and members are sensitive to the idea of sharing information. With DB schemes now seen as the gold standard of pensions, they have once again significant value in the recruitment and retention of staff. Employers fear losing control if their scheme is part of a much bigger scheme.

There are often significant differences in benefit structures which will reduce the savings from consolidation. There is also an unhelpful focus on the employer covenant; if there are to be significant gains to consolidation there needs to be both risk-pooling and risk-sharing among participant schemes. It is possible that risk-sharing among schemes, which as it entails the possibility of loss, may be legally problematic for some.

- **How might they be overcome?**

We are not sure that they should be. We regard these barriers as positive.

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

No. The individual design serves the specific purposes of the employer and their labour force. Consolidation works better when benefits are rationalised and standardised – as for example in the PPF. This is why we fear consolidation is a disguise for cutting benefits. Whilst there may be merit in having a broadly agreed benefit structure for schemes that do want to consolidate, this does not need Government intervention.

d) Should rules be changed to allow the reshaping of benefits without member consent?

They already may be, provided they are actuarially equivalent.

- **In what circumstances?**

Actuarial equivalence.

- **Should there be prescribed restrictions to the types or limits of such reshaping?**

Reshaping should not be permitted unless actuarially equivalent.

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

Costs and charges are high; per member costs perhaps too high. There are very substantial disparities in costs among schemes. This is partly excessive investment management and advice fees, but this is already being addressed by the FCA and Transparency Taskforce. For smaller schemes, regulatory intervention and compliance reporting massively increases costs for little discernible gain. Some relaxation of regulation may be appropriate, such as: no annual update or SFS applying to schemes with fewer than 200 members rather than 100. Wind up costs are particularly high and there should be greater analysis and challenge of these.

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

We would encourage greater transparency but the linkage with consolidation is unwarranted. An employer or scheme may wish to provide an expensive but high quality of service to members.

- **In what circumstances?**

None

g) Is there a case for mandatory consolidation?

No.

- **In what circumstances?**

None.

h) Should the Government encourage the use of consolidation vehicles, including DB master

trusts?

No. Consolidation is rightly seen as code for cutting benefits, as a covert way to achieve benefit reductions. We have seen two forms of argument around this:

a. Administration is only more efficient if benefits are harmonised and in the absence of additional cash, this can only mean levelling down;

b. If scheme A funded at 90% needs to merge with scheme B funded at 80% to benefit from cost savings, scheme B members need to give up 12.5% of their benefits.

We view consolidation as a variety of sovereign wealth fund envy, driven in large part by personal ambition, and the potential for professional profit. It is based upon flawed analysis presented in an alarmist and exaggerated manner.

- **If so how might it do so?**

As we consider this unwarranted, we have not considered it in sufficient detail to respond. There are far simpler solutions to the real issue, such as setting PPF compensation levels to full benefits.

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

There are changes to the employer debt regime (see earlier) which should be undertaken, but they are not motivated by any desire to encourage consolidation.

j) Is there a case for consolidation as a cheaper, but more efficient form of buy-out, with the employer and trustees discharged?

It really is not at all clear that consolidated schemes will as much as recover the initial costs of transfer into the consolidation vehicle, let alone operate more efficiently. Nor is it at all more evident that they will prove more stable and sustainable; when risk is concentrated in this manner they represent far greater risk to the PPF. From a risk management perspective, a steady stream of small failures is preferable to a single large catastrophe. With discharge of the sponsor and scheme trustees, there would be the question of capitalisation of risk buffers, and the level of prudence, In addition there is the issue of ownership of residual orphan assets. If this is to be considered a true alternative to buy-out, then there are also competition issues to be considered.

- **If so, (a) what should be the requirements for a scheme to enter such a consolidator, especially the level of funding; and**

We do not believe that there is any sensible solution to this problem. Unless benefits are standardised there will be significant differences in the valuation bases of schemes. There is also the *question of the level of funding on some common basis. This is analogous to the fee to join a club; there really can only be one fee. Differing funding levels would not be risk-sharing or risk-pooling, the better funded would be subsidising the weaker. The PLSA has suggested that small schemes may borrow to achieve 90% funding. Many of the smaller schemes could simply not do that commercially. If the consolidator were to undertake this lending, that would represent a significant self-investment risk. The circularity and wrong way nature of this 'pig on pork' risk should be evident; we may then see both default by the employer and failure of the scheme.*

- **(b) should the residual risk be borne by the member, or by the PPF?**

The PPF does not exist to provide guarantees. It is a compensation scheme. These consolidated schemes only come into existence because PPF benefits are partial. The residual risk could be borne by members in the manner of DA and CDC, but if this is to be the case for these vehicles there is no case for not allowing these designs more broadly.

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

No. A collection of small stressed schemes is transmuted into one large problem.

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?

No, it should not, but it also should not for single employer or group scheme arrangements.

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

Employer specific sections could be fully insured and exit the multi-employer scheme on sponsor insolvency. For schemes where the employer simply wishes to cease association while it remains solvent, they could provide insurance cover rather than funding.

n) Are new measures needed to help those trustees of an association or employers who could be held individually liable for an employer debt?

The problem is with the calculation of full buy-out (s75) when the actual liability is best estimate. The employer debt properly defined is any deficit between funding and the level of best estimate, and is far more manageable due to its smaller size. Again, insurance could be developed to deal with this potential problem. Indeed, this could even take the form of the scheme buying coverage on the failure of individual members, which might be structured in a wide range of manners.

Box 4

The origins of the prospective view

The prospective view is now well-embedded. This is hardly surprising as in the Regulator's Code of Conduct on Funding DB they assert that "trustee objectives": [are] "to comply with their fiduciary duties and ensure that scheme benefits can be paid as they fall due". We note that for much of the period when this prospective view was taking hold, and until very recently, the catchphrase or apothegm of the actuarial profession was: "Making Financial Sense of the Future." The profession was actively seeking a wider role in financial risk management.

The origin of the idea that schemes should exist beyond the life of the sponsor, the prospective self-sufficient objective, is shrouded in the mists of time. It is not a consequence of any of the reams of new pension and trust regulation introduced in the wake of the Maxwell affair in the early 1990s. The strongest candidate for this seminal role seems to be a 1987 actuarial paper by McLeish and Stewart: 'Objectives and Methods of Funding Defined Benefit Pension Schemes'. (See footnote 4, below box.)

However, this paper is a very weak foundation; merely a simple assertion, lacking any supporting evidence or even argument. Following recognition that the employer may cease to exist, the authors, McLeish and Stewart, assert: "It seems to us to follow, therefore, that the prime purpose of funding an occupational scheme must be to secure the accrued benefits, whatever they might be, in the event of the sponsor being unable or unwilling to pay at some time in the future."

They continue with: "To that end, the contributions would have to be sufficient both the pay the benefits as they fell due for as long as the scheme continued, and also to establish and maintain a fund which would be sufficient to secure the accrued benefits in the event of contributions ceasing and the scheme being discontinued, whenever that might occur." Allowing for the ambiguity of the expression "secure the accrued benefits", one interpretation is that the scheme should be self-sufficient.

The paper did not meet with universal acclaim. For example, JD Punter made the following discussion contribution: "I would like to refer to … the objective of funding. It … makes an astounding leap in logical consequence ... I think this logical leap is unfounded and, in many ways, affects the conclusions of the paper as a whole."

The problem of course is that now it affects real world pensions, not just the conclusions of an actuarial paper.

Part C

Our Principal Recommendations

We recommend that:

1) the precise role of DB pension schemes, and their funds, be debated and determined, and,

a. if it is deemed socially desirable for these to function as institutions capable of providing previously promised pensions after the demise of their sponsor, explicitly write this into UK Pensions Law;

b. accompany this with prudential regulation for schemes which is similar to that applicable for insurance and assurance companies.

2) a Royal Commission be established to investigate and report on the operations, accountability and role of the Pensions Regulator.

3) remove the Pensions Regulator's statutory duty of reducing the risk of pension schemes ending up in the Pension Protection Fund.

4) add a new statutory objective for the Pensions Regulator: to promote the provision of high quality occupational pensions.

5) require the PPF to pay the full pensions entitlements of scheme members.

6) end the monopoly of the PPF, at the same time as requiring compulsory pension indemnity insurance for occupational scheme sponsors[4].

7) require schemes to hold pension indemnity insurance/assurance.

8) privatise the PPF.

9) limit corporate liability for scheme funding to performance of the contract created by the pension award[5].

10) eliminate the section 75 valuation and its applications, while introducing a statutorily over-riding negative pledge which requires the company not to offer security or priority in status to other debt obligations without offering equivalent to the scheme trustees.

[4] This may be supplied by the scheme, if managed and capitalised as an insurance company, or by independent third party insurance or assurance companies.

[5] This would require calculation of the best estimate of accrued benefits.

11) eliminate the section 179 valuation[6].

If the desire for change is limited at this time, there are a number of technical improvements to valuation and security estimation procedures which may be made.

12) encourage a diversity of liability valuation viewpoints[7].

13) introduce legislation enabling defined ambition and collective defined contribution scheme structures.

Other context specific recommendations are made in the responses to the consultation questions.

We are concerned that the tax concessions enjoyed by DB schemes are excessively expensive under current arrangements. Funding a scheme at anything higher than best estimate under the employer contract terms really does not merit favourable tax treatment, such as deductibility.

Our Vision

The scope of this consultation is narrow, being confined to funded DB schemes. The analysis of UK pensions arrangements often slips into the polar opposites of individual DC and collective DB. There is, in fact, a multitude of possible arrangements between these, with their defining characteristic being variations in their risk-sharing and risk-pooling arrangements. Until recently these were theoretical rather than concrete schemes, known as Collective DC and Defined Ambition; with independent survivor schemes, such as British Steel and BHS, now being created, we feel it would be appropriate to ease the process of creation of such alternate forms of scheme, and complete that proposed legislation

We find it surprising that that DB pension regulation and management should be based on solvency testing. Its counterpart in the bankruptcy courts, the balance sheet test has proved contentious from its introduction over 100 years ago. These discussions can throw light onto some of the issues raised in the consultation such as the certainty of insolvency needed for RAA mechanisms to be brought into play. The recent Supreme Court judgement that Lord Neuberger's "point of no return" test *"should not pass into common usage as a paraphrase of the effect of section 123(2)"*[8] is a case in point.

It is notable that courts take a very different view of uncertainty and risk than the Pensions

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[6] With full benefits being paid, the section 179 value is redundant. The PPF risk exposure is then the best estimate valuation of the scheme. If the PPF wishes to specify some specific discount rate to reflect its opportunities and risk appetite it may do so under the specific terms of coverage.
[7] Several of those possible are discussed at various points in the body of this response.
[8] This section of the Insolvency Act 1986 is otherwise known as the balance sheet test.

Regulator; this is the difference between innocent until proven guilty and its converse. In this judgment, liabilities, some of which had terms of 30 years, were subject to 'imponderable' factors such as interest rates, currency movements and the state of markets; circumstances in which the court "should proceed with the greatest caution in deciding that the company is in a state of balance-sheet insolvency". The test differs in another regard; the court must be satisfied, on the basis of the balance of probabilities. By contrast, pension regulation refers to a biased standard, the level of technical provisions, and in practice to even more outrageous standards, such as buy-out.

There are other self-evident inconsistencies. Consider transfer values and pensions freedoms. Professor Sir Roy Goode in testimony to the parliamentary Social Security Committee stated: "The pension promise is a promise to provide a pension; it is not a promise to hand over a share of the assets." In his Pension Law Review, the point was also explicitly stated: "The pensioners … have an interest in the fund as a whole, although they do not have any claim on the assets. Their entitlement is to a pension, and not to the assets which enable that pension to be paid." We regard pensions 'freedoms' as being rooted in a fundamental misunderstanding.

The multitude of issues arising from the existing regulation and practice, which elsewhere would be taken as evidence of an incorrect model, led us to consider the purpose of the scheme and its fund in the provision of occupational pensions to former employees.

The Regulator's narrative has the scheme and its fund existing to pay pensions in all circumstances, including after the insolvency or cessation of business of the sponsor employer. By contrast, we see the purpose of the scheme and its fund as being twofold: to provide security to members for their benefits, and to offset or fully defease the obligation of the sponsor to pay pensions. It should be managed in ways which reflect these purposes; this is, in some regards, analogous to cash-flow based insolvency. The difference between the two views of purpose is not trivial; it is a very important of public policy issue. We would note however that schemes pursuing either of these different objectives could co-exist in the pension marketplace.

If we are to require that members' pension benefits are paid after the sponsor has ceased to exist, the involvement of some independent continuing third party is necessary. This may be the fund, but if it is, then it needs to be capitalised prior to sponsor closure as if it were an independent insurance company. This is both individually expensive for sponsors and collectively a clear folly.

The obvious alternative is for the sponsor employer to contract with an independent insurance company for it to step in on sponsor insolvency and pay the members' benefits in full. This class of insurance business is known as pension indemnity assurance. This is the first best solution.

Finally, we would add that far, far more pensioners have received their pensions in retirement than have lost any part of their pensions. Sponsor insolvency may be the most important risk face by a scheme but it is nonetheless small by any objective measure; a case of the tail wagging the dog.

The problem of course is one of political visibility.

Part D

This is a detailed discussion of and commentary on the text of the Green Paper.

Our first real difficulty comes with paras 13 & 16:

Para 13: DB pension schemes are funded through contributions from both employers and (normally) active members of the scheme, and the returns from investing these contributions. The employer meets the balance of the cost for the scheme and therefore where the assets are forecast to be insufficient to provide for the total liabilities associated with the promised benefits, additional contributions from sponsoring employers are required.

Para 16: On the other hand, the Government believes that it is right that members should be afforded meaningful protection. Pensions are deferred pay, for which members have worked, and it is critical that the interests of current and future pensioners are given appropriate protection as we seek to balance the interests of the various interested parties.

The pension is a form of deferred pay, but the pay deferred is at most the amount of the employer's initial contribution. The employee's contribution is an investment, plain and simple. The overwhelming majority of the benefits ultimately payable are derived from the investment returns realised over the term until the pension is paid. A question immediately arises: other than for the employer's contribution, why should this be treated differently from any other investment made by an individual? It should be recognised that a DC beneficiary or member would not have any additional protection or security.

Some have argued that the entire pension is deferred pay; that the implicit labour contract is for so much in wages today and so much at dates in the future. This view really does not capture employee contributions, and would carry the clear consequence that the pension is a corporate obligation, relegating the scheme to being security mechanism for members and source of income for the sponsor.

We are concerned that additional contributions and the initial employer's contribution are being conflated. We note that unpaid employer's contributions and wages are covered by the Employment Rights Act 1996 and the Insolvency Act 1986, which affords (limited) wages and holiday pay preferential status.

However, the primary problem with this (para 13) description is that future asset values are not forecast and compared to projected liabilities, but rather that liabilities are discounted to a present value and compared to market-consistent prices of assets. If the valuation process were as described, many of the issues we will discuss later would not exist.

We note that the process described is prospective and in this, it differs from standard practices for the valuation of other corporate obligations where delinquency refers to past performance shortfalls rather than future possibilities. We shall return to this point later.

Para 15: Some commentators have suggested that these pension promises were originally made by employers on a 'best endeavours' basis, meaning that payment of the pension benefits accrued should not be taken as a firm commitment regardless of the circumstances in which employers may find themselves in the future. They argue that subsequent legal challenge and Government regulation have had the effect of providing greater security and benefit provision for members of these schemes, but at a greater cost to the sponsoring employer. They imply that Government should consider easing the resulting burden of the promises.

In our view the pension promise is, in its entirety, a corporate obligation. We do not subscribe to the often-cited view that pension promises were based upon 'best endeavours' and not a 'hard' obligation. It is though true that the promise has become more onerous over time as a result of regulatory change, notably through the introduction of terms such as indexation. We do offer later one possible interpretation of the 'best endeavours' view.

This school of thought would happily see member benefit entitlements reduced, and this is part of the consolidation agenda, to be discussed later.

The introduction of the employer debt regulations in June 2003 may have formalised the position, but the promise was always as hard as any. Indeed prior to the introduction of government imposed treatments of distributions on sponsor insolvency, these were explicitly dealt with by scheme rules.

Para 17: The central challenge for all DB schemes is how best to provide a high degree of security in income, in a world where nothing can be certain or guaranteed. How do you put enough money aside to pay someone a pension when you cannot be sure how long that person will live? Or when you cannot be sure what inflation is going to be or how investments will grow?

The problem evident in these questions is that they contain the assumption that it is the scheme and fund which are responsible for the corporate obligation, the pension promise, with the corporate sponsor as some rather remote adjunct. There is also a difficulty with the concept of a degree of certainty, as it presently leads to levels of funding be pursued which far exceed those of standard commercial arrangements. See Box 3 for a discussion of this issue.

Para 18: Managing a pension fund is, therefore, all about understanding and managing risk and uncertainty. Pension schemes face fundamental uncertainties and the highest of expectations, knowing that if things go wrong, the consequences can be catastrophic for the individuals who rely on them.

An insurance company, a stand-alone independent pension scheme and even the PPF would need such understanding and management skills. They have an unconditional obligation to deliver pension benefits. However, the prospective element for an occupational scheme and fund is rather more limited, being concerned only with the quality of the factors governing benefit projections, such as mortality and indexation. The fund rightly is concerned only that it holds sufficient funds as security for the aggregate amount of benefits accrued to date. In this it would be at parity with and equitably comparable to any other secured creditor.

Although we will revisit this later, and for the avoidance of doubt, this means that scheme expenditures and actions on assessment of the sponsor covenant and risk management, integrated or otherwise, are misplaced. It is regrettable that this is actively promoted by the Pensions Regulator.

Para 22: A number of commentators have suggested it is not fair to preserve the current level of benefits payable to retired, or older workers in DB schemes when their younger colleagues are unlikely to enjoy the same level of benefits themselves when they retire. Some go further and argue that the increasing costs to employers of meeting their DB pension pledges is crowding out investment in jobs, wages, and dividends and affecting employers' ability to contribute adequately to the pension pots of predominantly younger workers in DC pension arrangements.

Para 23: The counter argument, which others have set out, is that there is no evidence that DB costs are impacting on investment or the provision of wages or pensions for younger workers.

