JLT

HOW DO WE GET OUT OF THIS PENSIONS ‘BLACK HOLE’?

Finding a lasting settlement for defined benefit pension schemes

FOREWORD

In the last ten years, the gap between the assets and the liabilities of defined benefit (DB) pension schemes has almost doubled. The deficit now exceeds £800 billion. This is despite many DB schemes closing and £160billion of contributions being made. The deficit is the equivalent of £73,000 for each and every member of the remaining 6,000 or so DB schemes.

There are many reasons for this black hole. But rather than explore these reasons in detail, this report focuses on finding ways to escape its gravitational pull. We want to find a lasting settlement that does two things.

First, it should make sure previous pension promises are sustainable.

Second, it should allow employers to get back to running their businesses and improving reward for all their employees.

Some of the solutions may have hitherto been branded as draconian – even heretical. But recent events have created new opportunities. Consider the Work and Pensions Committee's reports into the BHS pension scheme for example. Or the Government's consultation on British Steel pensions. And while Brexit is having a negative effect on deficits, it's created an opportunity for fresh thinking. Depending on how we exit the EU, we may be able to look again at funding, investment and Pension Protection Fund (PPF) regulations, without needing to comply with the full rigour of EU pension fund and insolvency directives.

With the prospect of millennials being the first generation to have worse pensions than their parents, this is an opportunity not to be missed.

BALA VISWANATHAN
CEO JLT Employee Benefits

CONTENTS

Executive Summary 3

1. The State Of The Nation 4

2. How Did We Get Here? 8

3. Managing vs Coping: The Employer Response 14

4. Outlook 20

5. New Thinking 23

6. Conclusions and Recommendations 25

Appendices 29

Appendix 1

Appendix 2

EXECUTIVE SUMMARY

- The time has come to take a fresh look at the UK's remaining DB pension schemes. All stakeholders – employers, trustees, members, policy makers and the pensions industry – need to come together to find a lasting solution to these schemes' unwanted consequences.
- Under the current framework for measuring DB assets and liabilities, deficits have doubled over the past decade, despite considerable efforts to reduce them. This has created a black hole, which seems to be getting bigger.
- We go back 30 years to understand how we got to this position.
- We consider the current options that sponsors and trustees have to de-risk their schemes and how these can have a positive effect on liabilities. However, we concede that these options may not go far enough – even if schemes adopt them more widely.
- We explain why the current environment is conducive to change, whilst highlighting the possible implications of doing nothing.
- We then recommend several reforms, all focusing on what is possible and what might be acceptable to the greatest number of stakeholders. Our recommendations include:
  - Reviewing the rules around transfers and conversions
  - Allowing schemes to reduce pension increases for preserved pensions and pensions in payment, to reflect prevailing rates of inflation
  - Reintroducing State Scheme Premiums for formerly contracted-out schemes, so reinstating members' SERPS benefits in return for reduced DB pension promises
  - Removing obstacles to liability de-risking through statutory overrides, so all options are available to all scheme sponsors, and limiting trustees' roles to helping members make informed decisions
  - Amending legislation so that advance funding only needs to match PPF benefits, allowing unfunded top-up schemes to meet any promises beyond that
  - Changing the remit of The Pensions Regulator.

1. THE STATE OF THE NATION

The current UK funding regime for DB pension schemes has been in place since 2006. We wanted to explore how pension scheme funding has evolved over these ten years.

We've analysed the last decade of UK pension scheme funding[1]. We've focused on the 6,000 or so DB schemes that are eligible for the Pension Protection Fund (PPF). Therefore, we've excluded, for example, unfunded (and some funded) public sector schemes. We've used the Purple Book, published by The Pensions Regulator and the PPF[2], as a significant source of data.

In 2006, there were around 7,800 schemes[3]. Around 200 schemes a year have wound up, gone into the PPF, or merged. We've allowed for this change in our analysis because, if we didn't, we would be overstating deficits in earlier years simply because there were more schemes in existence then.

