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How can defined benefit pension schemes be made more secure and sustainable?

Sponsors and trustees of defined benefit pension schemes have been facing problems for a number of years, with many employers making the move away to defined contribution alternatives. This has been exacerbated since the economic crisis, by persistent low interest rates and falling gilt yields, leading to ever greater scheme deficits.

The plight of British Home Stores and British Steel workers in the past 12 months has also sought to focus the spotlight on the difficulties experienced by both sponsors, and members of defined benefit schemes.

The DWP has published its long-awaited Green Paper on the security and sustainability of such schemes. This has not come up with any solutions, but instead proposes a number of ideas that could improve the future of defined benefit provision in the UK.

The consultation ends on 14 May 2017.

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Background

The value of the UK's private sector defined benefit market cannot be overlooked, with some £1.5 trillion worth of funds under management and around 1.1 million members. With many sponsors having moved their employees into defined contribution pension schemes, the sector is not as large as it once was; but there is still a vital need to ensure that defined benefit pension schemes continue to work, both for employers and members.

The Green Paper looks at a range of issues, but focuses in particular on four key areas so that the DWP can start to build consensus on whether the current system should be reformed. They are:

- funding and investment;
- scheme affordability;
- member protection; and
- consolidation.

Unfortunately the DWP has only really brought together a broad collection of ideas, rather than necessarily making any meaningful policy proposals at this stage.

Funding and Investment

Changes which have been suggested include:

- Better government and industry communications about the meaning and context of valuations so that there is a greater understanding of scheme funding and deficit data.
- The Regulator allowing for more regular valuations for high risk schemes, and a longer valuation cycle for lower risk schemes, with risk-based reporting requirements, so that there is better targeting of weaker schemes. There is recognition that a 'one-size-fits-all' approach may not be the best way forward.
- Reducing the timescale for valuations from 15 months to 9 months to ensure greater focus on the process from sponsors and trustees, prevent "unscrupulous advisers from dragging the process out", and allowing for timelier Regulator reporting.
- The Regulator taking a more proactive role in scheme funding and risk management. This could be done through mandating or encouraging alternative valuation measures, or through improving the skills of trustees by way of training. A greater use of professional trustees is also suggested.
- Commissioning further research into trustee decision making, the factors affecting investment strategies and choices of asset classes in all sizes of scheme.

There is a lack of a genuine steer from the government in this key area. The government has said its Green Paper is intended to encourage informed debate on what, if anything, it may need to do. Many people would have been hoping for clearer proposals from the DWP at this stage.

Are defined benefit schemes unaffordable?

While almost all defined benefit schemes currently have a funding deficit, the DWP's own 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.

The available evidence does not appear to support the view that defined benefit pensions are generally 'unaffordable' for employers. While defined benefit pensions are more expensive than they were when they were originally set up, the DWP suggests that many employers could clear their pension deficit if required. 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. The single biggest risk to the members of these schemes is the collapse of the sponsoring employer.

However, there are some employers who are finding that their pension scheme deficit is having a significant impact and where the level of deficit reduction contributions may become unsustainable. The Green Paper does consider that specific measures may be necessary for sponsoring employers of these "stressed" schemes.

These include:

- Making it easier for employers to use regulated apportionment arrangements.
- Cutting or renegotiating 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.

- Giving the Regulator a workable power to separate the scheme from the sponsor or wind-up schemes in certain circumstances.
- Providing more intensive support from the Regulator for both the employer and the scheme to review options including the potential for restructuring to rescue business value (even while keeping the pension scheme attached), and possible mandatory appointment of professional trustees, who have the relevant skills and experience of these difficult situations.
- Making greater use of the exiting funding flexibilities, such as for deficits to be repaired over a longer period. This would not mean directly cutting pensions, but would transfer some risk to members, as there is always a risk that the employer will become insolvent before the recovery plan is completed or that the funding position will deteriorate at a greater pace due to reduced sponsor contributions.

Exactly how a scheme is defined as “stressed” is clearly going to be critical.

Another issue considered by the government in terms of affordability is the indexation of pensions in payment. Schemes are required by law to increase pensions accrued between April 1997 and 2005 by inflation capped at 5%, and post April 2005 accrual by inflation capped at 2½%.

Although the government is not minded to abandon indexation generally, it is inviting views on when it may be appropriate to suspend the requirements.

There is also a suggestion that the government may investigate the possibility of a statutory override for schemes that are locked into using Retail Prices Index (RPI), for measuring revaluation and indexation, to allow a switch to the generally lower Consumer Prices Index (CPI).