We are far from convinced that there is, any longer, any general effect on dividends or investments. It is however clear that individual DC is significantly inferior as a form of institutional design. It is certainly possible that the high costs of DB provision under current standards may be one effect among many in the slow post crisis growth in wages. Given the relative costs we would expect the high cost of DB to have resulted in greater relative shedding of those benefitting from this. It would also imply that the cost of a younger employee was lower than might otherwise be the case.

It would take a rather sophisticated empirical econometric study to disentangle the possible effects, and we are far from convinced that there is a cost benefit case for that. The one irrefutable fact is that younger members do not have DB available to them and that leaves them with only a significantly more expensive savings regime.

Para 24: The Government believes it is right to examine the evidence in detail and evaluate those arguments. Given the need for clarity and certainty for sponsors and members of schemes, changes to pensions should be subject to a thorough test to ensure that the case for change is well made and that consequences are explored and understood.

These arguments have no merit. Changes may be made with the approval of the member under PA 1995 section 67. There is no sound case for altering historically awarded benefits unilaterally, though of course future benefit awards may well follow inferior terms. The high costs of DB provision have many causes, but are overwhelmingly a self-inflicted problem. Our discussion of the Green Paper Executive Summary covers this latter point.

Para 25: How DB pensions are funded and how members' benefits are protected are important issues for millions of current and future pensioners, for thousands of businesses, and for the wider economy. The issues can be very emotive: members of schemes work for a promised pension as a form of deferred pay and the pension promise was used by employers as an incentive to recruit and retain a motivated workforce. However, there has been significant change since the majority of these schemes were set up: increased life expectancy, increasing economic uncertainty and a more pessimistic outlook for future investment returns from most asset classes. These changes have left some businesses struggling to make good on promises made in a different environment.

We feel that this paragraph overstates the position, certainly so for current and future pensioners. As we noted earlier, pensions are only partially deferred pay. We would question the idea of increasing economic uncertainty. Most importantly, we would suggest that the change in regulatory environment and new valuation and accounting standards have had far more effect on pensions costs than increases in longevity or indexation. We do note that in valuations there is almost universal use by trustees of the market implied expectation of inflation, derived from index-linked gilts; a figure which is well understand to be highly biased. Crudely put, contributions have risen six-fold, while longevity costs have risen by 60% and the inflation has performed better than was expected.

We are also concerned that the pension scheme primacy viewpoint is not consistent with an occupational scheme; it is difficult to see why or how an independent, self-sufficient or stand-alone scheme could or should be used in the recruitment and retention of motivated workforce.

Para 28: …Defined Benefit (DB) – where the scheme promises to pay …

The promise of a pension is contained within the contract of employment. It is the employer who promises to pay, but elects to use a scheme and trust arrangement to do so. This structure has advantages for both employer and employee.

Para 33: Scheme liabilities represent the value of future pension entitlements, which have been built up over time by members of the scheme. DB schemes provide members with a good indication of what benefits they can expect to get and when. However, it also means that the scheme (and the sponsoring employer) is locked into funding pensions due many years ahead.

This is not true. The sponsoring employer and scheme are locked into liabilities due many years ahead but they may be funded in a myriad of ways, subject only to some minimum levels. Indeed, even these minimum levels, which in prudent form are 'technical provisions' levels, are frequently breached, with the cure taking place over many years as deficit repair contributions. We will discuss these issues extensively later.

Para 34: Scheme liabilities are often expressed in terms of "Present Value" (PV). PV is the sum of money needed now, which, invested over the duration of the scheme's pensions commitments, is expected to be sufficient to pay out all the pensions promised. Throughout this paper, references to DB schemes' liabilities should be read as such.

This is one of the problems with existing methods. They all rely upon discounted present values, when the appropriate test is one of performance due to date, an accrual process. If the rate used is time consistent there is no difference between discounted and accrued values. The correct and proper test, here, might be described as: has the company performed as expected under the terms of the pension contract. The valuations resulting reflect the terms of the pension award and the progress expected to date in meeting the award. This is how debt contracts would be valued in corporate insolvency.

Para 35: Contributions are paid to schemes by sponsoring employers and, in most cases, active employees who are in the scheme. Schemes invest the contributions into a fund to generate investment returns for the future – the fund is the scheme's assets. The scheme trustees must produce and maintain a statement of investment principles for a DB scheme, which covers investment choices, risk management and measurement, the expected returns on investment and other key principles of the scheme.

The question not addressed here is for whose benefit are these returns generated. In the prospective Regulator's view, these are for the benefit of the scheme and payment of members' pensions. In our view, these returns serve to offset or defray the sponsor company's obligation to pay these benefits. In this view, there is no need for any statement of investment principles. The question of security reduces to 'has the sponsor performed in accordance with the terms of the contract, and that are there sufficient assets held to cover the accrued liabilities at the point in time of the valuation?' Risk management reduces to the question of cure or remedy of any shortfall of assets relative to this accrued liability value by the sponsor employer. Governance and the load on Trustees is massively simplified.

Para 37: Schemes must have sufficient assets to pay out pensions whenever they are due. Holding assets to provide for future payments allows pension commitments to be managed in a prudent and structured manner, benefiting from returns on investments made specifically for the purposes of meeting pensions liabilities. Also, in the absence of suitable funding of the scheme, members would be left very exposed to the risk of losing (part of) their pensions if the sponsoring company becomes insolvent.

This description is ambiguous and consequently misleading; schemes must have sufficient assets to pay out pensions as they become due, a current rather than prospective duty. Schemes should have sufficient assets to cover their technical provisions. The final sentence is most troubling; it is an implicit call for the scheme to be funded as if it were a stand-alone, independent body capable of delivering the pensions promise after sponsor failure, rather than an entity charged with monitoring and enforcing performance of the sponsor pension contract. In current circumstances, it would raise the cost of DB pension provision very substantially as it requires funding sufficient to cope with risks arising after the demise of the sponsor employer. No other secured corporate obligation has such a requirement, and this requirement does not appear to be supported by any of the Pensions Acts.

This is hardly surprising since this requirement, if it existed, would be collectively folly; requiring all to adopt this standard would result in massive aggregate overfunding of the occupational DB system and with that, extreme and redundant costs for sponsors. The paper continues to explain what is required by law, which is funding sufficient to cover technical provisions, and in the event of a shortfall, the process of cure or remedy is known as a recovery plan, and takes the form of deficit repair contributions to be made over time. The manner in which technical provisions are derived will be discussed later.

Technical provisions are themselves a prudent standard; in the most recent funding statistics, they average 72.1% of the full buy-out value. This is extremely conservative, which would represent a capital adequacy (type) ratio of 144.2%[9]. This is substantially higher than evident for either banks or insurers. Funding in place averages 63.7% of buy-out, and would constitute a capital adequacy of 127.4%, still substantially above those evident in the banking and insurance industries. By these measures, schemes are collectively over funded at present. By contrast our analysis of the cost of insuring the full benefits of a scheme against sponsor insolvency is that it would only cost in the region of 5% - 7.5% of the best estimate of liabilities.

Para 40: The legislative framework therefore allows for flexibility in how trustees and employers meet their funding requirements, subject to the high-level principles set out in legislation. However, as this does not require full funding at a buy-out level, this leaves a risk that the employer becomes insolvent, with insufficient assets in the scheme or passing to the scheme from the insolvency process to enable all the benefits to be secured with an insurance company.

The risk-sharing and risk-pooling characteristics of DB design in fact mean that the cost of production of a unit of pension is lower than it would be when this pension is produced in other arrangements. This means that a shortfall relative to the funding required under these other arrangements is to be expected. One way of viewing the involvement of the sponsor employer, is that, through its support, capital funding for provisions for variation from the best estimate is unnecessary.

Funding as a solution to sponsor insolvency is grossly inefficient both at the level of the scheme and collectively across all schemes. This is not a victimless crime as it increases the tax cost of DB pensions, and that has effects for all.

Para 41: The legislative and regulatory regime of DB pensions is intended to ensure an appropriate balance between the needs of the sponsoring employer to operate and grow its business, protecting the security of members' benefits, and to protect the Pension Protection Fund (PPF). We consider this balance – including the role of the Pensions Regulator ('the Regulator') and the PPF - in detail in the next sections.

The statutory objective of protecting the PPF is deeply problematic. It provides incentives for the Pensions Regulator to promote over-funding of schemes, and it duly obliges. We note that there is some ambiguity in the specific wording of this objective, which is "reducing the risk of pension schemes ending up in the Pension Protection Fund (PPF)" though usually described, as above, as protecting the PPF.

The question which has really not been asked is: why should the PPF need protection? Functionally

[9] Under current conditions the best estimate or expectation of schemes is close to 50% of buy out value,

similar arrangements exist in many other countries but none need or are protected by an industry or other regulator. We shall revert to this issue later.

Para 43: …Trustees must appoint other advisors where necessary - for example, legal, investment and covenant advisors - to ensure they continue to meet their obligations.

The issue here is: which of these advisors is really necessary? In the stand-alone view, there is a plethora. But if we take the view of the trustees' obligation as being performance to date, many are not. Covenant advisors, a late addition to the Pension Regulator's list of expectations, are a classic example.

Para 48: Where a scheme's sponsoring employer becomes insolvent the scheme is required to wind-up and buy-out benefits with an insurance company, providing ongoing security for members' benefits. Where there is a deficit, the scheme may have insufficient assets to buy-out member benefits in full. In such circumstances the PPF may provide compensation to members if the scheme cannot afford to secure a level of benefits at least equal to the level of compensation the PPF would provide.

This is another problematic area. Prior to insolvency, there is no justification for a scheme to be funded to buy-out level. Indeed, notwithstanding the pension legislation in place, post-insolvency, this level of funding is inequitable to other creditors, and could be challenged on those grounds. It really cannot be justified by appeal to the deferred pay characterisation.

The requirement to buy out from an insurance company is a requirement to seek the most expensive solution. It is also not at all clear that insurance companies offer superior security than a scheme funded to the level of 'technical provisions'. Independent stand-alone continuation would in many circumstances be a superior result. The question should also be asked as to why we should not allow members to take transfers to DC arrangements. We note that the s179 valuation, which operates to commercial buy out terms, overstates the PPF cost of production of PPF level benefits. It should also be noted that, in theory, schemes funded to the level of best estimate of their liability would in aggregate constitute no risk to the PPF even if the benefits were paid in full and not reduced in the PPF manner. If schemes were funded to the level of technical provisions, they would in aggregate generate surpluses over and above full benefits.

Para 49: The Regulator is focused on enabling and educating trustees and employers about their duties, for example by providing trustees with Codes of Practice to help them comply with their legal responsibilities. This is supplemented with a range of supporting guidance, statements and other educational tools relating to scheme funding. The Regulator also publishes regulatory

intervention reports, known as Section 89 reports, which demonstrates its considerations in particular cases.

The Regulator actively promotes a particular narrative, much of which is evident in this Green Paper. A prime example: their Code of Practice , Funding Defined Benefits, states: "Paying the promised benefits is the key objective for scheme trustees." It is most interesting that the Regulator's more extensive descriptions of Trustee duties do not include this objective. It has been seized upon by many advisors and 'gold-plated'; used to promote elaborate, expensive and unnecessary management strategies. It is also reflected in the mistaken interpretation discussed in Box 3. Unless this is written into scheme rules, this objective isn't a duty or even desirable. This example is far from unique. The Regulator's Code introduces a 'Principle': "Managing risk: Trustees should implement an approach which integrates the management of employer covenant, investment and funding risks; identifying, assessing, monitoring and addressing those risks effectively." The shift to the independent stand-alone view is now total, though entirely unsupported in any of the many Pensions Acts. The Regulator's various publications promote this view.

Para 50: The Regulator's guides cover subjects such as how to adopt an Integrated Risk Management approach to scheme funding and assessing and monitoring the willingness and ability of the employer to back the scheme (the employer's covenant). In particular, the guidance highlights the importance of trustees understanding the scheme's exposure to:

- **risk across employer covenant, investment and funding, and having in place a risk management strategy that is integrated across these areas;**
- **trustees having a good understanding of the employer's financial position and growth plans (including how these enhance the employer covenant, or indeed otherwise); and**
- **trustees and employers using the flexibilities in the funding regime and working together to increase the likelihood of reaching an appropriate scheme funding outcome.**

These are all prescriptions relevant only because the objective has been wrongly defined. The lack of take-up of the flexibilities afforded in scheme valuation should not surprise when the objective has been shifted to one of self-sufficiency. These are prescriptions which support the Regulator's statutory duty to protect the PPF. The scheme funding outcome desired, and required by law, is clear; it is to the level of technical provisions, no more.

Paras 52 and 53 simply evidence the extent of the Regulator's promotion of this self-sufficiency objective. It is difficult to see how this could be seen as furthering occupational provision or the use of DB schemes in the recruitment, retention or motivation of employees.

The statutory obligation to protect the PPF should be removed, as it is the source of many inappropriate incentives.

However, it should be recognised that this, alone, will not remove all incentives for scheme sponsor to move to buy-out. The accounting standards currently in effect introduce bias and volatility into scheme valuations, and with that into company accounts. The desire on the part of scheme sponsors to de-risk schemes would be reduced but not eliminated. It would though remove many of the costly actions arising from the viewpoint promoted on protection of the PPF.

One of the reasons that schemes have not utilised the flexibilities in existing valuation regulation is that bulk-annuity insurers favour scheme asset allocations which are government securities heavy with the result that the yields and expected returns of scheme asset portfolios are depressed. The use of interest rate derivatives to hedge valuation variability would also likely decline.

Para 57: PPF compensation is based on the member's pension or accrued benefits, at:

- **100% for anyone who was over the scheme's normal pension age at the date of employer insolvency or who was paid their pension on the grounds of ill health, or who was in receipt of a spouse/dependant's pension; and**
- **90% for everyone else, subject to a cap (which currently produces maximum compensation of £33,678 a year at age 65).**

Para 58: The inflation protection given to PPF compensation may be less generous than the level which would have been provided by the scheme.

These reductions in benefits are unwarranted; members are not a source of moral hazard. The PPF should be required to pay full benefits. It is this lowering of benefits, which motivates much of the recent PLSA paper, The Case for Consolidation.

The level of PPF coverage for a scheme is easily estimated as the ratio of the section 179 valuation to the full buy out value. It is substantial – in one recent case, PPFs benefit were just 50% of the full benefits due to members.

Para 61: The levy calculation for each scheme reflects the risk that the scheme poses to the PPF. It takes into account the chances of the scheme having to enter the PPF following employer insolvency, and the size of the deficit the PPF would inherit.

The total levy raised by the PPF has been consistently around twice that stated as its expected cost to Parliament. The levy is out of all proportion to the aggregate risks faced by the PPF. The build-up of excess reserves or surplus is evidence of this.

Para 73: A regulated apportionment arrangement (RAA) is available in situations where the

trustees believe that insolvency of a company is likely and the company is proposing to avoid this by either re-structuring or selling the company to another, but needs to discard its liabilities (including its pensions liabilities) in order to achieve this end. The controversy normally arises because what is seen is that a company continues to trade, but the pension scheme has moved into a PPF assessment period, with all that this means for the members.

There would be no such controversy if scheme members were paid their full benefits. See Box 2 for a discussion of some of the issues here.

Para 84: The funding level of DB pension schemes is a matter of concern to many pension scheme sponsors, trustees and members. At the end of October 2016, about 90-95% of DB pension schemes are likely to be in deficit as measured by the Technical Provisions. The average funding ratio on a Technical Provisions basis at this date was around 80%.

Risk is properly measured around and from the best estimate. According to the most recent funding statistics (tranche 9) the average funding at this level was 113%.

Para 85: To help understand how funding levels will change over time, the PPF have adapted their Long Term Risk Model (LTRM) – designed to model the PPF's own funding position – to perform projections of funding levels for DB schemes under different future economic scenarios. This modelling uses a large number of economic scenarios and other inputs together with modelling assumptions to perform projections of DB scheme assets and liabilities. When this model is run using a particular set of assumptions termed the 'base case', the median projection is that by 2030 schemes will in aggregate be funded to around 90% on a buy-out basis, which, applying a rough rule of thumb, is approximately 120% on a Technical Provisions basis.

This form of analysis is appropriate for the PPF, but schemes have an obligation to fund to the level of technical provisions, and no higher. If they find themselves funded at levels higher than technical provisions they should lower contributions, or add further benefit liabilities.

Para 86: There is a distribution of outcomes around the median projection in the PPF's modelling results. In the worst 10% of outcomes in the "base case" scenario the aggregate funding level is projected to be 75% and lower on a buy-out basis by 2030. In the best 10% of outcomes, the aggregate funding level is projected to be nearly 100%, excluding schemes that are sufficiently well funded to buy-out as the modelling assumes these schemes buy-out and exit at the point they are able to do so.

This is most encouraging; it means that the worst 10% of schemes will be more than adequately funded at 150% of best estimate. It is notable that this model assumes that DB schemes are on the road to extinction through a buy out process.

At these levels of projected funding, the PPF would in fact be profiting materially from the insolvency of sponsor employers. Rather than charging a levy, it should then be paying a dividend to participants or increasing its benefits payable to members.

In general, we have severe reservations about the use of models over these terms.

Para 92: As noted earlier, for as long as an employer stands behind a scheme and is able to provide sufficient financial support then – regardless of the funding position of the scheme – members will receive their benefits in full. The critical risk to members (and the PPF) is, therefore, insolvency of the sponsoring employer(s) at any point when the scheme is underfunded. At the point of insolvency, the funding position of the scheme is crystallised. An underfunded scheme will not be able to secure members their full benefits, and members may require the safety net provided by the PPF.

The scheme is again seen here as primary. Insolvency is the trigger, but it should be recognised that even a scheme fully funded to the level of technical provisions would not be sufficiently well-funded to buy out commercially. By contrast, if schemes were funded to technical provisions levels, they would not actually represent a risk to the PPF, even if that were paying full benefits to members.

We would add one further note here. Technically a buy-out insurer will price the buy-out of a scheme on the basis of its contribution to the marginal risk of its book of business in force; the method used to estimate full buy-out values assumes a stand-alone valuation of the scheme. The differences may be substantial.

Para 94: Around 880 schemes and 235,000 members have transferred to the PPF to date, with total claims on the PPF amounting to around £5.5 billion (including both schemes that have already transferred and those that are expected to transfer). As figure 5 shows, in the mean case the additional claims on the PPF may amount to around £3.5 billion by 2030. If future experience of the ratio of claim amount to number of schemes transferring to the PPF is assumed to be in line with historical experience, then this would imply around 600 schemes and around 150,000 members transferring to the PPF by 2030.