SCHEMES BY SIZE BAND

Schemes	Status				All
	Open	Closed to new entrants	Closed to future accrual	Winding-up	
5 to 99 members	354	978	725	87	2,144
100 to 999 members	233	1,372	986	34	2,625
1,000 to 4,999 members	105	457	217	6	785
5,000 to 9,999 members	32	108	38	-	179
Over 10,000 members	41	138	32	-	212
Total	**765**	**3,053**	**1,998**	**127**	**5,945**

[1] JLT Employee Benefits, 2016

[2] http://www.thepensionsregulator.gov.uk/doc-library/research-analysis.aspx#s16224

[3] http://www.thepensionsregulator.gov.uk/docs/purple-book-scheme-demographics-appendix-2015.XLS

The growing risk of DB Pension Schemes

Our key finding was that the total shortfall between the assets and the liabilities of these pension schemes has grown over the last ten years from around £425bn to around £800bn[4]. This equates to around £73,000 for each member of these schemes. Coincidentally, this figure is very close to the average amount of DC savings that an individual retires with today[5].

This black hole has grown despite strong support from scheme sponsors, who have paid in £160bn of contributions over the same period.

The deficit issue is not unique to the UK. In the US, S&P 500 companies ended 2015 with pension deficits totalling $403 billion, with total pension obligations of $2,027 billion. Employees in emerging markets, on the other hand, don't generally get DB pension promises[6].

[4] On a buyout basis - the cost of securing members' benefits in full through contracts of insurance

[5] http://www.thisismoney.co.uk/money/pensions/article-3326892/The-pension-pot-map-UK-revealed.html

[6] Citigroup – 'The coming pensions crisis', March 2016

We've identified three reasons for why the black hole has grown over this period:

1. **Interest rates have gone down**. This, along with a general expectation of lower long-term investment returns, has had a massive effect. Pension schemes invest over 30, 40 or even 50 years, so even a small change in long-term investment returns has a big impact on the amount of money they need to hold today.

2. **Life expectancy has gone up by approximately two years**. This alone has added £135bn to pension scheme liabilities. This trend appears to have slowed down over 2014 and 2015, but it is difficult to identify whether this slowdown will continue.

3. **Brexit**. The vote to leave the EU led to a further deterioration[7], with deficits reaching £900bn. Equity markets have recovered, but the real damage has come, again, from the fall in long term-interest rates, which have hit record lows. This has resulted in the value placed on liabilities rising quickly and deficits widening further. Trustees will also be examining the potential effects on the strength of the employers' backing for their pension schemes – the so-called 'employer covenant'.

So the state of DB pensions seems bleak. This funding black hole is not, however, simply a symptom of events over the last decade. To understand how we got here, we need to look back at least thirty years. We'll do this in detail in Section 4.

DOES A BLACK HOLE REALLY EXIST?

Before we move forward, we need to verify that the black hole is real. After all, the liability values we and other commentators have discussed are only estimates. Some argue that the headline deficits are simply the result of a flawed basis of measuring liabilities.

Our calculations suggest that, altogether, UK private sector pension schemes would be broadly in balance if valued using a discount rate of 4.2% p.a. In other words, there would be no deficit if we could be sure of achieving a return of 4.2% p.a. over the entire life of the schemes. 4.2% seems achievable when you consider historic long-term investment returns on a variety of asset classes.

The problem, it is argued, arises because the traditional approach to valuing scheme liabilities involves discounting the future benefit payments at a rate linked to the prevailing government bond or 'gilt' yield. And as gilt yields have fallen, the present value of the future payments has increased to the headline deficit figures we have seen. Also, this basis of valuation, along with the current regulatory framework, encourages schemes to invest in 'matching assets' that move in line with the value of the liabilities - predominantly gilts and index-linked gilts. So we have a vicious circle: as schemes move to invest in these assets, the price is driven up. This reduces the yield and so increases the value of the liabilities. Schemes that have not invested in this way have been severely punished over the past few years as other asset classes have failed to keep pace with the underlying growth in the value of their liabilities, measured in this way.

[7] http://researchbriefings.files.parliament.uk/documents/CBP-7629/CBP-7629.pdf

Few commentators today believe that gilts will deliver positive returns in future. So, we're now investing in an asset class that we believe will lose money. The ostensible response to this is simply to deal with the problem that we 'measure' the value of these liabilities by reference to gilt yields[8].

The Government may welcome the additional investment in gilts and index linked gilts – not least because it reduces their cost of borrowing. But others argue that it starves the wider economy of investment. If pension scheme assets were invested in, say, UK companies or infrastructure projects, then schemes would benefit from higher expected returns – and lower deficits. The economy would also benefit from this investment.

So, whilst an over simplification, it could be argued that measurement methods, along with regulations, have led to a gross exaggeration of the funding shortfall. This exaggeration has driven behaviours that are not in the interests of scheme members, companies or the wider economy.

Can't we recognise this and lobby for a change in the way we measure pension liabilities?