Member Protection

The DWP believes that the funding framework and the wider system for protecting members’ benefits is broadly working as intended. A significant majority of members with defined benefit pension savings can expect to receive their full pensions.

However, the DWP is looking at ways in which the powers of the Regulator and role of trustees could be further strengthened in certain areas to produce additional safeguards. (Any increase in the Regulator’s powers would need to be balanced against the need to ensure the competitiveness and effective operation of the wider UK economy isn’t compromised.)

Some of the changes suggested include:

- Additional scheme funding powers for the Regulator. This could include explicitly stating requirements in legislation or setting binding standards perhaps with explicit standards set out in codes of practice, together with a “comply or explain” regime.
- Proactive compulsory clearance of certain corporate activities in limited circumstances.
- Levy substantial fines on companies for corporate transactions which have a detrimental impact on schemes. This could deter poor behaviours and also encourage employers to engage with the Regulator at an earlier stage.
- Impose a duty to co-operate and engage with the Regulator, backed by civil penalties. This could help with the provision of information to the Regulator and could be seen as an extension of the powers it already has with regard to automatic enrolment.
- Require sponsors to engage with and provide information to trustees in a timely manner that might reasonably be needed by trustees to carry out their functions.

- Require sponsors to undertake formal consultation with trustees before paying dividends if a scheme is severely underfunded.
- Better communications with members about the level, and nature, of risks run by the scheme. There is often an assumption on the part of members, that contributions from them and their employer that have been paid into the scheme is all the monies necessary to guarantee the promised benefits. The Green Paper also suggests improving the language used in summary funding statements to help members better understand the risks to their scheme.

Scheme Consolidation

A familiar theme from the Regulator in recent years has been the idea that small pension schemes do not generally deliver the same value for members as larger schemes. While the consolidation of small schemes has been seen as a desirable aim for some time, this has generally been applied to schemes in the defined contribution arena. However, the Green Paper makes the case for consolidation within the defined benefit market as well.

Potential benefits that consolidation might support – depending on the nature of the consolidation options taken forward - 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.
- Providing a potential solution to stressed schemes/sponsors.

The Green Paper also notes a number of challenges to the successful implementation of this:

- The considerable up-front costs to be incurred for sponsors in terms of improving the quality of scheme records before passing over the management of the scheme, and the significant challenges in amalgamating different funds.
- The vested interests of trustees and advisers – losing control over the day-to-day running of the scheme, including important decisions over funding and investment strategy and on sensitive matters such as discretionary benefits.
- A possible unwillingness of sponsors to share sensitive information about their business and commercial strategy, which often must be shared with scheme trustees when they consider the strength of the employer covenant.
- Where schemes pool investments, there may be different characteristics, such as maturity and funding levels which cause difficulty in agreeing investments which meet the needs of their sponsor and members.
- Full consolidation of schemes is difficult if schemes have different benefit structures, and moving members to new benefits structures can be complex.

The DWP does believe that there is a strong case for voluntary consolidation, and would like to see more schemes consolidate. It would appear to offer significant savings in terms of administrative costs, as well as the benefits of scale such as access to more sophisticated investment advice and the ability to access better investment opportunities, that might not be available except via unitised arrangements with their additional levels of costs to smaller schemes.

Changes which have been suggested include:

- Making it easier to simplify and to re-shape benefits – particularly where member consent is required.
- Setting standards for consolidation vehicles such as DB master trusts, and a standard simplified benefit model.
- Requiring schemes to publish their administration costs and the charges paid for investment and other advice and services.
- Providing a legislative framework for new consolidating superfunds targeted at delivering an alternative to buy-out, or at consolidating stressed schemes – and allowing the industry to innovate to create new vehicles.
- Changes to the employer debt regime in multi-employer schemes – particularly in relation to the treatment of orphan liabilities (relating to members whose employers no longer participate in the scheme).

Comment

The government appears to be rejecting the idea that a fundamental problem exists with defined benefit schemes in general, and instead any assistance should be targeted at those schemes in most need.

The lack of genuine proposals, or even a clear direction of travel, from the government is disappointing. While the DWP is clearly eager to obtain the views from as many interested parties as possible, including members of defined benefit schemes, it has already been given a great deal of feedback from the industry and Parliament's Work & Pensions Committee.

The government is willing to listen though, and suggestions of an RPI/CPI override and some possible modification of the indexation requirements will be welcomed by sponsors and trustees. Another look at the communication of scheme issues to members should also be welcomed. The successful disclosure of information to members can often be difficult to achieve, but can assist greatly in the smooth running of a scheme.

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