The point to note here is that the PPF has incurred claims of £5.5 billion and has accumulated a surplus of approximately £4 billion (after provisions), more than sufficient to cover the base case loss of £3.5 billion. It would appear that the PPF is exploiting its monopoly position and charging levies well in excess of those justified by the risks experienced or faced. In addition to being required to offer full benefits coverage, the PPF should be privatised and opened to competition. If it really is desirable to offer DB pensions full coverage even after sponsor insolvency, this pension indemnity assurance may be made mandatory.

Para 101: Longevity increases have also significantly affected the value of scheme liabilities. Longevity has been rising faster than was predicted when most DB schemes were set up. For example, as figure 8 overleaf shows, in 1983 it was predicted that life expectancy at age 65 was going to be 15.2 years in 2014; it actually turned out to be 21.0 years, which is nearly 40% higher than predicted at the time.

Some care is required here. This is a change in cohort expectations; we do not yet know what the experience will be for those who attained age 65 in 2014. It is also only too easy to overestimate the impact. The fair comparison here is that the expected cost (without considering wage and inflation growth) of a new pension award has risen by 38% over the 35-year period. The 65-year-old in 1983 did not experience an average life of 21.2 years.

Para 104: At the same time, there are signals that pension deficits are seen as a problem either now or in the future by many sponsoring employers. For example, according to a 2015 survey by the consultancy Barnett Waddingham, '80% of companies with material funding shortfalls recognised their DB pension scheme as a principal business risk within their annual report and accounts'.

The deficits reported in sponsor accounts are accounting standard based assessments. They are based on bond yields and this is not the same basis as scheme technical provision valuations. The accounting standard introduces bias and volatility into sponsor accounts – for many it is significant in terms of their operational results. Indeed, it may have effects on corporate activity, such as the ability to pay dividends, but these are the exceptions rather than the rule. It is clear that large deficits do affect investor attitudes, but that is a reflection of the fact that investors are concerned that these deficits will distract corporate attention and resources to deficit repair and other expensive pension actions, rather than business activity.

It may be argued that deficits, as simple accounting numbers, should not affect real corporate activity. However, that would ignore the real effects that arise, such as those due to deficit repair contributions and cash equivalent transfers, as well as new contributions derived under current standards. There can be little doubt that the acquiescence of the sponsor in allowing self-sufficiency and buy out objectives, with their associated costs, is driven as much by the nuisance value of reporting deficits as by the real costs incurred.

Para 105: It is argued by some employers that DB pension contributions are far too high to be sustainable and are certainly far higher than originally intended when schemes were set up. For example, according to a 2016 report by Lane Clark and Peacock, the cost of providing pensions for FTSE 100 companies was 24% of salary back in 2009, whereas in 2016 it was 50% of salary, calculated on an IAS19 accounting basis based on the cost of accrual in a typical 60ths final salary scheme. While this relates to the cost of future accrual rather than the removal of accumulated deficits, it does highlight the increase in expected cost of funding pension benefits.

All that this actually illustrates is the irrelevance of the IAS19 standard, which implies an expected return on the contribution equal to the gilt discount rate. The actual contribution is set according to the actuarial standard.

Para 107: However, the figures and statements quoted above show the aggregate positions and there are outliers presented in some of the same publications. For example, according to Lane Clark & Peacock45 six companies paid contributions that were greater than the dividends they paid out. In addition, there were seven FTSE 100 companies with accounting liabilities greater than their market capitalisation as at year end 2015 according to the same source. Therefore, on aggregate there does not appear to be clear evidence of affordability issues, however at the more individual scheme level further scrutiny could be beneficial.

The comparison of accounting liabilities to market capitalisation is a favourite example of poor financial analysis, since the market capitalisation arises after consideration by the market of the reported deficit and its likely financial performance consequences.

Para 111: Whilst it is hard to find evidence that deficits are driving companies into insolvency, there are clearly employers for whom their pension scheme deficit is a significant call on their resources. Also, we are beginning to see some signals that DRC to PBT ratios may be higher for smaller companies. So in general, while most schemes look to be affordable for their sponsors there is a mixed picture and a need to explore this further.

It seems to us that a further diagnostic is called for – the required rate of return on scheme assets to achieve solvency and this may be compared with the rate of return on capital employed within the sponsor, as well as in absolute terms. First Actuarial report this statistic alongside their best estimate index, and for the PPF index universe, it has recently been around -0.6% real, implying that schemes are very well funded indeed.

It would also be informative to consider current DB pensions cost in the context of the current labour bill, as this will offer an indication of the potential for this to depress current salary growth.

Para 124: The Regulator has estimated that around 89% of members are in schemes where either the covenant is deemed adequate to support the scheme (assessed either through the Regulator's covenant grade approach or using publicly available sponsor data), and where the scheme is in surplus or the scheme has in place a funding and investment strategy which is deemed adequate under current circumstances.

We note here the presence of consideration by the Regulator of the investment strategy of the fund. With the PPF levy also based in part on the investment allocation, there are distorting influences on fund investment policy.

We would also note that the investment strategy of the fund should be conditioned on the insolvency profile of the sponsor over time. A strong sponsor, with a long corporate life expectancy, can expect to reap the gains of long-term investment in equities over more secure lower yielding assets such as gilts.

Para 128: While this analysis is based on modelling outputs and assumptions and so should be viewed with a degree of caution, it does help illustrate that the number of members in schemes with potential affordability issues is likely to be relatively low and could be as low as 5% under the Regulator's approach above, and even then, not all these schemes are expected to fail. This broad conclusion is also consistent with the expected number of members to be in schemes that fall into the PPF assessment by 2030, which is just 2% (as discussed above).

These expectations are broadly in line with our own work on sponsor failure, and notably far below the estimates contained in some academic work and the Gazelle modelling discussed later.

Para 131: The PLSA's results indicate that schemes with the weakest sponsors (Covenant Grade 3 and Covenant Grade 4) are likely to struggle to reach 100% funding on a buy-out basis in 30 years' time, with members facing the prospect of benefit losses as a result. The results also suggest that de-risking of investment strategies for some DB schemes with the weakest covenants is more likely to increase instead of decrease the overall probability of benefit losses for members, due to the increased length of time the scheme is reliant on the sponsor for Deficit Repair Contributions.

This modelling starts with the idea that funding to full buy-out is a desirable objective and that de-risking is the way to achieve that. This is the most expensive possible combination of events; it should come as no surprise that it projects higher failure rates. As this course of action would be close to one of corporate suicide, there is no reason to believe that any rational sponsor will permit such strategies or that trustees would demand them, once the consequences are made evident to them.

Issues and Options

Para 139: During the summer of 2016 the Department for Work and Pensions (DWP) undertook an informal consultation on the state of the DB sector as a whole, taking views from a range of stakeholders representing employers, members and industry professionals in a series of meetings. The overarching view of virtually all stakeholders is that the regulatory regime for DB pensions is satisfactory, and that the funding regime sets a fair balance between the interests of the members and those of the sponsoring employers (though it was recognised that many employers are paying more for their DB pensions than expected when the schemes started). There was no overall consensus though, on the level of member protection. While some stakeholders feel members are over-protected, and therefore employers over-burdened, others thought that additional protection was needed to further reduce the risk of employers walking away from their pension promises. Nearly all agreed however that there is no need to change the fundamentals of the overall regime for DB pensions.

The regulatory regime cannot possibly be satisfactory; new DB pension awards and schemes are as scarce as hen's teeth. Millions are now being consigned to DC arrangements which are vastly inferior in almost every regard. This is a direct consequence of the regulatory regime – real increases in cost account for only a small fraction of the total increase observed.

The question of member security is a question of public policy. In DC any pretence at achieving this has already been abandoned. The narrative promoted by the regulatory authorities is of protection of the PPF, rather than the protection of members. This takes the form of encouraging over-funding with self-sufficiency and stand-alone status being presented as desirable; buy-out and wind-up are seen as positives rather than as failures to provide new pensions awards. If total security is socially desirable, it is most efficiently achieved not by any form of funding but by pension indemnity assurance, as is done in several other jurisdictions.

The fundamentals of the regime most definitely need to be changed. We listed our principal recommendations earlier.

Para 144. The UK DB funding regime is not designed to eliminate all risk to members' benefits at all times. That is why it is underpinned by the Pension Protection Fund (PPF). If it were designed to eliminate risk, employers would need to fund their pension promises to the much higher "full buy-out" levels, so that members' benefits could be secured with an insurance company in the event that the employer could no longer support the scheme. Rather, the system is designed to strike a reasonable balance between the demands on the employer and the security of member

benefits (with the underpin of the PPF). Within this context, a strong, sustainable sponsoring employer supporting a prudently funded scheme is the best protection for members of a DB scheme.

It is not true that funding is the only route to ensure member security at all times; this may also be achieved by pension indemnity assurance. It may be true that schemes would need individually to fund to full buy-out, but collectively funding at the level of technical provisions is more than adequate to ensure total member security. Indeed, funding at the level of technical provisions actually offers more security from a capital sufficiency standpoint than is provided by most insurance companies.

Given the nature of the issue and the massive cuts in benefits applied by the PPF, it would seem more than acceptable to most members for other alternatives to the near-binary PPF/Buy-Out option. This should include transfer at the option of the member to other DC arrangements, defined ambition and collective DC, and a wide spectrum of variants among these. As the PPF benefit cuts are unwarranted, it really should be required to offer full benefits. The statutory objective of the Regulator to protect the PPF should be removed and substituted with a new objective: to promote the sound provision of occupational pensions.

Para 145. The valuation measure used for a DB scheme does not directly affect the cost of paying the benefits. Ultimately the pension will cost what it costs, based on a number of factors including the longevity of members and the rate of inflation amongst others. The valuation measure used can however affect the speed at which funds are built up to cover the cost of the benefits, and it can also affect decisions about the investment strategy. This in turn can change the amount of return achieved on the assets and the volatility in that return. That may impact on the proportion of the cost met through sponsor contributions, and the amount that is met from investment returns and the risks to these expectations.

The valuation measure may directly affect the cost of paying benefits through transfer values as has been most evident recently. Moreover, volatility of the valuation measure brings with it costs for both sponsor employer and scheme; this motivates much of the interest rate hedging undertaken by schemes. While it is true that the primary effect may be one of timing, this brings with it the possibility of opportunity cost.

The general rule as to proportionality of the cost burden between employer and scheme is quite simple; the higher the investment return, the lower the sponsor contribution cost. For most of the 1980s and 1990s, the cost, beyond initial contributions, was met entirely by investment returns.

Para 146. It is therefore important to understand the behaviours that result from the existing funding regime, and whether there are ways in which they can be fine-tuned to improve outcomes for scheme members, whilst remaining affordable for sponsors. Although the regulatory regime may influence behaviour, the investment strategy and deficit repair payments are not mandated by the system. Rather these are agreed through negotiation between the sponsoring employer and the trustees, based on a range of complex factors and objectives. These may include among others, the current position and future expectations of the funding position of the scheme, its maturity, the employer's financial situation, economic situation and asset returns, the objectives that sponsors and trustees have in the short and long run, and the employer's ability to stand behind investment risk.

It is true that strategy and deficit repair payments are not mandated by legislation, but they are, in common with this Green Paper, heavily influenced by the Regulator's narrative and that is very heavily conditioned by its objective of protecting the PPF.

Para 147. There are four main approaches to the calculation of DB liabilities in the UK system, each of which is used for a different purpose: …

These are not separate approaches. They are all discounted present values for liabilities with comparison to the current market consistent prices of assets. This is point in time solvency testing. They are all prospective. They are all time inconsistent and that introduces unnecessary costs. These are all mixed attribute in nature; this introduces volatility and bias into the resultant solvency estimate. Different approaches might be projection of asset values and comparison with projected liabilities, use of the contractual accrual rate, or variation of and from the required rate of return on assets. We have discussed some of these different approaches earlier.

We would advocate, at the least, the use of additional approaches, as further viewpoints may lend a sense of perspective to the results derived under the current approach.

Para 148. The Statutory Funding Objective for DB schemes was introduced by The Pensions Act 2004. It is scheme specific and requires a scheme to have sufficient and appropriate assets to cover its Technical Provisions - the actuarial calculation of the liabilities of the scheme.

This is the correct standard though the levels of prudence being incorporated by trustees appear excessive. The problems arise with its estimation. For example: the use of market derived inflation expectations biases liability estimates upwards, and the volatility of discount rates, and their level, when these are gilts-based, introduces further difficulties. When we consider the contractual accrual rate, that is the investment rate of return implicit in the promise made by the employer, then we observe massive variation, and significant and sustained bias arising from the current method.

It is regrettable, and economically inefficient, that funding to higher standards than this are being promoted.

Para 149. Under the current system, a Statutory Funding Objective valuation is required at least every three years. In simple terms this establishes the value of assets expected to be needed at that point in order to pay benefits in the future. This takes account of a prudent assessment of anticipated asset performance - via the discount rate - and is used to set the level of ongoing employer contributions and forms the basis for agreeing a recovery plan to deal with any funding deficit identified.

Prudence is often expressed in both the assumptions with respect to factors determining liability projections as well as in the discount rate applied to them. However, there is little doubt that schemes have been recklessly prudent. The difference between the best estimate of liabilities and the prudent technical provisions estimate is now very large indeed. As has been noted previously, schemes are funded at better than best estimate levels but less than the prudent technical provision.

The over-emphasis on prudence has greatly increased deficits reported and the costs imposed under repair contributions. The levels of prudence being applied far exceed anything justified by the volatility of asset portfolios.

There is a paradox for many schemes here; those following de-risking strategies should be those that require the least by way of prudent buffer, as the volatility of the asset portfolio, combined with interest rate hedging, is intentionally lowered, and the prudent buffer is a provision against untoward events. Indeed, in years when such an event occurs we should expect that buffer to be reduced, to be restored in better times. Otherwise, this represents Charles Goodhart's 'Taxi-problem', where the tired traveller arriving at a remote railway station is delighted to see a taxi waiting at the rank, but on asking the driver to take him on to his final destination is told that it is not possible as the local regulations require there to be a taxi waiting on the rank at all times.

Para 151. When undertaking a valuation the trustee, advised by the scheme actuary, is required to use prudent economic and actuarial assumptions, taking account if applicable, of an appropriate margin for adverse experience.

The problem arising from this adverse experience formulation is that most of the variability in technical provisions arises from variation in the discount rate, that is, variation in the measure, not the asset portfolio or the factors determining benefits projections. They are conflated and the result is recklessly prudent valuations, with significant costs to sponsors. In addition, it motivates much of the de-risking of asset portfolios. We should not forget that one of the few things we know about risk (or the possibility of adverse development), is that it means more things may happen than will.

We would also note that the risk associated with sponsor insolvency is small. A scheme with a 50% deficit and a sponsor with a likelihood of insolvency of 1% faces risk of just 0.5%.

Para 152. This measure is designed to tolerate a certain amount of risk based on the support that can be provided by the sponsor as a going-concern. If a scheme is fully funded on this basis, it does not mean that members' benefits would be secure if there were no longer a sponsoring employer. The funding regime allows for the fact that a fully funded scheme will continue to have sponsor support. So if the sponsor fails, and the scheme is fully funded on a Technical Provisions basis, the scheme could still either have to buy-out at a level below full benefits, but above the level of PPF compensation, or enter into the PPF. Since Technical Provisions are scheme specific and trustees are responsible for choosing the assumptions, (although in most cases requiring the agreement of the employer) schemes will inevitably choose differing approaches. Therefore, the level of protection for members afforded to them by the funding level of the scheme will vary from one scheme to the next.

In fact, funding to best estimate is funding to the level of the expected cost of benefit provision; funding to the prudent technical provisions level is more conservative and more secure. A scheme funded on this basis would be more likely to pay all benefits than not. The problem that arises is with the treatment after sponsor insolvency. Though funding to technical provisions levels should be more than adequate to pay all pensions in an aggregate sense, it appears that schemes are being priced on an individual risks basis rather than on the basis of their marginal contribution to the total risk exposure of the insurer or PPF. Certainly, the buy-out and section179 valuations are conducted on this individual basis. Given the high costs of these two 'solutions', there is a strong argument for allowing other options to be introduced, such as transfer by a member to another DC scheme, or much discussed variants such as defined ambition and collective defined contribution. This applies more generally. It seems much more likely that companies may sponsor new schemes under defined ambition or CDC than DB.

Para 153. As part of the actuarial valuation, actuaries are also required to provide an estimate of the solvency position of the scheme. This is an assessment of funding relative to the cost of buying out benefits with an insurance company. The solvency valuation tends to use a discount

rate close to, or perhaps even less than, gilt yields. This is due to the constraints of the insurance regulatory regime, and must also include an allowance for ongoing running costs, and a margin for prudence and profit, that an insurance company is likely to use. The solvency valuation should also include an allowance for the expenses of winding-up the scheme that can be quite significant especially for the smaller schemes. As a result, the solvency measure is usually very high relative to the Statutory Funding Objective.

It appears that in the buy-out valuation there is conflation of the wind-up costs of the scheme with the insurer's price for assuming scheme liabilities. It would be helpful if wind-up cost experience and the distribution of assumptions being made by scheme actuaries were published.

Para 154. The corporate accounting measure is underpinned by international accounting standards, and uses high quality corporate bond yields to set the discount rate. This is the measure that is used for the valuation of the pension liabilities that appears on company balance sheets. This means that the accounting value of the scheme liabilities will move broadly in line with corporate bonds. Therefore, where the scheme invests in assets other than high quality corporate bonds, volatility in the accounting position may arise. As a result there may be an incentive for some sponsors to prefer an investment strategy that more closely aligns asset values with changes in the accounting liabilities – so investment in corporate bonds, or other interest rate matching investments. While this may be in the interests of the scheme sponsor, it may further constrain a scheme's ability to invest in higher return seeking assets.

The corporate response to the accounting standard is often to 'de-risk' the scheme by buying bonds or using derivatives. Indeed, many schemes are now using leveraged interest rate derivatives – something we believe to be illegal as it involves borrowing albeit in a non-transparent fashion. On just two occasions we have been asked to provide a cost benefit analysis of 'de-risking'. In both cases, the additional funding required and lower discount rate arising have generated costs to the sponsor far in excess on the benefits arising. Note that the accounting standard is prospective and time inconsistent. Though frequently described as being supported by the theories of financial economics or financial analysis, this is untrue. The standard values a pre-existing liability of defined cost to the sponsor as if it were being newly created today with a cost equal to the discount rate applied. This is simply illogical.