We are assuming, of course, that companies will be around to meet their pension duties over the long term. The sad reality is that many will not. Each economic cycle inevitably brings some corporate insolvencies. Many schemes will fall into the PPF. This gives members a degree of protection, but they still lose a valuable part of their hard-earned benefits.

It is, however, possible to envisage an alternative system in which the PPF continues to invest its assets for the long term, and pays members of insolvent company schemes the full benefits they were expecting. This would create a different balance of risk between the various stakeholders (members, companies and ultimately perhaps the taxpayer). We believe that such a structure might be found if the risk is appropriately redistributed and the PPF is allowed to raise its levies. Many companies may prefer this option to putting even more cash into their scheme to plug a deficit created by the 'measurement problem'.

However, this does not address a harsh reality of today's DB pension scheme world. We believe it is untenable for most UK pension schemes to continue for the next 40 to 60 years, paying full benefits until their last beneficiary dies. Aside from the practicalities, we do not believe such an approach is consistent with the needs or wishes of corporates, which dislike (and find very difficult to manage) the volatility such schemes bring to their balance sheets.

We think that most UK DB pension schemes will, at some point over the next 10 to 30 years, seek a way out by offloading their pension scheme's assets and liabilities onto an insurance company. A 'buyout' like this removes the liability from their balance sheet and allows them to feel safe that the members' benefits have been secured.

We accept that this may not hold true for all schemes. For example, large schemes with a strong sponsor covenant may not feel the need to buyout in this way. But for most schemes this is the reality. The problem for these schemes is that insurance company pricing is linked to gilt yields, for various reasons including regulatory requirements. So negotiating an acceptable buyout has become much harder.

For the remainder of this paper we therefore work on the assumption that the disclosed pension scheme deficits are real and we need to find ways to address them.

[8] In reality, however, the issue is more one of 'security' and the appropriate level of security for the liabilities under consideration.

2. HOW DID WE GET HERE?

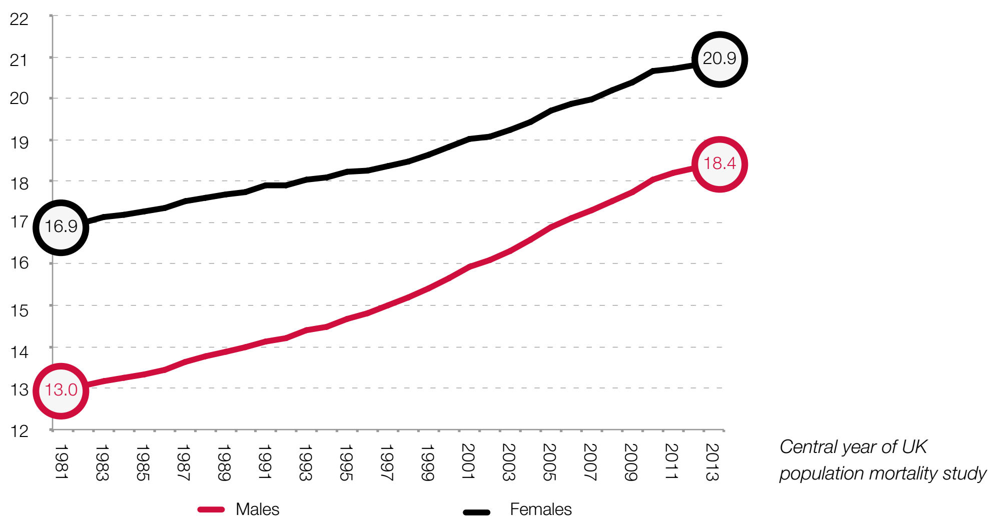
The easy answer to the question is: 'cost, red-tape and rash promises'.

Finding a more helpful answer is difficult. But a good place to start looking is the underlying reasons for the rising cost of providing each £1 of pension income: increases in life expectancy, changes in the economic environment and changes in regulations.

INCREASES IN LIFE EXPECTANCY

The chart below shows how life expectancy at age 65 has increased since the 1980s. For men this has gone up by 5.4 years.

Period Life Expectancy at age 65 (UK Life tables 1980-82 to 2012-14)



ECONOMIC ENVIRONMENT

Economic conditions in the 1980s were very different. Long-term government bonds (gilts) have historically been a popular investment for pension schemes because they provide a steady income with which schemes can match their pension outgoings. But yields on gilts have fallen from around 15% p.a. at the start of the 1980s to around 1% now. This has also been reflected across other asset classes. This has a big impact on the cost of supporting a pension scheme, given that it is a long term investor.