Para 155. The s179 basis valuation is similar to the full buy-out measure, except the liabilities are calculated based on the estimated cost of buying-out at PPF compensation levels rather than full scheme benefits. It is used to determine the funding position of an eligible pension scheme for the purpose of calculating PPF levies.

The ratio of the S179 valuation to the full buy-out cost is a good indicator of the extent of the PPF coverage of scheme benefits. In one recent case, this was as low as 50% of member benefits. Current presentations of PPF coverage, though true, are profoundly misleading.

This is the source of the risk that motivates the PLSA desire for consolidation of small schemes.

Para 156. Despite the evidence that the sector as a whole is not in crisis, …

We share the concerns expressed here.

Para 157. Furthermore, many pensions specialists have told us that many members understand neither the value of their DB pensions, nor the risks of it not being paid in full. Many are unlikely to fully understand the meaning of the scheme's funding position as set out in the Annual Statement which schemes must provide to members every year by law. Similarly, there is no disclosure of the strength of the sponsor covenant which is key to understanding the risks to the scheme and the members.

It is also true that many pensions specialists do not understand the risks. See Box 3 earlier.

We do not believe that providing such information to members would provide benefits – indeed it might well create unwarranted transfer runs. The real position should though be understood by trustees and they are in possession of this information already. It should of course be available to members on demand. See our fuller response to Question 2.

Para 158. We think that more might be done by both Government and industry to help people better understand valuation and deficit data and provide an improved overall sense of the degree of certainty and risk in the regime as a whole. A range of deficit measures is published by Government bodies and advisory firms. It has been suggested, for example, that it might be helpful to provide a more coordinated and holistic view that includes measures such as 'best estimate' of expected investment returns at the same time to give a more balanced view of the state of the sector.

We strongly support the publication of the actuarial 'best estimate' and would suggest that it should be accompanied with the explanation that this is the level of funding required to pay all benefits in full on average.

Para 159. Another way to improve understanding would be to require schemes to use a range of measures to report their funding position to members, trustees, sponsors and the Regulator. This could provide a richer and more rounded view of the funding position, and the actual risks to member benefits. However, we accept that costs may be a problem especially for smaller

schemes, and it may be difficult for members to understand or make use of the information.

We strongly support the production and distribution of a range of measures, but believe it sufficient that these be available to members on demand. Many of the additional measures involve extremely little incremental cost; for example, the require rate of return on assets to achieve solvency.

Para 160. There are a range of different approaches to valuation or providing information on valuation results which have been suggested. These include:

- **a stochastic assessment of the ability of a scheme to meet its liabilities;**
- **a deterministic comparison of the expected asset and liability cash flows;**
- **an assessment of the "break-even return" required on the scheme assets to meet the liability cash flows; and**
- **an approach based on the existing Statutory Funding Objective but allowing for a smoothed market value of the assets rather than the asset value at the valuation date, and calculating the liabilities using a consistently smoothed discount rate.**

There are further approaches than these, which are discussed elsewhere in this response. We do not support the use of stochastic models in general. In all too many cases they simply reflect the assumptions driving them together with poor quality, over-simplified models. We would make the point, again, that this would be yet another prospective approach, and a highly technical and probably extremely expensive one at that.

There is an important lesson from stochastic control theory: that the control mechanisms for complex non-linear systems need to be simple if they are to prove robust and reliable in functional application.

We do not support the concept of smoothing. Though well-intentioned, it is a reflection of the accrual properties of both benefits and asset portfolios, but in practice would be a poor substitute for deriving those properties.

We do support both the cash flow projection and 'break-even return' methods, if by that term this means calculation of the required rate of return on the asset portfolio to achieve timely discharge of all liabilities.

Para 161. There are advantages and disadvantages to all of these approaches and any move to abandon the current approaches completely and move to a completely different measure for the Statutory Funding Objective would be extremely disruptive. In order to give a more rounded assessment of the actual risk to members, it could be helpful to encourage or mandate the use of more than one measure. Whilst such measures may or may not be used for funding decisions,

they could provide the basis for communicating risks and expectations to members.

We would not advocate immediate abandonment of the existing methods. The problem currently is that the numbers currently produced are taken as 'gospel' truths, with the consequence that perverse actions often result. We favour a more holistic view, using a range of metrics. We believe that once permitted or mandated they would tend to displace the existing methods as the basis for management decisions. However, this would not resolve the issue of the accounting standard. This would involve little more than widening the existing scheme funding prescriptions; arguably many could be introduced without any change beyond a reinterpretation of the expected return on scheme assets. However, there is clearly a need for method which reflects the accrual nature of DB benefits and asset portfolios, which would be consistent with standard insolvency practice.

Para 162. Some commentators have suggested that valuation measures are having a negative impact on trustee decision making, resulting in short termism, and in some cases an overly conservative investment strategy. Sponsors have to be consulted on the strategy, given it is the sponsor who can be expected to have to pay for any such conservatism. Although adopting a lower risk investment strategy is aimed at reducing the risks to members and reducing the potential volatility in sponsor contributions, it could result in shifting the balance from investment returns to sponsor contributions, thus increasing costs for sponsors. Of course, higher risk investment strategies could also result in higher sponsor contributions if the investment risks crystallise; on the other hand, conservative investment strategies may result in higher returns foregone, increasing the burden on sponsors and putting at risk members' benefits.

The valuation measures together with a persistently negative press and trade commentary, and advice (with the notable and commendable exception of First Actuarial), are having negative effects on trustee decision making, resulting in 'reckless prudence' and over-conservatism. However, we have seen no evidence that these measures induce 'short-termism'. There is a degree of short-termism in fund manager behaviour induced by the frequency of reporting required by trustees. We would suggest, perhaps counter-intuitively, that this is best overcome by continuous reporting of mandate values (this could certainly be done electronically). Rather than seeing short-termism in trustee behaviour, we actually observe excessive patience – poorly performing portfolios are held for terms far beyond that warranted.

De-risking, or hedging is intrinsically a shift to the short-term.

We do not see portfolio risk, a prospective issue, as being rightly the concern of trustees. However, clearly it is for the sponsor company. We are unimpressed by the standard techniques for risk evaluation and management, such as those advocated by the Pensions Regulator as 'Integrated Risk Management'; they failed abysmally during the crisis in both banking and insurance sectors. We favour application of the precautionary principle[10] as this better reflects the nature and time scale of uncertainty faced by schemes. We would also point out that this higher risk higher return concept, together with the linear relation between risk and return in the capital asset pricing model (Capm) are easily falsified. Indeed, presentation of decisions in 'risk based' settings is absolutely certain to result in redundant and costly action. One of the few things we know in a risk setting is that more things may occur than will. The trade-off between high and low expected return situations, such as those between bonds and equities, is that we are assured low returns with bonds, while we may experience low returns or losses with equities. This is a trade-off of sure expense for possible expense.

Para 163. It is worth noting that it is not just the trustees who influence decision making on the funding strategy. The employer is also central to this process, and does not necessarily approach the negotiation with the assumption that the lowest contributions are the optimal outcome. Some employers will have a range of concerns such as limiting the volatility of liabilities on the balance sheet, and maintaining a stable schedule of contributions with funding risks minimised. The trustee will also take account of the strength of the covenant when assessing the level of risk that is appropriate in the investment strategy.

We believe that the sponsor should be the decision-maker with respect to investment strategy, provided that the accrued benefits have been secured; that is, that the employer has performed as contracted. We do not believe that the sponsor covenant, a prospective issue, is rightly the concern of trustees, provided the sponsor is in good-standing with respect to performance to date. The sponsor covenant may become an issue when determining the period over which cure or remedy of the shortcomings are to be executed. The level of risk in the investment strategy is a matter for the sponsor, not the trustees.

Para 164. There is a question about whether trustees are always sufficiently skilled to make decisions about the deployment of funds in what is an ever more sophisticated investment market. In contrast to Financial Conduct Authority (FCA) rules about a "suitable person" to advise on investment of assets, trustees do not require any particular skills or qualifications – although they are required to take advice from a suitably qualified person. So one way of improving the

[10] https://bankunderground.co.uk/2017/01/27/how-should-regulators-deal-with-uncertainty-insights-from-the-precautionary-principle/

quality of decision making could be to require trustees to be trained, or to limit trustees to appropriate professionals.

We do not support the idea of professionalising trustees. In our accrual view the load on trustees is in fact light, being limited to consideration of the adequacy of current funding and becoming prospective only when the sponsor employer is delinquent. We have also observed (independent) professional trustees 'pick fights' with other scheme advisors weakening overall relationships between the trustee board and those advisors. We interpret this as a battle for influence.

We are also concerned that professional trustees have been captured by the Regulator and effectively serve as its agents, which we find alarming when the Regulator is conflicted and promoting a very particular narrative.

Para 166. This is an issue that the Regulator has recently explored and is taking forward in its work on 21st Century Trusteeship and Governance. The Regulator found that respondents to their discussion paper thought minimum qualifications could not adequately test and measure the broad range of experience, skills, knowledge and attitude required of trustees on an ongoing basis. In particular, the qualities of a good chair were seen as more behavioural in nature and qualifications or registration with a professional body would not necessarily demonstrate competence for the role. There were also concerns that requiring qualifications would discourage people from becoming or remaining as trustees or chairs, and therefore hinder diversity on boards. Some respondents also stressed the importance of focusing on the competence of the board as a whole. Qualifications were thought to be too standard and not sufficiently flexible to meet the needs of trustee boards.

We are very concerned that the Pensions Regulator will pursue the encouragement of independent professional trustees. We see this as a retrograde step, not least because we would see such a development leading to Regulator's quality advice and a lack of diversity in scheme management styles. It is indeed the aggregate board which matters.

Para 169. However, expectations for future returns may be very different. The relatively high returns achieved by schemes in the past may be largely a result of the increased market values of their existing bonds, due to yields falling. This implies a much lower return in the future for future purchases of these assets. In addition, equity returns in the past do not mean that these returns will necessarily continue into the future (but note that the investment return figures presented above cover the period of the recession, so one might expect that they will be even higher in the future). It is also important to note that the returns assumed in the discount rate include

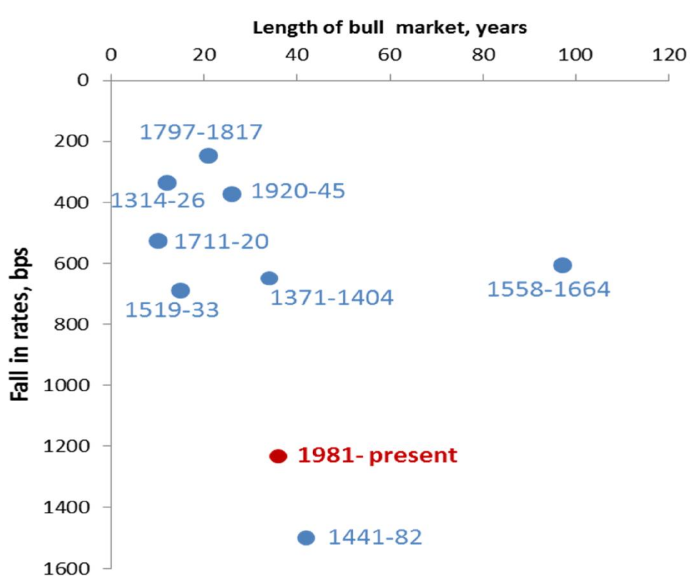
allowance for future changes in investment strategies, where schemes may be on a path to lower risk.

Far more importantly, the returns quoted by the OECD in the preceding paragraph include the Dot.com crash, which saw a combined three-year downturn of 41% in equity markets. Of equal importance is the lack of predictive power of bond yields with respect to future returns. Somehow, the idea that gilt yields are a sound predictor of future returns has taken hold. This simply is not true. By way of contraindication, we report below the correlation between gilt yields and the subsequently achieved real ten-year equity, gilt and cash returns. Not one is substantial and none are statistically significant.

Correlation	
10 Year Returns	Gilt Yield
Equity	0.21
Gilt	0.42
Cash	0.43
Gilt Yield	1.00

Para 170. It is difficult to reach a firm conclusion from the data about whether discount rates are overly pessimistic. The most important element of this is whether the discount rate is arrived at in an informed way and is fit for purpose, and that decisions are taken rationally.

There is little doubt that gilt yields are artificially suppressed; that was the method of operation quantitative easing. In modern times, this is the longest and most severe decline in interest rates observed in the UK, as is illustrated by the following work published by the Bank of England:



The question of whether rates will remain low over long-terms has been investigated rigourously in the context of the US. A recent Federal Reserve Bank of New York Staff Report entitled: Safety, Liquidity, and the Natural Rate of Interest posed the question: "Why are interest rates so low in the Unites [sic] States? It concluded: "We find that they are low primarily because the premium for safety and liquidity has increased since the late 1990s, and to a lesser extent because economic growth has slowed." In turn implying that "the natural rate of interest will likely remain low". A finding qualified by "Yet, this conclusion is subject to significant uncertainty, since sudden changes in expectations, regulation, market structure, investors' degree of risk aversion, or in their perceptions of the safety and liquidity attributes of U.S. Treasuries could all be sources of shocks to this trend."

In addition, we have investigated the variation in liability values arising from the historic contractual accrual and the gilt yield then prevalent. This is shown below. It is shown as a proportion in order to facilitate comparability over time. This ranges from over 80% overstatement of liabilities in recent time to a 58% understatement in 1974 when gilts yields were extremely high.

Para 179. Some commentators argue that the valuation approach may also be causing significant volatility in the deficit measure, and driving some overly conservative investment strategies to mitigate this volatility. It is to be expected that as schemes mature – and most schemes in the DB sector are now closed to new members and to new accruals – they will seek to more closely match their assets to their liabilities, and so shift assets to bonds and gilts and other matching assets from potentially higher earning but more volatile assets. But it is argued that some schemes may be overly cautious in their investment strategies as a result, shifting the expected balance of funding from investment returns to contributions from the sponsor.

It is clear that the valuation methods in use induce both volatility and bias in the deficit measure. There is absolutely no doubt that interest rate hedging has in large part been due to these effects. The effects were prominent among the reasons for scheme closure. This in turn is causal in the increasing maturity we observe. While it is commonplace to assume that schemes should be matching (technically dedicating bond portfolios) when mature, and indeed it is a widely-followed prescription, there is nothing in financial theory to support this idea. It is also implicit in the actuarial practice of using a lower discount rate for post-retirement benefits. This seems absurd when, in part due to increasing longevity, the investment accruals post retirement are larger than those during the active or pre-retirement period.

The conservatism with which trustees approach valuation may be judged by the increasing separation of best estimate and technical provisions. The conservatism in asset allocation may be judged by the extent to which they have sold equities and bought bonds; this far exceeds the rate at which they have been and are maturing.

Para 180. Where schemes are targeting a buy-out of the scheme with an insurance company …

The question which should be asked here is why schemes and more importantly, their sponsors should entertain such an expensive resolution or wind-up of the scheme. There is little doubt that the self-sufficiency and overfunding narrative has conditioned the environment in which trustees and sponsors make decisions.

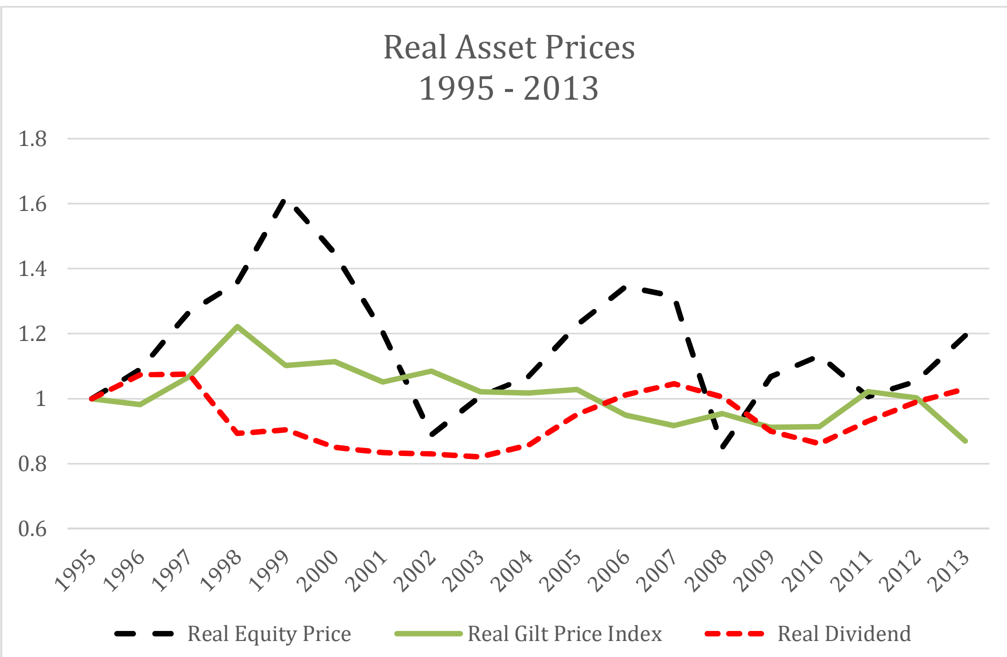
Para 181. There can be little doubt that schemes have chosen to invest less in return seeking assets over recent years (as illustrated in the figure 17). This is part of a trend that started decades ago, and cannot therefore be entirely driven by the current valuation regime. But over the last decade the proportion of pension scheme assets held in equities has fallen from around 60% in 2006 to around 30% in 2016. At the same time, the proportion invested in government and corporate bonds rose from 30% to 50%. Schemes have done this for a variety of reasons. Among them there may be reasons like lower returns on equity since the start of the global recession back in 2008, which have nothing to do with DB pensions and their regulation. On the other hand, there may be pension specific reasons like schemes willing to change cash flows when schemes stop being open to new members and start maturing more quickly.