Datastream Benchmark 20 Year Gilt Yield 1980-2016

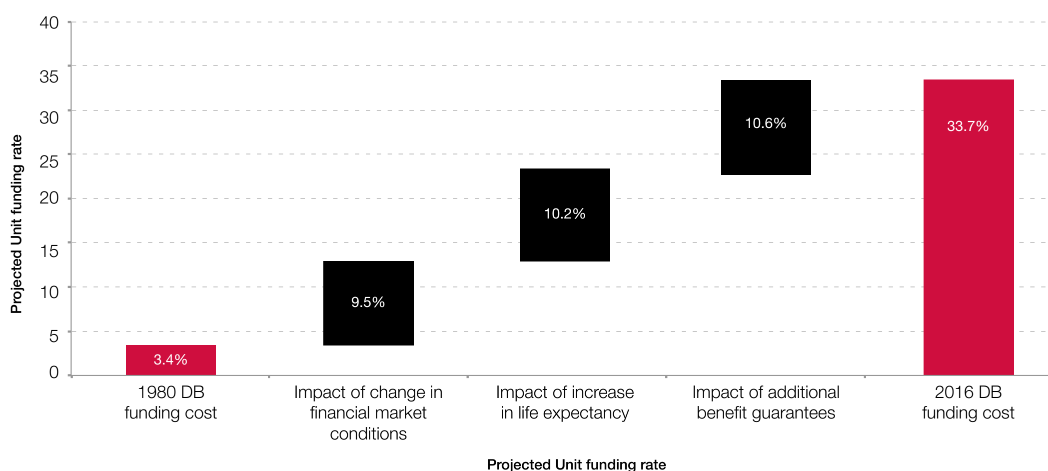
REGULATIONS

Changes in pension legislation and regulations have added additional benefits and guarantees for members. And they've added to the cost of providing pension benefits.

Bringing these three items together we can see that the cost, as a percentage of salary, of providing one year's pension accrual has increased from 3.4% in 1980 to approximately 34% today.

It is important to note that the impact of additional benefit guarantees (revaluation in deferment and escalation in payment allowed) adds 10.6% to the cost of accrual. This is to say that statutory increases for members' benefits, which were imposed on sponsoring employers by Parliament, have had the biggest impact on the cost of funding DB schemes.

Change in funding cost from 1980-2016



BREAKING IT DOWN

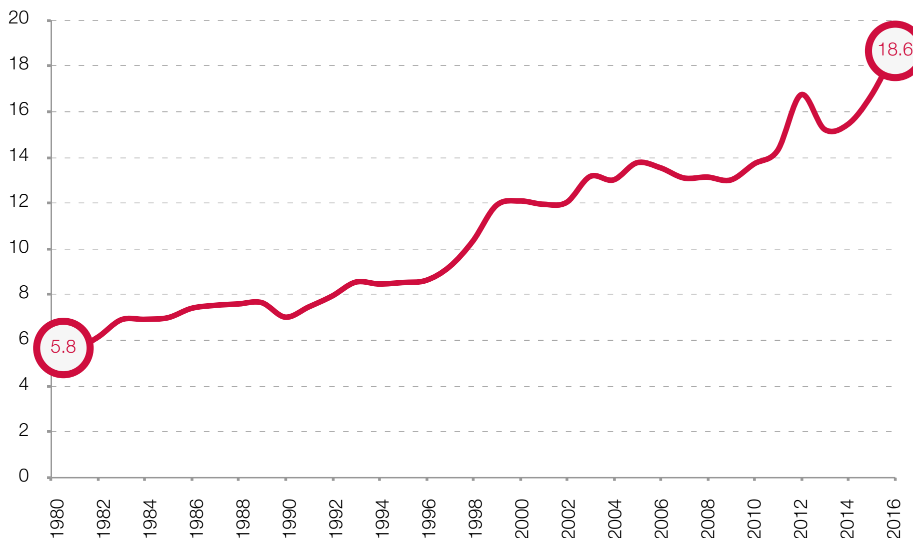
The effect of legislation (see image on page 13 and Appendix 2) has been at least three-fold:

- Legislation brought in to protect members and their benefits (especially in the 1980s and 1990s) came at a price.
- Pension schemes that appeared to build up a buffer between their assets and liabilities were sometimes effectively forced to reduce it because it was seen as an excessive surplus.[9]
- There is a direct correlation between regulation and schemes closing, though many employers would have done well to close their schemes much sooner.[10]

In effect, regulation has improved the pension promise beyond the original intention of scheme sponsors – turning it from a ‘best endeavour’ to a ‘contingent guarantee’ – that is to say, subject to employer solvency.

The effect of changes in actuarial methods and assumptions, particularly longevity, and taking into account prevailing economic and market conditions, has resulted in the cost of a £1 of pension increasing from £6 in 1980 to £18 in 2016.

Immediate annuity values at age 65 - single life / nil increasing



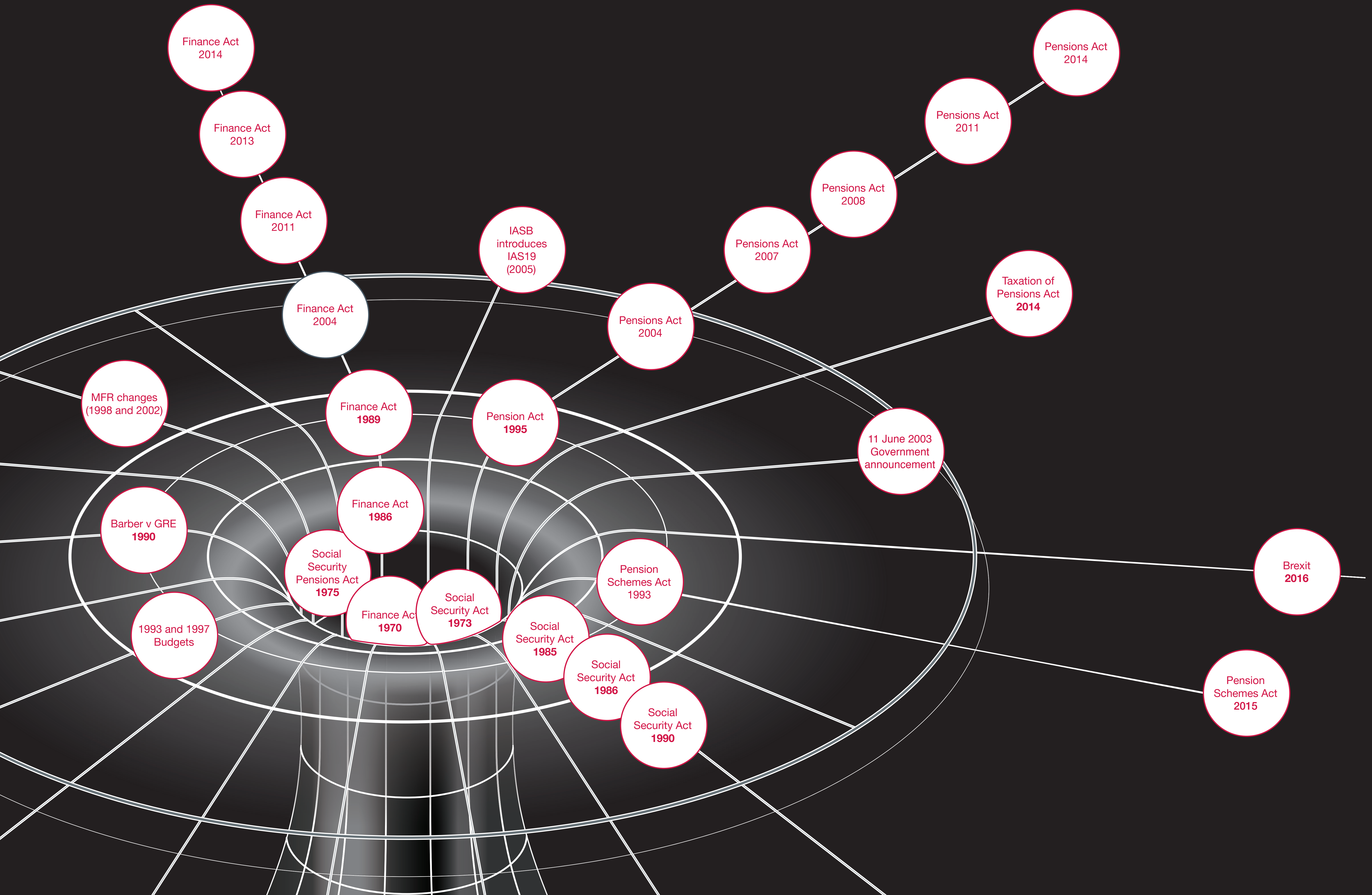
[9] Schedule 22 of the Incorporation and Taxes Act 1988 (previously Finance Act 1986), which set out provisions in relation to ‘statutory surplus’. Until their repeal in 2006, these provisions required regular actuarial valuations on a prescribed basis. If assets were shown to exceed liabilities by more than 5%, the scheme administrator was required to submit proposals to the Inland Revenue for reducing it to an acceptable level (not more than 5% of the scheme's liabilities) or eliminating it altogether. The Pension Scheme Surpluses (Valuation) Regulations 1987 (SI 1987/412) required the valuation of the assets and liabilities of a scheme to be submitted to the Inland Revenue by the scheme administrator whenever any other actuarial valuation of the scheme was made. The regulations also prescribed the manner in which the actuary was to value the assets and liabilities of the scheme.