Indeed, the trend to bonds started decades ago: in the mid-1990s, when MFR was first being discussed and then introduced, and as importantly, if not explicitly recognised, as the prospective view of pension schemes took hold. It was further advanced by the introduction of FRS 17 and IAS 19, with the 2004 Pensions Act and subsequent Scheme Funding Regulations. Closure to new members and future accrual does make a scheme mature more rapidly; the increasing dependence upon the fund for cash flow generation is a direct result of these actions. As most trustees were, as recently as a few years ago, not considering the income characteristics of their investment allocations, it is clear that this consequence was either not explained to them or if explained, not understood.

Para 182. A point of interest in regards to this trend is the evidence that gilts and index-linked bonds seemed to have provided higher nominal returns than UK equities over a 10-year period from 2005 to 2015 (see Table 4). The lower average return on equities over the 10-year period was most likely due to the volatile period during the 2007/08 financial crisis. During this period share prices of most FTSE companies drastically fell thus lowering capital gain, in addition many of the said companies suspended dividend payments thus lowering dividend income for

investors. Therefore, in retrospect the de-risking strategies that schemes chose to make may seem to have been a sensible decision.

We do not recognise this narrative; we show below the annual real price and dividend of the FTSE all-share index together with the real gilt price, for the period 1995 to 2013. The relative strength of bond returns in this period may be explained by 1) the volume of quantitative easing (or bond purchases) undertaken by the Bank of England, and 2) the performative nature of the transition in asset allocation undertaken by pension funds. When pension funds collectively buy large amounts of bonds they will tend to perform well, and when they collectively sell large amounts of equity, they tends to underperform. This is certainly evident in the index linked gilts market where prices are now RPI - 1.8% and pension funds own more than 80% of the outstanding stock. The Bank of England did study these effects a few years ago and concluded that there was material depression of ILG yields induced by pension fund activity.



Para 183. The Government believes that while there is evidence of a shift away from return seeking assets over time, there is no evidence that this is driven by inappropriate measures of scheme liabilities. Rather in most cases it seems to be driven by decisions made by trustees and sponsors based on a number of considerations. There is a question, though, as to whether all parties have the information, skill set and experience that they need to ensure that they reach a well informed and appropriate decision.

This is an insult to the reader's intelligence. It suited the Regulator to develop a narrative which facilitated its statutory objective of protecting the PPF, overzealously, and that was achieved by scheme deficits being overstated and asset allocations made less volatile, by selling equity and buying bonds, as well as by making substantial demands on sponsors for deficit repair contributions. Given the sensitivity of insurance-type operations to their experience in early years, this may even have been justifiable. Scheme asset allocations were even introduced as a risk factor in PPF levy determination. The information available to trustees was entirely framed in this 'de-risking' narrative. In this newly regulated world trustees were intensely dependent on guidance and their advisors (for whom this portfolio churning was extremely profitable). Liability 'management' exercises were equally so. It is only in more recent times that consideration of the effects on sponsor employers was required or that promotion of the flexibilities in valuation has come to the fore.

Para 184. Trustees operate under a duty to act in members' collective interests. It is therefore understandable that they might seek to minimise the risks of downside losses from the riskier investment options. Schemes are obliged by law to take specialist advice and to discuss their approach to investment with the sponsor. Most experts argue that both schemes and sponsors have chosen to de-risk to a greater or lesser extent in order to reduce the volatility of pension funding partly due to:

- **their desire to match their maturing liabilities (as a result of scheme closure);**
- **providing a degree of matching to the Statutory Funding Objective or accounting standard;**
- **to minimise the risk of calling on the sponsor for higher contributions in future, potentially affecting their plans for sustainable growth; and**
- **because their long-term funding goal is to be in a low risk position or to buyout their pension liabilities with an insurance company.**

All of these have common cause in the accounting, valuation approach and regulatory narrative. The explanation here fails to account for an important empirical observation: that technical provisions are growing larger than best estimate valuations, while de-risking a scheme, making it less volatile would suggest that they should converge, and that has very significant implications for the cost of provision.

Para 186. But it is possible that there are instances of trustees and their sponsors choosing to take less risk than they reasonably could, given the strength of the sponsor covenant standing behind the scheme. As a result, investment strategies may be overly cautious resulting in sponsors having to pay more towards their schemes than would be required if higher returns on assets were achieved – of which there can be no guarantee in advance. This approach also limits

the potential requirement for even higher contributions should investment risks materialise and may be agreed to by the sponsor for that very reason, indeed may have been suggested by the sponsor in order to minimise that risk and accepting the higher expected cost. We would like to better understand whether the decisions made in this context are optimal, well informed and rational, or whether they are overly conservative and potentially sub-optimal as a result of existing regulation. Some of the reasons put forward which we think at least in theory could pose a risk, and which we are keen to explore are:

- **the trustees are not sufficiently skilled to deal with investment choices in an increasingly sophisticated investment environment;**

In looking at the evidence on trustee decision making, Clacher et al (2017b) have investigated some of these issues and showed that trustees had a much higher level of capacity than many people suggest.[11] This is not to say the model is perfect and given the status quo, there is significant work to be done in building up the skills and expertise of trustees, and this is especially true at the smaller end of the market. However, trustees were able to pick the best funds on a net of fees basis and did so across a range of different tests. As well as this, Clacher et al (2017a) showed that trustees were considerably more financially literate than the general population.[12] While this is to be expected given the role they have, the results are based on a large number of trustees and covers a range of scheme types and trustee types and provides a robust evidence base for this. In addition, Clacher et al (2017b) also show that trustees are primarily focused on strategy, with costs and fees being a secondary concern. This is consistent with trustees thinking first about what they want to achieve, and then how best to execute the strategy. In combination with the net of fees result, this is suggestive of a higher level of competence in the trustee world than many expect. That said, where trustees in general, and the trustees of smaller schemes in particular struggled, was on the implicit costs and fees of fund management. In light of the Financial Conduct Authority's investigation into the fund management industry, and the possibility of implicit costs and fees being something trustees have to engage with, then this is an area where trustees may have to be supported going forward, to allow them to effectively discharge the fiduciary duty placed upon them.

- **their decisions are being influenced by what some people claim is overly cautious guidance or influence from the Regulator;**

This is clearly true – see for example the 2016 Annual Funding Statement: "Given the current

11 http://www.aon.com/unitedkingdom/retirement-investment/investment/costs-fees-and-trustee-decision-making.jsp
12 http://www.aon.com/unitedkingdom/retirement-investment/investment/mapping-the-trustee-landscape.jsp

market conditions and expectations for the medium to longer term, all else being equal, we would expect that most schemes will set funding strategies based on lower expected investment returns from most asset classes than at their last valuation." This was a year in which many funds returned more than 20%.

- **the decisions are influenced by overly cautious advice from the pensions advisory community, possibly influenced by herding (the tendency for individuals to follow the actions – whether or not rational – of a larger group);**

This will be true in some cases but the question is whether this is systematic. Clacher et al (2017b) presented some preliminary evidence that the consultant recommendation was not as influential as individuals think. While this is based on a stylized test, it is the first attempt to try and test this proposition, and the result suggests that the consultant may not be all powerful in this environment, which is a view many hold.

- **trustees are constrained in their decision making by a cautious approach from sponsors who are concerned about volatility, and minimising risk;**

Sponsors are concerned by both the cost and volatility arising from their income statements and balance sheets under the accounting standards and trustees have to operate within the constraints this places on the firm and the fund.

- **smaller schemes are not able to access specialist investment advice, and may lack the scale to take advantage of some investment opportunities;**

Specialist advice is available to all. Only the smallest schemes lack the scale to pursue a wide range of investment; it is hard to think of a sector or investment style that does not have pooled funds available for small-scale investors.

- **the decisions are influenced by expectations that high uncertainty currently present in the economy will remain in the medium/long term.**

This is an all-purpose excuse, to be wheeled out whenever convenient. There are sufficient indicators of growth around the world that the Economist used this as its front cover recently. There is always much uncertainty. As it is unquantifiable, there is no case for arguing that it is currently greater or smaller than historically. In fact, if this is true, and only for those where concern for the future is relevant, it is then the slam-dunk argument for those concerned to be applying the precautionary principle and not the integrated risk management favoured and promoted by the Regulator.

Para 187. We have seen some evidence from commentators, most notably the PLSA in their interim DB Task Force report, which suggests that the investment de-risking undertaken by some schemes may be short-sighted, and may be having the effect of crystallising deficits, and

depriving schemes of the opportunity to benefit from returns from riskier assets.

The very nature of de-risking is short-term; it is about ensuring interim movements in price or yield are similar even if the expected holding period is far longer in duration. This said, we should also note that the asset allocation methods used and recommended, almost universally, by investment advisors are only valid in the short-term. This is the idea, due to Brinson and Beebower, that asset allocation dominates investment performance; it is only true in the short-term when price movements dominate returns but returns in the long-term are dominated by income and changesto income. By de-risking, a scheme is fixing the long-term and regardless of the riskiness of assets considered, reducing its ability to achieve higher returns in the future.

Para 190. Some commentators have also suggested that a conservative approach to asset allocation may be depriving the UK economy of capital, in addition to depriving schemes of good investment opportunities.

This is economic nonsense. The aggregate amount of capital employed has increased. The allocation of this capital will affect only the distribution of capital ownership. There may be, for some sponsor companies, a difficulty arising from their high capital calls in the form of deficit repair contributions but there can be no aggregate issue. We would also make the point that investment in listed equity supplies little or no capital to companies – the process is redistributive. Stock markets are not now places to raise capital for investment but rather places in which existing investments may be realised or 'cashed-out'.

Para 191. To ensure benefits are paid when they are due, trustees and sponsors need to strike a balance between maximising the return on investments, whilst being mindful of the need to reduce, as far as possible, the risk of future contribution calls on the sponsoring employer that may ultimately be unaffordable. This means that they usually spread the majority of their assets between safer, low earning investments such as gilts and high grade corporate bonds, and higher earning but more volatile assets, such as equities, property and high yielding bonds. To diversify and hedge against certain events, they may make use of other asset classes such as hedge funds and insurance and derivative investments.

This is framed in the primacy of fund view, while we see the purpose of the fund as being to defray or defease employer cost of provision. We note that the rate of return on employer capital, private sector non-financial company capital, is far more stable and much higher the returns from markets.

Para 192. Some pension schemes adopt a wider range of asset classes than others. There may be several reasons for this. For example, larger schemes, or schemes with access to better levels of

advice may be able to adopt a more sophisticated investment strategy. Also, larger schemes, or schemes backed-up by financially stronger sponsors, may be able to make use of relatively less conventional assets which over the longer term may deliver returns at least as good as the more traditional asset classes but offer diversification and the potential for out-performance.

In our experience this is a triumph of hope over experience.

Para 193. However, schemes have said that the alternative and probably more esoteric asset classes are not suitable for all schemes. For example, smaller schemes may not have sufficient assets to be able to invest in infrastructure projects. But on the other hand, smaller schemes can access investments that require scale through investment products that are available in the market such as pooled arrangements – although of course there are costs involved in so doing. Other schemes may, for cashflow reasons, not wish to tie up their assets in long term infrastructure projects, or may find it difficult to find suitable investment opportunities in alternative asset classes which meet their needs in terms of risk and return or liquidity.

There are far more funds and pooled vehicles than underlying investment securities. There really is no class of investment that cannot be acquired in this way. Infrastructure certainly can be. Moreover, pooled funds may usually be bought or sold in ways which the underlying may not. There are management costs associated with these funds but with the pooling of investments within them, this is usually offset in part by the reduced volatility of the exposure to the class acquired in this way. This unavailability argument is a central plank of the "consolidation" advocates; they have not evidenced the problems of scope or scale they assert.

Para 195. Suggestions for changes that might bring about a change in investment approach include giving the Regulator a more central role influencing or determining the level of risk a scheme should be taking, mandating or encouraging alternative valuation measures, or by improving the skills of trustees through training or professionalisation of trustees. We would welcome views on the full range of options that have been suggested.

We are appalled by the idea here. With this power would have to come liability. Indeed, it would remove the rationale for the structure of the industry as it currently exists. One of the great problems that we currently have is precisely that the Regulator's narrative is influencing behaviour. It is tantamount to direct interference in the management of much of the UK private sector. Our survey work (see earlier) indicates that trustees are far more competent than they are generally given credit for.

Para 196. However, the Government is not convinced that there is sufficient evidence about the

nature and quality of trustee decision making, nor what the various influences are in smaller and larger schemes that result in the investment strategies that are adopted, and the asset classes that are chosen.

We have conducted some survey work – see response to para 186 earlier.

Para 197. We therefore intend to work on collecting more information and insights on the nature and quality of trustee decision making, and to further investigate the factors that influence investment strategies and choices of asset classes in smaller and larger schemes. This should throw more light on the issue, and may throw up further options for change.

We welcome this approach.

- **Changes which have been suggested**
- **Mandate or encourage schemes to publish a range of valuation measures.**

We support this wholeheartedly.

- **Better Government and industry communications about the meaning and context of valuations.**

We are doubtful as to the value of these actions

- **Regulator to allow for more regular valuations for high risk schemes, and a longer valuation cycle for lower risk schemes.**

No. This is counterproductive; it introduces more costs for precisely those who can least afford it when correct and is unnecessary expense for those affected when wrong.

- **Reduce the timescale for valuations from 15 months to 9 months.**

No – See earlier.

- **Introduce risk based reporting and monitoring requirements for schemes.**

No. This is the prospective scheme-centric view at work. The Regulator's integrated risk management is in any case the application of a dated and failed set of methods.

- **Improve trustee decision making skills through training or better guidance.**

Our evidence suggests this may be unnecessary.

- **Mandate the use of professional trustees.**

Absolutely not. This would be replete with problems.

- **More proactive role for the Regulator in scheme funding and risk management.**

Absolutely not. This would fossilise the view of the primacy of the scheme and it could not be done without incurring significant contingent liabilities for government.

- **Commission further research into trustee decision making, the factors affecting investment strategies and choices of asset classes.**

We would support this research agenda.

Para 198. Employers are required to fund the scheme to a level which is expected to allow the promised benefits to be paid when they fall due. This must include an appropriate margin for prudence to mitigate adverse outcomes. The regime is designed to allow for schemes to temporarily fall into deficit. This can often happen due to the volatility in financial markets, despite employers paying all their contributions as agreed with the trustees, and is allowed by the regime provided that the employer agrees to a recovery plan. The length of the recovery plan and the level of contributions take into account the employers need to invest in the sustainable growth of the business.

We would point out that in aggregate risk to benefits only arises if schemes are funded below best estimate values. We would support a regime which required rapid cure of deficits to that level. We would also point out that the prospective regime in force creates volatility which may be entirely spurious – we really cannot explain why market price for bonds or equities are as volatile as they are.

Para 200. Since the financial crisis in 2008, deficits of UK DB schemes have increased significantly. The aggregate deficit of schemes in the PPF 7800 index (which estimates the ability of schemes to secure PPF compensation levels on a buy-out basis) was £196.5 billion at the end of January 2017 compared to a small aggregate surplus in early 2008. However, the aggregate deficit reached a peak of over £400 billion earlier in 2016, which demonstrates the volatility of the measure. The deterioration of the aggregate funding position since 2008 is largely the result of depressed bond yields driving down the expectations of returns from investments which trustees use to set discount rates to calculate the liabilities. Whilst scheme assets have increased in value over this period, this has been more than offset by the corresponding increase in liabilities.

We would again draw attention to the fact that today's yields have extremely little value as a predictor of tomorrow's returns. We showed the correlation between subsequent ten year returns and today's gilt yields earlier.

Para 201. Up to a point the increase in deficits is a natural consequence of the way the system is designed to work. The existence of the flexibilities in the UK DB funding regime is one reason why schemes have been able to operate in deficit. Today, around 90-95% of schemes are in deficit on a Technical Provisions basis. On average Recovery Plans are around eight years long,73 which is only marginally shorter than the average length when the current regime was introduced around

10 years ago. However, this is despite the volatility seen in market conditions and the historically low yield environment.

This is actually saying that the regime has become much tighter. The modified duration of schemes has increased significantly over this period and a neutral regime would have resulted in a similar proportional increase in repair timescales.

Para 202. Apart from waiting for interest rates and gilt yields to rise, and/or for expected investment returns to follow suit, there are only four possible ways of improving the funding position of schemes. These are for employers to pay more Deficit Repair Contributions (DRCs) into the scheme, for the trustees to change their asset allocation to get better returns from investments, for the scheme to reduce liabilities, perhaps by reducing benefits or restructuring exercises, or for the prudence in the valuation assumptions to be reduced (although this latter option would only change the perceived funding position of the scheme rather than actually change the cost of the liabilities). Issues concerning investment strategies and asset classes are dealt with in the previous sections.

It is incorrect to think of the prudent technical provisions funding level as the correct level to which funding is needed; that is the best estimate value, which accurately reflects the true expected cost. Altering the level of technical provisions amounts to altering the scheme's primary risk buffer.

Para 203. One of the best ways of protecting members' benefits in a DB scheme is for them to be backed by a strong employer that is able to generate the funds necessary to ensure a strong growing business and pay the contributions if the scheme needs them. This enables the scheme to take greater levels of risk with a high degree of confidence that the downside will be covered. This means it is in the interests of the trustees and the members for the employer to be able to invest and generate profits and capital.

We do not agree with this view. We see the employer as primary and the scheme and fund as a device to provide security to members for the awarded benefits to date, and to defray or defease the cost of these benefits to the sponsor employer. We would draw your attention to the fact that these are occupational schemes and that elements of the benefits are deferred wages. We would ask what support there is in law for the scheme-centric view adopted. We are unaware of any.

Para 205. A key question is whether the current regime is sustainable for employers, or whether it may be in the best interests of members, employers, the PPF, and potentially the wider economy, to alter the current balance of the regime between the protection of members, and the demands on sponsors.

Concern for the PPF is misplaced here.

Para 206. Various commentators have suggested that the scale of DB deficits and the substantial calls on sponsors' resources mean that DB has become an unsustainable drag on employers' resources. They suggest that there is a compelling case for a re-evaluation of the DB promise, necessitating the reduction of future benefits to take the pressure off employers, and to make the whole system more sustainable for the future.

We concur in the subsequently expressed view that schemes are not unsustainable and that member benefits should not be changeable without the express approval of the member. With most schemes closed to new members and future accrual, this reduction of benefits can only refer to members' existing property. That simply cannot be altered without the members' consent.