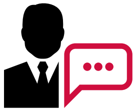
[10] http://www.plsa.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0587-DB-Taskforce-Call-for-Evidence2.pdf

Pension promises, such as fixed 5% p.a. compound increases on preserved benefits and pensions in payment, were made, and hard coded in scheme rules, based on conditions the likes of which we are unlikely to see for many years. It is no exaggeration to say that we may not experience them again until long after the last pension instalment is paid from a traditional private sector DB pension scheme.

Nevertheless, employers still need to stand behind these promises. In most cases they need to do so without recourse to members, as the scheme will now have ceased accrual. So employer contribution rates have increased – in some cases exponentially – but there are no active members left to pick up at least some of the growing cost.

This is not to say that employees are not affected. Indeed, current employees are indirectly paying for their predecessors' pensions whilst being offered retirement and death benefit schemes that are far less generous. We'll return to this question of intergenerational unfairness later.


Finance Act 2014
Finance Act 2013
Finance Act 2011
Finance Act 2004
Finance Act 1989
Finance Act 1986
Social Security Pensions Act 1975
Finance Act 1970
Social Security Act 1973
Social Security Act 1985
Social Security Act 1986
Social Security Act 1990
IASB introduces IAS19 (2005)
Pension Act 1995
Pensions Act 2004
Pensions Act 2007
Pensions Act 2008
Pensions Act 2011
Pensions Act 2014
Taxation of Pensions Act 2014
11 June 2003 Government announcement
MFR changes (1998 and 2002)
Barber v GRE 1990
1993 and 1997 Budgets
Pension Schemes Act 1993
Brexit 2016
Pension Schemes Act 2015

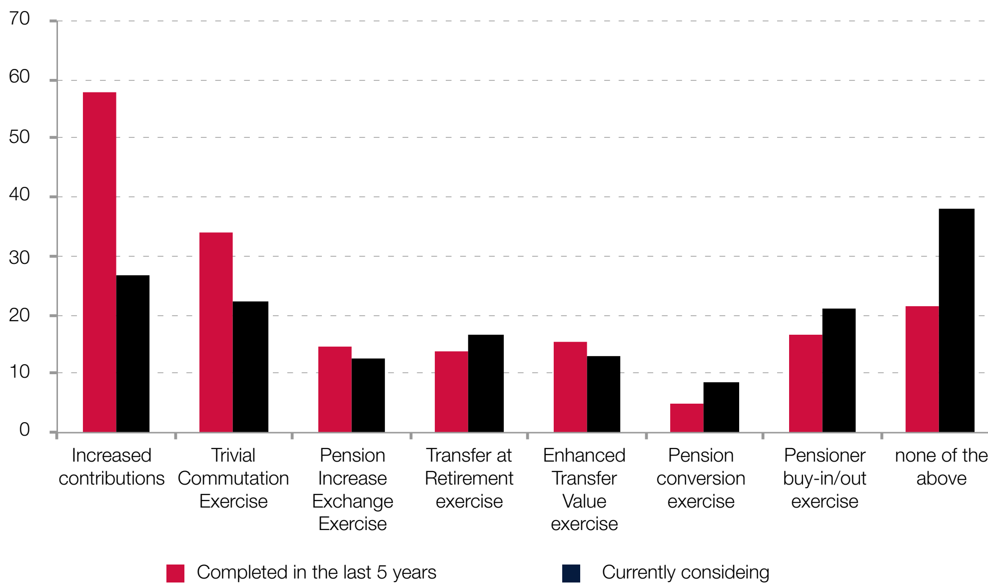


3. MANAGING VS COPING: THE EMPLOYER RESPONSE

Companies have deployed a range of strategies to respond to the increasing cost of their DB pension promises. These include:

- Deficit reduction contributions and, in schemes still open to some members, increased employee contributions
- Liability reduction / de-risking exercises
- Reduced benefits for the future
- Investment strategy
- Asset pledges / contingent funding
- Profit sharing agreements
- Scheme closures
- Switching to defined contribution (DC) arrangements
- Business failure, often leading to PPF entry

Which of the following actions: 1) has your DB scheme completed in the last 5 years, 2) is your DB scheme currently considering in order to ensure that it meets its liabilities?[11]



[11] JLT survey, 2016 (as part of the research leading to this report, we conducted a survey of nearly 200 employers and trustees)

By 2006, 58% of schemes were already closed to new members. By 2015 just 13% of schemes were admitting new entrants[12].There is no longer any company in the FTSE 100 with a final salary pension scheme still open to new entrants. In fact, according to our latest research[13], only 5% of FTSE 250 companies still offer DB pensions to their employees.

In terms of the impact of the cost of DB pensions on how trustees invest scheme assets[14], over the last 30 years there has been a large shift in investment strategy thinking. Until now schemes predominantly had large equity holdings in order to drive performance. This had replaced 'balanced mandates' because investment managers had merely driven up equity holdings to raise their league position. Now a true consideration of risk has come into play as trustees became concerned about volatility of returns and liability values, particularly where the scheme sponsor's covenant was in doubt. These initially merely led to increased costs through increased holdings of bonds (gilts) in place of higher yielding growth stocks.

Fortunately, the investment fraternity has not been idle and now clients are able to moderate the cost aspects without sacrificing long term returns through use of leveraged liability driven investment (LDI) funds. Nevertheless, the need to reduce volatility and target buy out (the ultimate run off) has caused clients to worry about increased costs, both through lost investment opportunity cost and concerns over locking into low yields. As it happens, and somewhat perversely, these strategies have reduced costs for early adopters (and indeed even for those who thought they were late to the party but still wanted to de-risk). The number of pension schemes now looking at higher yielding asset classes to meet liability cash flows is increasing, albeit this often requires accepting illiquidity and an understanding of the risk of default.

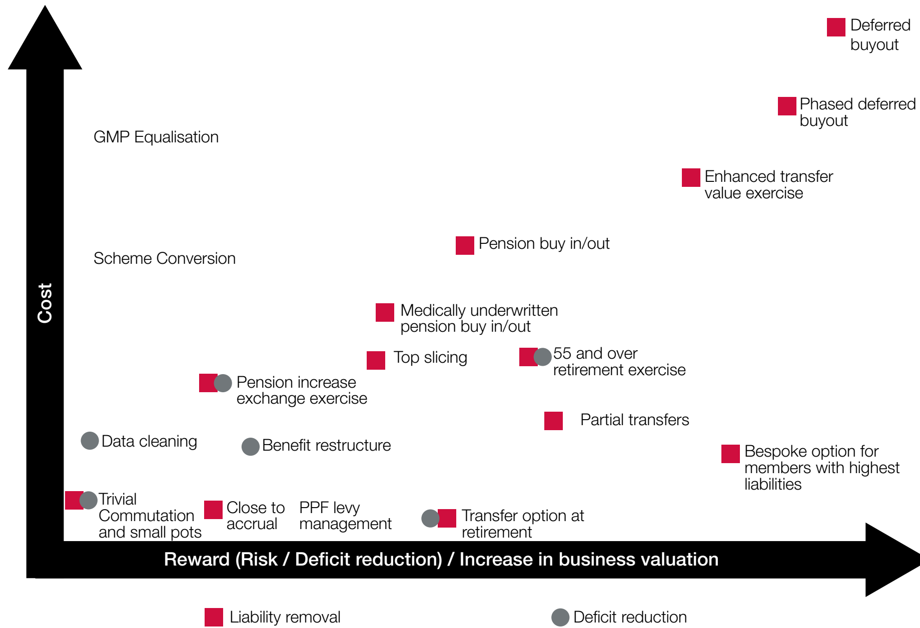
The primary response to the pensions black hole in recent years has, however, been de-risking exercises. These are multi-faceted in both options and impact, as illustrated overleaf.

[12] http://www.thepensionsregulator.gov.uk/doc-library/research-analysis.aspx#s16224

[13] JLT Employee Benefits, 2016

[14] Under the Pensions Act 1995, trustees have the same powers of investment in relation to scheme assets as if they were the beneficial owners of the assets. The scheme's sponsoring employer has no right to restrict the trustees' investment powers. Given the breadth of the power, trustees can use the investment powers to increase pension scheme liabilities.