Para 207. Based on the evidence available on general affordability, we do not believe that this case has been made. Part Three of this paper suggests that overall most sponsors can manage their DB schemes including any DRCs and some could potentially afford higher levels of contributions.

We do believe that sponsors can and should manage their DB schemes; this is our view of the position.

Para 208.The Government is not persuaded that there is a case for across the board changes that would reduce members' benefits in order to relieve the pressure on employers. The Government believes that DB pensions are hard promises – they are debts like any others, and debts should be honoured where sponsoring employers are able to do so.

We agree.

Measures to reduce pensions would be highly controversial, and would have significant legal implications, given that a pension is regarded as deferred pay, and is the property of the member.

We agree. This agreement is not conditioned on the idea that the pension is deferred pay.

Also, it would introduce a significant additional uncertainty in the already uncertain environment which risks discouraging pensions savings in general.

This aspect should not be underestimated. We agree.

If the Government were to consider across the board measures to reduce DB liabilities by reducing benefits, very compelling evidence would be needed. We have not seen such evidence,

but would be interested in views.

Benefits may already be reduced with the consent of the member; that is appropriate and no more is required or advisable.

Para 209. It is clear that there is a wide range of circumstances for sponsors and schemes within the DB sector. It might make sense to have a tailored approach, with different measures targeted at stressed sponsors and schemes, and those where there is more affordability.

This is neither feasible nor desirable.

Para 210. From the evidence the Government has seen, as discussed in Part Three, it appears that at the aggregate level there may be a reasonable level of affordability in the system, and some sponsors may be able to go further and reduce deficits more quickly. Evidence suggests some employers with pension schemes in deficit have substantial cash holdings, or profitability which might allow them to reduce or eliminate their deficits. Although the DRC to Profit Before Tax (PBT) ratio data has to be interpreted very cautiously, since PBT only measures profit in a given year and often does not reflect the employer's underlying profitability. Around a quarter of all sponsoring employers that are paying DRCs and have positive profits are spending less than 5% of their PBT on DRCs. This suggests that there may be spare capacity for these employers to eliminate deficits more quickly. In failing to make faster progress in repairing deficits whilst they are able to do so, scheme members and the PPF are exposed to potentially unnecessary levels of risk. Employer strength can deteriorate rapidly and if the scheme remains underfunded when this occurs then members' benefits would be under threat.

We would draw attention to the fact that gilt yields are at all-time lows with the consequence that benefit valuations are at all-time highs, and that contributions made to a scheme cannot be subsequently withdrawn by the sponsor should rates rise. With the exception of last year, returns from investment in financial markets have been far below those of the UK's private non-financial sector. This is not the time to increase employer contributions no matter whether they are affordable or not.

Para 211.There may therefore be a case to encourage some sponsors who have significant resources available, but also have substantial deficits in their schemes, to make faster progress in repairing those deficits and so reduce risk to members. Some commentators have argued that such an approach could be good for business as well as good for members, as reducing deficits when funds are available may help to prevent sponsors sliding into the category of stressed sponsors in the future, and companies with well-funded schemes will tend to be favoured by the

market.

In fact, paying more into a scheme today, will increase the likelihood of future sponsor stress. Companies with smaller deficits are favoured by markets but paying in excessive amounts of money will rapidly change that – particularly when the one-way nature of these flows is understood. Simply put, markets will understand that investments in schemes tend to produce far lower returns than in their business and that will be penalised by the market

Para 212. One way to achieve this might be to tighten up the scheme funding regime for employers where there is significant affordability. One option, for example, would be to limit extensions to recovery plans, or to set hard limits on the lengths of recovery plans in certain circumstances. It could be argued that the employer should not be able to push back the date for dealing with the deficit or have a long recovery plan while they have significant resources available.

Recovery plans are based upon technical provisions – the buffer between best estimate and technical provisions is just that: a buffer or provision. Deficit repair schedules to best estimate levels are warranted, but moving the contingency provision from employer to scheme really is re-arranging the deckchairs on the Titanic.

Para 213. Another approach which has been suggested is to set interim funding targets for severely under-funded schemes, and, until they are met, require the employer to stay closely in touch with the Regulator and explain on a regular basis what action is being taken to repair the deficit. One way of focusing these requirements for consultation would be to only apply them to schemes which were not funded to PPF level, because if their employers were to go insolvent this would have negative repercussions for the DB universe as a whole, rather than just for the scheme's members.

No. We do not believe the involvement of the Regulator is warranted, particularly when it has the conflicting objective of protecting the PPF. Funding to PPF levels is not materially different from funding to technical provisions levels in amount. There is nothing about this idea which goes to increasing the security of members.

Para 215. While DRCs may be affordable on average, this masks the fact that some companies are clearly struggling. Some companies are paying very substantial DRCs, which may not be sustainable in the long term. This section therefore looks at what measures are available or could be introduced to help schemes in this scenario and how these measures may mitigate or reduce risk to members, sponsors and the PPF.

The protection of the PPF is unnecessary and the source of many of today's issues. Arnold Wagner did state that the PPF is more than adequately financed during a recent OPDU General Meeting.

Para 218. As we set out in Part Three, the results from the PPF's scheme funding modelling include schemes that aren't expected to be sufficiently well funded to buy-out where the employer has become insolvent, and at the 90th percentile (the worst 10% of outcomes) there are around 1,000 such schemes where the employer is predicted to become insolvent by 2030.

It is the modelling of companies not the modelling of schemes that should be undertaken.

Para 219. Although the system would be working as Parliament intended if members in these schemes were to get at least PPF compensation, this does not suggest that the system is free from problems. For the vast majority of stressed sponsors, business failure would occur regardless of the burden of DRCs. But there is a subset of employers where reducing the burdens of supporting a DB scheme, potentially coupled with business restructuring could result in better outcomes. We should therefore think very carefully about what can be done to relieve pressure on stressed sponsors and schemes to help to deliver the best possible outcomes.

This is best handled on a case by case basis if and when insolvency becomes a high and imminent likelihood.

Para 222. While we do not believe a case has been made for across the board reductions in benefits paid by DB schemes, there may be a case for changing the arrangements for stressed schemes and sponsors, which will help to preserve value and jobs in the economy, while also delivering a good deal for members.

Members may approve lower benefits currently. We should also not fail to understand that there is differential value from continuation of the sponsor; active employees will keep their jobs, but for pensioners in payment and deferred members, it is not at all clear that continuation of the sponsor at the cost of some part of their benefits.

Para 223. If stressed employers are to be allowed additional flexibilities, the key questions then are how a struggling or stressed employer is to be defined and in what circumstances would it appropriate to target such easements. Wherever such lines are drawn there will be significant issues which would need to be resolved – for instance there is the possibility of moral hazard, where sponsors could seek to reduce their DB liabilities and take advantage of safety valves, by manipulating circumstances to ensure they meet the criteria.

This is not moral hazard.

Para 225. Some stakeholders argue that the current system leads to outcomes that are excessively binary in nature – an all or nothing approach where the scheme is either able to pay benefits in full, or for the scheme to enter the PPF which only happens when the employer fails – and that other measures could be put in place to help develop a 'middle ground'. In practice, however, many schemes whose sponsors fail are able to buy-out a level of benefits higher than PPF but still less than full benefits. Around 700 schemes comprising 235,000 members have transferred to the PPF to date and around 100 schemes comprising 50,000 members have bought out following insolvency of the sponsoring employer with a higher than PPF level of benefits. Around 40 schemes have been rescued to date following insolvency of the sponsoring employer.

Current possibilities are clearly not binary, but we would argue for further variants to be added, such as the ability of members to transfer out to other DC arrangements or for stand-alone independent successor schemes to be permitted. In particular, we would suggest that defined ambition and Collective DC would be appropriate structures for such schemes.

Para 228. There is a question therefore about whether the right balance is struck here and whether there might be alternatives. There may be a considerable prize – some employers who are struggling to survive with their DB commitments could potentially be given more breathing space, allowing the emergence of a sustainable business and potentially greater value to be realised for the scheme which would also effectively protect the PPF. Members might also be able to receive higher benefits than they would have in the PPF, despite not being able to receive their full benefits. Some commentators have suggested that more flexibility is needed to provide a safety valve for stressed employers in wider circumstances where it appears that it is unlikely members' benefits will be paid in full and that this could be of benefit to sponsors, members and PPF Levy payers. However, it is unlikely that any solutions in this area would benefit all parties and so a different trade-off would need to be made between sponsors, members and the PPF levy payers.

There is an excessive concern with protection of the PPF is all of this.

Para 229. It is also important to recognise that the options that involve a 'transfer of wealth' from the members to the sponsor would raise moral hazard issues and there would need to be appropriate quid pro quo provisions in place. For example, similar provisions to the condition for RAAs where the scheme would need to receive more than it would otherwise on insolvency, to ensure that the scheme is being treated fairly compared to other creditors to the employer.

Assuming no movement of assets out of the scheme, any transfer of wealth is to other stakeholders, ultimately shareholders. It is not moral hazard.

Para 230. Suggested options for change include:

a) allow struggling businesses to separate from their pension scheme more easily e.g. through widening the criteria for RAAs so it is available to more sponsors;

While dependent upon the detail, this could be feasible. The section 75 buy-out valuation is deeply problematic, and should be removed.

b) cut or renegotiate benefits, e.g. by a proportionate cut to the pension promised or tiered proportionate cuts for different levels of entitlement, or a reduction in inflation protection, or through a rise in the age at which an unreduced pension can be taken;

This can already be achieved with member consent; this should not be altered.

c) give the Regulator a workable power to separate the scheme from the sponsor or wind-up schemes in certain circumstances; and/or

No. This is simply a step too far.

d) provide more intensive support from the Regulator for both employer and scheme to review options including the potential for restructuring to rescue business value (even while keeping the pension scheme attached),

Again No, unless this means that the Regulator assumes a role similar to a creditor in possession, providing finance and the liabilities which go with that. This would have to be funded by central government, not the industry.

and possible mandatory appointment of professional trustees, who have the relevant skills and experience of these difficult situations.

We do not believe that this is an appropriate power for the Regulator – again there is the question of liability for the appointee's actions.

Para 231. As described above, it is already possible to separate the scheme from a sponsor via the mechanism of RAAs, although the circumstances in which they can be used are very limited. There is an argument that the current criteria for an RAA allowing separation of the scheme but leaving a viable employer are too strict in terms of the likelihood of insolvency within 12 months. Relaxing the RAA requirements was one of the recommendations made by the recent Work and Pensions Select Committee inquiry.

We would favour relaxation.

Para 232. Where insolvency is considered to be highly likely but not within 12 months; and where restructuring could deliver significant benefits and realise more value for both the scheme and PPF than would be possible for insolvency, and leave a viable ongoing employer, then the current "within 12 months" rule prevents action being taken. Waiting until the 12 months rule is met may in some cases be too late to rescue value. So it makes sense to ask whether these rules should be relaxed. But such an approach raises many fundamental issues:

- **if struggling employers have the option to not honour the pension promises made to their employees by separating themselves from the scheme, there is a danger that some members will have lost out unnecessarily if the business would have recovered without separation and that other creditors will have benefited at their expense;**

This can be dealt with in large part by 'claw-back' clauses. We would note that companies are not expected to cease trading simply because they are insolvent in the legal sense, but that directors put themselves at risk when doing so.

- **even if the sponsor eventually goes insolvent, members would continue to receive a higher level of benefits prior to then so early separation of the sponsor and scheme is unlikely to be in their interests;**

This is actually a question of the sums involved. The trade-off is essentially some specific loss today versus a larger loss in the future.

- **there is a moral hazard risk that an unscrupulous employer might deliberately aim to abandon their pension scheme in order to avoid the costs involved;**

True, but it is not moral hazard.

- **employers that do honour their pension promises may be faced by unfair competition from companies that no longer have to honour them; and**

This really is not reasonable. A company that has shed its pension scheme in order to survive is unlikely to be able to compete with one that was already strong enough, particularly with any product or service requiring warranty or after sales service.

- **the addition of a new option, in addition to the existing ones of either fully honouring the pension promise or, failing to do so with the result that the scheme enters the PPF assessment, might undermine the current regime.**

Benefits may be altered with the consent of members; there is no proven need for more here.

Para 234. Nevertheless, if it is possible to define the circumstances when separation would be allowable, and to manage the risks posed such action might increase the number of businesses that survive, with all the related benefits of employment and growth, but at the potential expense of some members.

This should be a matter between the sponsor employer and the members of the scheme in question. There is no need for anything beyond the most basic recognition of that.

Para 235. Under the existing system, where a scheme's sponsoring employer (or employers) becomes insolvent the scheme is required to wind-up and buy-out benefits with an insurer. This is a long standing legislative requirement and a principle on which a large part of the system (e.g. the basis for calculating employer debt) is built. This requirement is intended to ensure members have the greatest likelihood of receiving promised benefits. Without an employer to make good any shortfall in funding that arises at the point of insolvency or develops subsequently – through, for example, liability movements (including changes to life expectancy), poor investment returns, or unexpected costs it was decided that risks should be minimised by securing benefits with an insurance contract. The Pensions Act 2004 introduced the PPF into this system to provide a floor to members' losses. Where a scheme sponsor becomes insolvent the scheme would transfer to the PPF and members receive PPF compensation instead unless benefits can be bought out at an equivalent level or higher.

This buy-out valuation basis is problematic. It far exceeds what might reasonably be demanded. In the different context of sponsor insolvency, defining the claim as the difference between assets and this value is profoundly inequitable to other creditors and stakeholders. Although it is expressly the result of pension legislation, we believe that the amount of this claim might be successfully challenged on the grounds of its inequity.

Para 237. The potential for a scheme to run on without an employer – as an alternative to PPF entry or buy-out – has also been discussed. The idea is often linked to arguments for allowing reductions in scheme benefits in order to reduce the schemes liabilities to a level that may be affordable given the scheme's assets, with risks minimised to an acceptable level. This sort of approach would provide the possibility of scheme members receiving more than they would if the scheme wound up and sought to buy-out with an insurer or enter the PPF. However, facilitating this sort of arrangement carries with it some significant issues:

- **how to avoid unscrupulous employers deliberately abandoning their scheme in order to avoid the costs involved and avoid honouring their commitments on deferred pay. And linked to this how to ensure the pension scheme debts are still enforced against the company;**

Provided member approval is sought and given, sponsor abandonment is not a problem. To the extent that debts may need enforcement, the scheme has recourse to the courts as would any other creditor.

- **with no sponsor to make good investment losses or cover unexpected costs who bears the**

risk: scheme members or PPF members and levy payers? Similarly, should this type of arrangement facilitate an approach whereby investment and longevity risk is shared amongst the whole membership;

With reduced benefits being used to capitalise the scheme, clearly there is risk pooling and sharing among members – the question of PPF fall back only arises after that has been exhausted – that is that benefits under these arrangements would be lower than those under the PPF. These arrangements could be insured independently of the PPF, and provide member security superior to it. Both defined ambition and collective DC are variants to this type of scheme.

- **if the PPF underwrote these schemes it would be a significant change from its current role – making it responsible for compensation for schemes in cases where a scheme's investment strategy has failed.**

This does not have to be the case.

This raises the question of how entry to the PPF should be triggered given that an insolvency event is not possible.

Insolvency is possible. The prohibitions on and liabilities from trading while insolvent are not limited to limited companies. If a scheme wishes and needs to lower liabilities and members deny this solution, it is insolvent.

Given schemes running on in this way are likely to pursue similar investment strategies there is a potential for a significant concentration risk here (with many schemes claiming on the PPF at the same point in time).

We feel that this assertion requires empirical justification- how similar are pension fund investment performances? For there to be simultaneity in scheme failure from this cause, it also requires that all these schemes have the same risk absorbance capacity, a highly unlikely circumstance.

Schemes have been run in precisely this independent manner highly successfully in other jurisdictions, notably Holland.

These risks would effectively be underwritten by the PPF's existing members and levy payers. There may then be a need for a new or separate safety net;

We believe that the PPF should be required to pay full benefits, that it should not be protected by the Pensions Regulator, that it should be privatised and opened to competition from other insurers.

- **what wider changes are needed to legislation and regulation to police and support what would effectively be a new system? Including how to control which schemes are allowed to run on in this manner and how (and when) to ensure wind-up/closure when funding deteriorates; and**

This is a very large subject indeed. It involves reopening the DA and CDC debates. It should be subject to an entirely separate consultation. Schemes should be allowed to run on provided they are funded to a best estimate basis and there remains the capacity for members to accept lower benefits; that is to say that there is unexpended risk absorption capacity.

- **underlying these issues is the question of what level of risk is acceptable for members or PPF members and levy payers to bear. Will this be at different levels than for buy-out or for employer sponsored schemes? In which circumstances would this be a 'better' outcome than a greater level of certainty of receiving a lesser amount of PPF compensation, or the cost of securing benefits with an insurer.**

The question of risk level acceptable or tolerable is for the members to decide. If the PPF prices the risks it faces correctly, there is no additional risk to members or levy payers. The question of a 'better' outcome is for trustees and members to decide.

Para 238. A further dimension of this issue is that, if it is decided that such arrangements should be encouraged, whether it would be beneficial to establish a single fund – a Central Discontinuance Fund – to manage the benefits. This issue is discussed further in the consolidation section below.

It would not be. This would impose standardisation and rigidities on benefits increasing the fragility and vulnerability of the enterprise.

Para 239. Another approach for stressed employers is to allow reductions in benefits in some circumstances, either by employers and trustees renegotiating benefits at a reduced rate (potentially requiring approval from the Regulator), or by reducing the rate at which deferred pensions and/or pensions in payment increase over time, but allowing the scheme to continue alongside its existing sponsor(s).

This is part and parcel of the earlier discussion. Member consent is the critical element.

Para 240. Allowing even stressed employers to renegotiate pensions and reduce benefits in certain circumstances would be a radical move and highly contentious, as it undermines the nature of the hard promise of a pension as deferred pay. A very high bar in terms of evidence would need to be met before such an approach could be considered. There does not seem to be evidence of a crisis in affordability across the board that would warrant such action. However, some commentators have suggested that in certain circumstances it might be in the interests of both the members (even when the underpin the PPF provides is accounted for) and the employer to consider a renegotiation of the DB promise. A key question here is then when is the risk in the scheme too much for those whose scheme sponsors cannot show insolvency is likely.

The deferred pay characterisation of a pension is only partially true; this is limited to the initial employer contribution(s). The balance is an investment contract. We agree that there is insufficient evidence for renegotiation in a wholesale manner. There are clearly circumstances in which this will result in superior outcomes for members. This is particularly true for schemes with high managerial content and PPF benefits are punitive. The test of insolvency is clear: if a scheme cannot be or is not funded at the level of the best estimate of liabilities, it is insolvent.

Para 241. We would be interested in views on whether there are any circumstances in which it would be appropriate to allow benefits to be reduced and how this would be defined.

We do not believe that there is any circumstance in which members' benefits can or should be cut unilaterally. We also believe that members' benefits may be varies at any time with the consent of members.

There should be no 'cram-down' of dissenting members; their future lies with the PPF or indemnity insurer.

Para 242. The Regulator currently has a wind-up power dating from the Pensions Act 1995 focused on the interests of the generality of the membership. One option is to widen this power to recognise some or all of objectives introduced by the Pensions Act 2004 including to reduce risks to the PPF.

In our opinion the majority of the problems we have observed with DB pensions arise from Regulatory action in pursuit of its objective of protecting the PPF. It has done this so well that we no longer have a DB system worthy of the name. Granting this power to the Regulator would be the same as granting the Regulator the power to cut benefits to those of the PPF. This would be a fundamental breach of their rights and would certainly be subject to contest in the Courts. It would also be political suicide for whoever is in power at the time.

Para 243. Using such a power would be a very serious step in that it would essentially crystallise the scheme's current funding position. It is in these stressed situations where the Regulator's objectives are most likely to conflict and therefore while scheme wind-up may reduce risks to the PPF, it could have a negative impact on employers and/or not be in the interests of members.

Yes, and the litigation would make Jarndyce look a short cartoon.

Para 244. However, such a power may provide a back stop in situations where these sort of issues are already under active consideration and it seems unlikely that other solutions will lead to a positive outcome.

This is a matter for member decision and they are perfectly at liberty to accept the certain if worse circumstance.

Para 245. It is impossible to predict with accuracy exactly which schemes falling within the potential criteria for winding-up would be successful in paying full benefits either through their investment strategies and/or significant turnaround in the fortunes of the employer. The Regulator would therefore run the risk of winding-up schemes that might otherwise have been fine without such intervention and so leaves the Regulator in a difficult position where key judgements will need to be made.

This is a problem with the prospective viewpoint. If the scheme has performed "as contracted" there are no grounds for wind-up to be initiated by the Regulator. Interventions by the Regulator will result in litigation. There is unlikely to be any relevant 'business judgement rule' exemption.

Para 247. RAAs are initiated by sponsors and the Regulator has no direct power to enforce separation of this nature. The Regulator's powers could therefore be extended to include a power for the Regulator to require severance of a sponsor from its liability to a scheme.

If there is a sound reason for the Regulator to interfere in the affairs of a company in this manner, it is not obvious what it might be. The question of the Regulator's powers and responsibilities needs consideration in a broader context.

Neither the employer covenant nor integrated risk management receive as much as a passing mention in any of the volumes of pension legislation. They are inventions of the Pensions Regulator and lack the force of statute law, but as a trustee, God help you if you stray from the Regulator's narrative, because there is little or no recourse available through the courts.

We have seen instances where the behaviour of the Regulator has been arrogant, capricious and abusive; instances where their actions have been totally disproportionate, such as the issuance of section 72 (PA 2004) notices, so much so that the costs of compliance have been materially deleterious to the security of member benefits, a clear breach of the Regulator's prime statutory objective to protect members' benefits.

Since its inception, the responsibilities and powers of the Regulator have grown seemingly unceasingly. The Regulator has proved remarkably adept at capturing the ire and indignation of politicians to its gain. Its track record in discharging these responsibilities has been far from illustrious; its accountability almost non-existent.

Rather than granting additional powers, a further dose of a failed medication, we recommend that a Royal Commission be established to investigate and report on the operations, accountability and role of the Pensions Regulator.

Para 249. One approach to helping stressed schemes/sponsors would be to facilitate greater and more intensive support from the Regulator for these schemes. The Regulator already provides a number of statements and guidance documents around scheme funding. However, it could provide further guidance specific to trustees and sponsors of stressed schemes/employers, if this would add value and enhance understanding as to the actions schemes should take under the existing framework.

Para 250. Similarly, the Regulator could increase its active engagement with stressed schemes/sponsors including to ensure appropriate expertise was in place (including consideration of professional trustees) to deal with the extremely complex situation the scheme is in. The Regulator already engages with a limited number of schemes each year, with the decision over which schemes to engage with based on the Regulator's risk based criteria.

This is a nonsense. The Regulator cannot support anything and engagement is about interpretation and variation of existing legislation. There is nothing 'fundamentally complex' about the position.

Para 251. In many cases, there may be little value that can be added through further Regulator guidance and/or Regulator engagement with a stressed scheme/sponsor since the sponsor is contributing what it can afford to and the scheme has limited its risk appropriately. The Regulator may therefore need further tools (such as those discussed above including power to wind-up the scheme, separate the scheme from the sponsor or reduce benefits) in order for the Regulator to have meaningful engagement with schemes in this position. This could also include a differing monitoring and reporting framework where stressed schemes/sponsor are required to report certain data and information to the Regulator while they are under a period of 'increased scrutiny'.

There is no case whatsoever for additional powers such as those discussed here to be granted to the Regulator. We should not forget that the Regulator is fundamentally conflicted. We would also note that the problems arise from the nature of the employer's business, and is not an area in which the Regulator has any expertise. Additional reporting and monitoring will only add costs to a stressed situation.

Para 253. On average, Recovery Plans were around eight years long for Tranche 9 schemes in the Regulator's latest published statistics. They vary greatly across schemes as they are decided on a scheme and employer specific basis. Again for Tranche 9, this ranged from around 22% schemes

in surplus with no recovery plan, to about 20% of schemes with plans over 10 years in length. Factors that influence the length of the recovery plan include the following, which can be conflicting considerations:

- **size of the deficit – a large deficit may need a longer recovery period to pay off;**
- **employer strength and affordability - impact upon the employer of paying the DRCs. The more cash an employer generates the faster it can pay its deficit; conversely a struggling employer may be pushed over the edge into insolvency by a short recovery period with larger DRCs up front;**
- **strength of the sponsoring employer – the lower the chance of employer insolvency the longer a trustee may be willing to wait for them to pay off the deficit, although it may also be possible for more to be paid faster; and**
- **risk to members – a large deficit with a struggling employer may ring alarm bells and encourage the trustees to seek earlier repayment of the deficit due to concern the employer may not still be solvent at the end of a longer recovery period although this would in practice be balanced against the affordability of the sponsor.**

With a range of viewpoints being used, rather than the currently used single approach to valuation, the majority of these issues may be resolved properly as the true position would be clearer. We commented earlier on the shortening of DRC schedules relative to the duration of schemes, arising from lower interest rates.

Para 254. Therefore, all else being equal, lengthening recovery plans places greater reliance on the strength of the sponsor covenant as it relies on the sponsor still being in business and generating sufficient cash to meet its pension liabilities over a longer period of time.

This may well not be true. As lower discount rates raise the present value of liabilities lengthening the term may not require more cash from the employer. Put another way at a five percent discount rate the present value may equal, say 10 years of actual projected payments while at 1% it is 20 years.

Para 256. There may be an argument to go even further. The current valuation methods essentially estimate the size of the gap between when the money will run out and the demise of the last member many years in the future. Some have argued that there are cases in which a valid question upon identifying a deficit is when, in fact, the deficit needs to be paid. Should we consider rebalancing the risk so that future members such as the youngest and the longest lived have a greater degree of uncertainty? In other words, should we consider deferred recovery plans or back loaded plans, where contributions are lower or suspended in the early years to allow greater investment in the business, provided that the short to medium term insolvency risk is considered low?

Such plans should certainly be considered. This constitutes an argument for cash flow projection valuation methods. One of the great failings of the recent PLSA 'consolidation' paper is that it did not consider the reduced level of liabilities outstanding at future dates. This risk exposure over time is shown for a (perhaps) typical scheme with a constant rate of insolvency. The loss is that accruing to members under the current PPF benefits structure. See also Box 3.

Para 257. Inevitably even if the insolvency risk is judged to be low, this involves transferring more risk onto both the members and the PPF – there is always a risk that if the recovery plan is longer, or skewed to allow more of the contributions in the later years, that the company could suffer a downturn or become insolvent, leaving the scheme in a worse funding position than it would otherwise have been. One way to mitigate this additional risk might be to require the sponsor, where possible, to offer some other form of security to the scheme in return for some flexibility with its recovery plan and DRCs.

This again does not need to be true (see previous paragraph comment). In large part, there is a trade-off inasmuch as pensioners in payment will have received their full benefits.

The emphasis on protecting the PPF is clearly misplaced. If as we advocate, pension indemnity were in place, all of these issues go away as the member is fully protected – the situation would be one of commercial arrangement between sponsor and insurer. It may well be that it suits the insurer to see a larger claim later in time. We would also make the point that the insurer may well wish to see a company continue and even supply funding to do that; the ability to influence the timing of sponsor insolvency is extremely valuable to the indemnity insurer and almost unique in the world of insurable risks. The PPF is an appalling example of institutional design, being a mutual compensation fund and not a pension indemnity assurer.

Para 270. Under the new Defined Contribution (DC) pension flexibilities introduced from April 2015, anyone with a right to a "cash equivalent transfer value" in a funded private sector DB scheme can transfer their benefits to a DC scheme in order to access the DC pension flexibilities, which would allow them to take some or all their benefits as cash (subject to tax) from currently age 55. Any changes to the rules regarding trivial commutation also need to consider the impact on the DC regime. In particular, if the minimum age for trivial commutation was reduced, then the DC pension flexibilities might also need to be changed to allow members to take some of their benefits earlier than age 55 up to the same limits used for trivial commutation. This would be a significant refocusing of the role of DC pension savings. Further, if the trivial commutation limits were changed, then we may need to review the amount above which independent financial advice is required for members taking transfer values from a DB scheme.

Under current arrangements, Cash Equivalent Transfer Values (CETVs) are very expensive and represent a significant drain on scheme funding. They effectively transform the DB promise from a promise of a pension to an option on the performance of financial markets, the discount rate in particular. This option is extremely expensive for the scheme to bear. It is also not helped the Regulator's disapproval of scheme's decreasing the amount paid under CETVs to reflect current funding levels, as would be equitable. This is just one part of the cost currently being experienced. The whole Freedom and Choice agenda as an option introduced and imposed upon schemes is expensive for them, if popular with members and productive for the Treasury. It should not have been introduced as it reduces the levels of pension coverage.

Paras 271 – 276 cover indexation.

Our attitude is simple; there should be no further changes. For those schemes with retail price index (RPI) fixed by the trust deed, member approval should be sought for any changes.

Para 277. It would also likely have significant interactions with the gilt market and wider government financing objectives. Currently, index-linked gilts (ILGs) are linked to RPI, as this was the standard measure of inflation when ILGs were introduced. As pension funds hold nearly 23% of their assets in ILGs, any changes to scheme indexation could have significant consequential effects on the price of these gilts, which would affect the Government's ability to issue debt in a cost-effective way.

The relevant statistic is that pension funds own over 80% of ILGs in issuance. This has already affected the basis on which they are priced. Investment in them at today's levels of RPI-1.8% is nonsensical, even with rising inflation. In our opinion government should issue more while they can. However, the cost of government finance is not a valid consideration for a Green Paper on pensions; that is a matter for the UK Debt Management Office.

Para 279. The Government does not think the evidence is strong enough to suggest that indexation should be abandoned or reduced across the board. There could however be a case to suspend indexation in cases where the employer is stressed and the scheme is underfunded. And there may be a case to rationalise indexation arrangements, as the current arrangement where some schemes are prevented from moving to CPI by scheme rules is something of a lottery. This is covered in the upcoming section on Rationalising Indexation.

We believe the scheme trust deed is the definitive document and that member approval may be granted for variation that may be desirable. Of course with DA and CDC schemes such variation is a principal management tool.

Para 280. One suggestion is that increases should be conditional on the scheme and the sponsor having the resources to make the payments – so that no increases would be paid, for example, if the scheme was in deficit and the sponsor was unable to make up the deficit, and the trustees were satisfied that the best interests of members would be served by suspending indexation to allow the employer to strengthen its corporate finances. Increases could be restarted in future years once the employer had recovered. The Work and Pensions Select Committee in their recent report recommended permitting trustees to propose changes to scheme indexation rules, in the interests of members.

We do not agree that this ability be granted to trustees to make changes unilaterally; they should seek member approval. In collective DC arrangements, the situation differs in that indexation is, by design, discretionary. In many ways, this is similar to the 'with profits' insurance policy.

Para 281. Whilst this may be a suitable way of ensuring that stressed schemes and their employers are supported in their endeavour to address deficits in hard times, as with all measures designed to help a subset of stressed schemes and employers, there is a moral hazard issue. There is the danger this could encourage employers to allow the funding level of their scheme to deteriorate in the hope that this would help reduce their liability to inflation link the scheme benefits. Therefore, requirements that the sponsor funds the scheme to a high level and limits risk when 'times are good' may be needed in conjunction with allowing relaxations in times of stress.

This is not moral hazard, but it is a perverse incentive. The tit-for-tat remedy is inappropriate. In good times schemes should be funded to the level of technical provisions, no higher. The purpose of the buffer is precisely that it may be run down during difficult times, but recognising that funding below best estimate does put pensions at risk.

Para 284. There is an argument that if the fundamental nature of the promise that was made to members was to protect them against inflation, then the specification in scheme rules of a particular rate of increase, or a specific index, may have made sense at the time, but may now be anachronistic, and has little to do with the fundamental nature of the promise to protect against inflation.

Para 285. The PLSA DB Task Force research found that "increasing pensions by a lower level of inflation was seen to be the most palatable benefit adjustment if one had to be made". Introducing a statutory over-ride to allow schemes to switch from RPI to CPI could amount to a saving to sponsors and lower future pension increases for members amounting to £90 billion as

discussed previously. However, the changes would impact schemes differently, where the largest schemes would experience the largest monetary savings, and not all schemes would see a benefit from such an easement, but some members' pensions would be significantly lower.

We do not believe that scheme rules should be overridden in general. If change is necessary, it should be done with member's approval. The anachronism argument is without merit.

Para 288. The Government has not received any representations suggesting that revaluation itself ought to cease. However, there are indications that a small number of schemes may have either a high fixed rate revaluation or the requirement to use RPI rather than CPI, the measure of inflation used by Government to set the statutory level. Exactly the same issues face these schemes as for schemes which have corresponding provisions for indexation.

We have heard the argument made that deferred members should be the bearers of first loss in the case of indexation modification. We do not subscribe to this view. We feel that it should be a matter for members if the idea is to reduce revaluation rates at the same time (and presumably in the same manner) when altering actives and pensions in payment. We would caution that this would represent double jeopardy, as well as being problematic for trustees.

Para 289. While it does not seem that there is an affordability problem across the board, it is clear that there is a very wide spread of experiences amongst sponsoring employers and schemes. It does not appear that there is evidence to support measures to reduce burdens on employers across the board. However, there may be a case for rationalising indexation so that there is a level playing field across the sector.

There is no need for such a level playing field. Apart from anything else it would reduce the employer's ability to use the scheme as an attraction for recruiting and retaining staff.

Para 290. But the wide spread of experience of sponsors and schemes, some of whom are clearly stressed, suggests that a targeted approach is needed. For some employers, there may be a case for encouraging or requiring deficits to be closed more quickly, to reduce risks to members, while for a subset of stressed employers, there may be a case for greater use of existing flexibilities or new easements, but subject to finding ways to mitigate the moral hazard risk. We would welcome views on whether such a targeted approach is appropriate, and if so, what measures would be helpful.

Changes which have been suggested.

- **Interim funding targets, or a tougher funding regime for employers with severely underfunded pension schemes and capacity to pay more, or limits on the length of recovery plans in some**

circumstances.

Given the uncertainties and inaccuracies of current valuation techniques, we would not favour any of these actions. We discuss our preferred method elsewhere.

- **Making it easier to separate schemes from struggling employers.**

We support this idea but see it primarily as an issue related to the section 75 debt, as is discussed elsewhere.

- **More intensive support from the Regulator for challenged schemes and sponsors.**
- **This is not within the capabilities of the Regulator, nor should it be.**
- **Power for the Regulator to wind-up schemes.**

No – see previous.

- **Make it easier for schemes to "run on" without a sponsor where they have sufficient funding, or make it easier to transfer members in bulk to a scheme with lower benefits.**

With member agreement, we favour these approaches. We would also favour allowing members, on sponsor insolvency, to transfer to other DC arrangements more easily.

- **More use of existing flexibilities such as longer recovery plans.**

Yes

- **New flexibilities like deferred or back loaded recovery plans.**

Yes

- **Allow renegotiations of pension promise in some circumstances.**

Yes

- **Allow schemes to suspend indexation in some circumstances.**

Only with member approval, unless the scheme is expressly CDC in nature.

- **Allow schemes to move from RPI to a more modern index of inflation.**

Only with member agreement.

- **Make trivial commutation rules easier to operate.**

Yes

- **Measures to ensure transparency and members are aware of the risks to their benefits.**

These are unnecessary, and may be harmful to scheme stability under Freedom and Choice and CETVs.

Para 292. One way to ensure that sponsoring employers do make the contributions that are needed, and to ensure that they do not seek to evade their responsibilities might be to

strengthen the powers of the Regulator or to strengthen the position of the trustees.

We would favour strengthening the position of trustees rather than the Regulator.

Para 296. The Regulator has issued a Code of Practice in relation to scheme funding that sets out practical guidance and standards of conduct for schemes. The Code sets out the key principles to enable trustees and employers to put in place an appropriate funding plan and comply with the law. Central to the Code is the concept of Integrated Risk Management whereby trustees should consider the management of employer covenant, investment and funding risks; and that risk taking should be set in the context of the ability of the employer covenant to support those risks. Therefore, an appropriate funding outcome would be one that reflects a reasonable balance between the need to pay promised benefits and minimises any adverse impact on an employer's sustainable growth.

The concept of integrated risk management is entirely an invention of the Regulator. It is totally inappropriate. It is the ultimate folly founded on the mistaken prospective view.

Para 299. The absence of any clear boundaries or legislative definition of what is 'prudent' or 'appropriate' has contributed to a significant divergence of approach across schemes which has been highlighted by the published data from the Regulator regarding valuations and recovery plans.

This is appropriate. We suggest a standard for prudence as one standard deviation above the best estimate of liabilities, where the one standard is of changes to the realised funding level. In other words, the prudent valuation level will be insufficient in one period in six.

Para 301. Some have said that not only is this this lack of clarity challenging for trustees and their sponsors, but it also makes it particularly challenging for the Regulator to use its powers to enforce a more appropriate approach. A number of commentators, including the Regulator, have argued that the efficiency and effectiveness of the Regulator and the level of protection for members and the PPF could be enhanced if improvements were made in this area to allow more effective use of the Regulator's scheme funding powers. The recent Work and Pensions Select Committee Report into DB schemes also suggested that the Regulator should set out more clearly how trustees should use information from the sponsor when setting funding and recovery plans, but also that the Regulator should be tougher on recovery plans.

We do not believe that there is a problem here. The evidence is that technical provisions levels are excessively prudent and costly. As long as the Regulator has as an objective protection of the PPF, it will offer a narrative that promotes over-funding. The Work and Pensions Committee is wrong to relate this to information from the sponsor – that is relevant only if the scheme is funded below best estimate and a repair schedule needed. More relevant for trustees is the level of funding and technical provisions relative to best estimate.

Para 302. Options might include:

a) setting out requirements explicitly in legislation, or

b) giving the Regulator the power to set binding standards in this area, or asking the Regulator to set out its expectations in the form of detailed codes or guidance – which, to be effective may need to be supported by a legally enforceable "comply or explain" regime requiring trustees and sponsors to explain why they have not complied with the code.

Neither of these is warranted.

Para 303. Under option 'a', legislation could set out the requirements for funding in more detail so that it is clear what is expected of schemes and employers. This could be either a fixed target for all or cover a 'range' of acceptable outcomes that covers either or both the funding target and the expectations over how to reach this target (recovery plans).

Para 304. This has the advantage of giving clarity to all parties over what is expected and a clear path for use of the Regulator powers where there is a breach.

The terms under which pensions are awarded vary over time and across employers and this determines the correct level of funding for member security. This would seek to deny that.

Para 306.Under option 'b', legislation could set out a broad framework (or give the Regulator the power to do this) and would give the Regulator the power to set binding standards (or parameters). The Regulator would be responsible for setting out the details and full consultation is likely to be necessary. Some areas would need to be set out in legislation, but other areas/parameters could benefit from regular reviews and flexibility in implementation would be left to the Regulator to set out (e.g. setting limits for recovery plans in certain situations or defining 'prudence' for certain scheme types).

Absolutely not. These would ensure that no company in its right mind would ever again offer DB pensions and that the few remaining open would close. It would be totally counter-productive with respect to the prime objective of ensuring employees have pensions in retirement.

Para 307. This has the same advantages and disadvantages as option 'a' but would give greater flexibility and ability for the framework to adapt to market conditions and give the Regulator the ability to adjust/revise as appropriate. This may mean that some flexibilities for schemes are

reduced, but if done in a considered and open consultative way, it can be targeted on areas where flexibility is less necessary or is at risk of being misused.

A cynic would say that regulation is a one-way street.

Para 308. This approach also brings into focus those schemes that would be unable to meet whatever framework is put in place. This is similar to issues discussed above in relation to stressed schemes/sponsors and is an important consideration. Solutions to this should be dealt with in a consistent and joined up way. The possible approaches set out to stressed schemes/sponsors are therefore all relevant here.

Para 309. Such an approach might also help to address some issues around where there are concerns of excessive de-risking, or excessively conservative investment strategies, as the Regulator could take an explicit view on the level of risk appropriate in the circumstances.

What qualifies the Pensions Regulator to make judgements about the health and prospects of UK companies, let alone make judgements as to risk, appropriate or otherwise? What business is it of the Regulator if a company and scheme decide to avoid all risk, investment or other? Currently with the PPF protection objective in mind, they should and do encourage this.

Page 312. The Work and Pensions Select Committee have raised a question about whether it would be more effective if the Regulator were to have powers in some limited circumstances to act proactively to prevent certain corporate activities, rather than deploying retrospective anti-avoidance powers.

This is a truly appalling idea. It amounts to: "I am going to send you to prison for rehabilitation, if not punishment (though it feels the same), because I think you will commit a crime in the future". It runs contrary to basic British justice.

Para 318. The argument being put forward is that additional proactive powers, if designed effectively, could help to protect members and the PPF from detrimental corporate activities. They could also remove uncertainties for the parties involved. Passing through a clearance regime could give employers confidence to press ahead with changes, safe in the knowledge that they will not be subject to future sanction from the Regulator.

Leslie Titcomb's caution that TPR would need 'additional resources' should not be taken lightly; this has the potential to make the old exchange control function of the Bank of England look small. Who would pay for this?

Para 319. But the risks here are quite stark, and the Government recognises that it would be

challenging to design, even if narrowly drawn, a regime which delivers benefits without potentially significant detriment to legitimate business activity. We would welcome views on whether this could be achieved, and if so, how.

We do not believe that this is feasible.

Para 320. Another less stringent option for change would be not to require clearance but if the activity was shown to have been detrimental without appropriate mitigation, the Regulator would have the power to levy a significant fine in addition to pursuing the employer for any support. This fine could also work to deter poor behaviours and nudge employers to engage earlier with the Regulator. Such a punitive approach was recommended by the Work and Pensions Select Committee in their recent report.

This is another of the WPC's follies: how would levying fines improve the security of pensions benefits?

Para 323. The Government is interested in exploring the case for considering stronger Regulator powers in this area. However, we also believe that if the Regulator is given new powers in this area, they must be proportionate and workable, and not be detrimental to the effective functioning of the economy.

If any such powers are granted to the Regulator, they will inevitably be detrimental to the functioning of the economy, even if only as a matter of timings.

Para 324. An effective regulatory regime requires clear and easy information flows. The current regime has been criticised on this count. One option to promote good information flow at any point in an investigation is to create an overall duty for parties to co-operate with the Regulator. This could be seen as an extension of existing powers which they already have in respect of Automatic Enrolment. An addition along these lines would help the Regulator to be more proactive in its approach to regulation and be in a position to investigate schemes and/or particular risks in a more efficient manner.

Para 325. Further options would be a power for the Regulator to interview parties supported by a sanction for non-compliance with an information gathering notice to attract civil penalties, in addition to the existing possibility of criminal sanctions.

Para 326. The Government believes that extending these existing powers to DB schemes is reasonable and proportionate and would be interested in views about the circumstances in which they should be available.

As long as the Regulator has its obligation to protect the PPF, this is entirely inappropriate.

Para 328. T**here are options for how any additional resourcing might be approached. The most straightforward would be simply to increase the levy that is currently paid by schemes. But a more targeted approach might be to introduce hard charging for certain services provided by the Regulator. For example, a charge could be introduced for clearance of corporate restructuring proposals.**

As we noted earlier regulation is a one-way street; in volume and cost.

Para 331. A further option might be to require employers and trustees to agree and publish a joint statement of objectives for the pension scheme. And there might equally be a role for Government in setting out a range of acceptable objectives such as buy-out, a reduction in balance sheet volatility, or reaching a certain level of funding by a certain time.

There is and should be no such role for Government. These are private contracts. Beyond setting a minimum standard of funding, which in our view, is best estimate as the minimum funding and technical provisions as the minimum objective; other objectives are entirely a matter for trustees. We have been very concerned that the Regulator has been promoting far higher funding standards than are needed or justifiable other than as protection of the PPF.

Para 333. Members of DB pension schemes are often unclear as to the level and nature of risks their scheme runs. There is often an assumption that they and their employer have paid into the scheme all the monies necessary to guarantee the promised benefits.

There is a real problem here. A company cannot guarantee anything beyond its own lifetime other than by retaining a third party to conduct some promised action. It is incorrect to view the scheme as such a stand-alone third party. In other words, a scheme would need to be insured or have the PPF compensation levels set to full benefits for this guaranteed view to be the case applicable.

Para 335. Should the company collapse and, at that date, the scheme has insufficient assets to buy annuities for at least the amount each person would get in compensation, the scheme transfers to the PPF. In either case, all members are likely to face some loss, with those under the scheme pensionable age with high accrued pensions losing the most.

With full PPF or insurance coverage there is no such loss. It is also possible that stand-alone successor arrangements such as DA and CDC might achieve full benefits as previously promised. In addition, for many members the ability to transfer out easily to other DC arrangements might be most attractive.

Para 336. With regulatory pressure from Solvency II and limited resources, insurers will necessarily prioritise larger transactions when it comes to buy-outs and buy-ins. As a result, smaller schemes may find it difficult to be quoted a competitive price when trying to buy-out their liabilities. According to a report by LCP, smaller pension plans who do not engage effectively with the insurers and fail to get 'engaged pricing' from insurers can receive quotes as much as 5% higher and therefore may not complete a transaction. In addition, small schemes with fewer than 200 members have lower opportunities to diversify their longevity risks and their total longevity risk can be almost twice relative to large schemes. This is a matter of efficiency arising from economies of scale and a potential 'market failure' as smaller schemes are being 'crowded-out' of the market. Although the counter argument is that if the smaller schemes were to achieve good engagement with insurers they might benefit from more competitively priced buy-outs.

This is garbled. The full buy out valuations reported in financial statements are stand-alone values, whereas when properly priced the buy out value would reflect the marginal contribution of a scheme to the risk of the insurer's aggregate portfolio. When priced in this way it is not uncommon for the scheme actuary's estimate of full buy out price to be materially high.

In one recent case, for a small scheme, the funding level was estimated to be 81% of buy out by the scheme actuary, but 95% by the insurer.

It is not possible for the scheme actuary to know the marginal contribution to an insurer's risk of a scheme, for the obvious reason that he or she does not know the buy out insurer's portfolio, hedging or risk appetite. It should be understood that for a fully diversified buy out insurer, the entire difference between the buy out price and best estimate is income to the insurer. How much is profit depends upon the insurer's cost of production of the investment returns it may achieve with the assets transferred. These costs and the limitations on investment by such insurers determine the profitability, but they also lead to a preference for receiving assets which satisfy their limitations or have a very low cost of reorganisation or exchange such as gilts. This encourages schemes approaching buy out or buy in to hold conservative, bond-based asset portfolios.

Para 337. Actions needed to ensure these losses cannot occur would have to be radical, such as requiring schemes to fund to the full buy-out level, which would have significant knock-on effects, and runs counter to the fundamental nature of the regime which accepts a level of risk to balance the interests of the member, the employer and the PPF.

Funding to full buy-out would be economically illiterate. Full buy-out on an individual effectively operates with a risk margin of 100% relative to the best estimate. The correct solution lies with indemnity assurance. Equivalently the PPF should offer compensation at the level of full benefits.

Para 338. However, the PLSA DB Task Force found that 71% of respondents to their survey agreed with the statement "you are guaranteed to get the income you have been promised from a DB pension" and that, of those with a DB pension, less than half (48%) had previously considered whether a deficit could affect their scheme. The Task Force also found that a significant majority (62%) would prefer a lower level of income in retirement if it could be guaranteed, suggesting an appetite for certainty of a lower income over risk of a higher income. It may therefore be the case that members do not understand the nature of their DB benefits and that they have the potential to be reduced, but that the PPF offers a significant underpin with a high degree of certainty attached.

This indicates the extent to which DB pensions have been misrepresented. And, also the extent to which they have been misunderstood by many market participants.

Para 342. However, we are not complacent. In the light of recent cases, we have set out our thinking on how the powers of the Regulator and role of trustees could be further strengthened in certain areas to produce additional safeguards. We have also considered whether more needs to be done to improve the knowledge and understanding of all parties concerned including scheme membership.

The proposals contained in this Green Paper will not resolve the issues of concern.

- **Changes which have been suggested**
- **Additional scheme funding powers for the Regulator – perhaps with explicit standards and a "comply or explain" regime.**

No

- **Proactive compulsory clearance of certain corporate activities in limited circumstances**.

No

- **Levy substantial fines on companies for corporate transactions which have a detrimental impact on schemes.**

Emphatically No

- **Impose a duty to co-operate and engage with the Regulator, backed by civil penalties.**

No

- **Require sponsors to engage with and provide information to trustees in a timely manner.**

We are not convinced this is necessary.

- **Require consultation with trustees before paying dividends if scheme is severely underfunded.**

No

- **Better communications with members.**

Unnecessary

Consolidation

We do not favour consolidation. We would point out that with full pension Indemnity assurance the consolidation convolutions are entirely redundant, and indeed, the Regulator's DB workload decimated.

Para 348. These findings are also supported by the recent PLSA DB Task Force report, where they cited evidence that the impact of good governance could add up to 1% of the funds value in year or improve the performance margin by 2% or more each year over their benchmarks.

We do not find these figures credible. In our experience consolidation is extremely costly to implement and the subsequent gains minor.

Para 349. In addition, such a vast landscape of schemes with differing characteristics and scheme specific circumstances makes for a challenging landscape for the Regulator to effectively regulate. The Regulator has finite resources and so is only able to actively engage with a small fraction of schemes directly and so approaches regulation in a risk based fashion. This inevitably means that, all else being equal, it is likely that larger schemes will be the primary focus since they contain the greatest number of members and assets under management. Similarly, in publishing guidance and codes or practice, the Regulator has to 'talk to' a very large and diverse range of schemes of differing circumstance and size (and therefore budgets for key tasks such as risk management). This can reduce the effectiveness of that guidance and risks it speaking to the 'lowest common denominator' or being too focused on larger schemes better able to apply the standards required.

Then the Regulator should stop inventing tasks for trustees such as integrated risk management.

Para 351. In addition, some of the areas discussed above with regards to potential new solutions for stressed schemes/employers, such as easier separation of schemes from their employers or reducing members' benefits, could be taken a step further by requirements that certain standards of efficiency or good governance are a prerequisite for approval. Requiring such

schemes to transfer to a consolidation vehicle could also serve this purpose as well as having the broader benefits that consolidation could bring.

The question of efficiency is matter between the sponsor and the trustees – we would love to see the proposals for a "good governance" metric.

Para 352. The (potential) benefits that consolidation might support – depending on the nature of the consolidation options taken forward - therefore fall into the following main areas:

- **efficiency and lower costs 'per member', due to economies of scale;**
- **access to more investment opportunities, and a more sophisticated investment strategy;**
- **improved standards of governance and trusteeship;**
- **more cost effective approach to buy-out for smaller schemes; and**
- **providing a potential solution to stressed schemes/sponsors.**

All of these so-called benefits are contestable. Let us get this into the open: consolidation is just code for cutting member benefits by stealth.

Para 360. It is similar to the approach already offered by DB master trusts which have one actuary, one set of trustees, a single pool of investments, and a single shared back office function. These arrangements have not proved to be very popular thus far, and there is a question as to whether the model is suitable, or whether more needs to be done to incentivise or to encourage consolidation in this sort of model. In effect this is consolidation of administration rather than consolidation of schemes.

The so-called benefits either do not exist or are much smaller than advertised.

Para 371. We would therefore be interested in views on whether the rules for WULS could be widened, for example, allowing schemes to partially wind-up simply to allow them to pay WULS. The rules for WULS should be considered alongside those for trivial commutation and transfer

values to ensure policy objectives are met and the rules are not open to abuse or considered too confusing so that people are put off from considering the options.

We have serious concerns around transfer values, and about the cost of redemption optionality generally. We do not believe that further easing winding-up lump sums would help. We would not be surprised to see the rumps left after such exercises running in significant trouble a few years after the lump sums has been paid. Simply put, this does not go to increasing the attractiveness of DB provision to sponsors, and that needs to be an objective of pension policy and regulation.

Para 375. A new consolidation vehicle – a type of "central discontinuance fund" or "superfund"

might help to meet the needs of this group.

Para 376. Such a vehicle could be targeted at smaller schemes which are at or close to 100% funding on a buy-out basis. It might have a single benefit structure, and a single consolidated fund, rather than having assets allocated to individual schemes. It would then pursue a low risk investment strategy, allowing both employers and trustees to be discharged. This could provide a welcome additional route for smaller employers to remove the risks associated with running a DB scheme, providing greater certainty for members and employers.

This is insanity. Schemes funded to best estimate are adequately funded to meet all liabilities on average. This would just embed excess cost. We hear time and again about small schemes being problematic, but most schemes in normal circumstances start small and grow.

Para 377. But there are a number of key questions that would need to be addressed before such an approach might be considered. These are private arrangements between companies and their employees, and the Government does not think that there is a case for transferring any of the risk to the taxpayer.

We agree.

Until para 398 the Green Paper is a discussion of the problems associated with consolidation; it is hypothetical. When we see such a wide collection of issues, it is rational to believe that the model is flawed and inappropriate.

Para 400. Consolidation is already possible through multi-employer schemes, which provide DB pensions for a range of associated or non-associated employers. These schemes have had their own problems, and we have had representations from a number of them, particularly about the way orphan debt and employer debt as a whole is managed.

The problems of multi-employer schemes are well-known, and give a good indication of the welcome that would await consolidators.

Para 403. An employer debt is calculated by reference to the cost of buying-out members' benefits with an insurance company on full buyout basis and includes a share of any orphan liabilities. Orphan liabilities are those attributable to members whose employers no longer participate in the scheme. The policy rationale is that trustees have a duty to ensure that all members' rights are protected and that their scheme is properly funded.

But that does not mean ensuring that pensions are paid. We have significant reservations with respect to the s75 debt; in particular, arising from its inequity with respect to other stakeholders, such as other creditors. It is also a source of a major perverse incentive.

Changes which have been suggested

- **Make it easier to simplify and to re-shape benefits.**

No

- **Set standards for consolidation vehicles such as DB master trusts, and a standard simplified benefit model**

No – This would embed gross inefficiency and cost.

- **Require schemes to publish their administration costs and the charges paid for investment and other advice and services**

Perhaps, but recognise alongside that publication that member benefits are not impacted by these costs.

- **Provide a legislative framework for new consolidating superfunds targeted at delivering an alternative to buy-out, or at consolidating stressed schemes – and allow the industry to innovate to create new vehicles.**

No

- **Changes to the employer debt regime in multi-employer schemes. Indeed, and changes to the s75 regime more generally.**