Pension Scheme Solutions



Some employers have also used alternative finance initiatives (AFIs) to help finance their DB pension schemes. AFIs are methods of financing a pension scheme that do not involve the immediate application of cash (or other assets) into the scheme. They include:

- Parental guarantees
- Security over assets
- Letter of credit from a third party
- Enhanced creditor status or 'subordination'
- Escrow accounts
- Asset backed contributions

This list is by no means exhaustive and new AFIs are still emerging. However, their objectives are often the same.

To bring this all to life, here are a couple of examples that illustrate the impact that de-risking can have on a scheme's liabilities depending on the characteristics of the scheme (e.g. the amount of small pensions that are eligible for payment in lump sum form) and, where members are offered an alternative to their DB pension, the level of take up in respect of the offer.

Illustrative Transfer Value Exercises

	Scheme 1	Scheme 2	Scheme 3
Number of members in scope for exercise	1,004	28	42
Total Transfer Values for members in scope	£126m	£6.4m	£3.7m
Percentage of members who sought financial advice	61%	86%	79%
Total Transfer Values paid out	£25m	£1.8m	£1.8m
Percentage take up rate	20%	28%	48%
Saving against current buyout deficit	£24.9m	£0.7m	£1.1m

DB PENSION SCHEME (CASE STUDY)

In 2001, our client – a privately-owned engineering company – had two DB schemes with four sponsors, and assets totalling £20m. They realised that, with the introduction of FRS17, the assets in the schemes were effectively part of the company and so part of their wealth. Their choice was either to hold on to their assets on the balance sheets outside the schemes and give underfunded benefits, or transfer assets in to the schemes and so give fully funded benefits.

Further, the next generation of family expressed a desire to exit from the business. So selling the company became an important agenda item for consideration in future. With an FRS17 focus, potentially underfunded schemes would simply mean the sale price would be lowered because of the deficit, or even no sale would be possible. As a result, they would simply have to asset-strip the business as they came to retire. If they funded the schemes, they would target getting their money 'back' through an improved price and increased saleability.

Equally, the trustees did not want to be left without a sponsoring employer as the current family generation aged or exited. They either wanted to have a sale to a stronger employer (for which they appreciated they needed the schemes to be better funded) or ideally get to a fully secure or at least self-sufficient position themselves.

A plan needed to be put in place.

Initially the plan was to get to 100% funding against FRS17 (and so funding assumptions were broadly aligned to the accounting assumptions) as this was believed to be the metric appropriate for a sale. Buyout was seen as the long term goal but at the time, was too far away to realistically focus on. We settled on a plan made up of four tasks:

TASK ONE: STABILISE THE POSITION

The schemes were closed to future accrual in 2001. The stakeholders realised they could not keep providing an open-ended provision, so a reasonable DC, contract-based scheme was put in place, which we benchmarked against their competitors.

TASK TWO: FINANCE THE SHORTFALL

We advised the Trustee to implement a 12-year strategy orientated on high-growth to achieve a 100% funding position against FRS17. Significant contributions were made to make this likely, but the overall strategy had not yet built in a significant liability management de-risking strategy – a philosophy the Trustee took some time to agree was needed!

Little progress was made over the next five years, but we convinced the Trustee to consider ways to manage and reduce the scheme liabilities, rather than simply focus on growing the scheme assets. Also, it was agreed that FRS17 was no longer the relevant measure for any potential corporate activity and that a journey to self-sufficiency or buyout would be necessary.

TASK THREE: AGREE A REVISED STRATEGY

We sought efficiencies and as a result, managed the merger of both schemes to allow a simplified focus on the required tasks, make cost savings where possible and at this point recommended a small cash injection to equalise funding to allow this.

The Trustee and sponsor agreed to offer full (not reduced) transfer values to those members who wanted it, and provided fees for the cost of advice. As a result, 19% of liabilities were removed.

Following a gap of two years, the owners of the business transferred their benefits out of the scheme – again part of realising that the money was theirs either within the scheme (but lower business sale price), or out of the scheme of smaller value (but higher business sale price).

To aid the group company sale, it was realised that group participants needed to be freed from the shackles of the scheme, rather than being linked to an acceptably funded scheme. So with our help they underwent restructurings and apportionments – to leave a company comprising properties alone being responsible for the scheme: As a result, the Trustee required significant funding improvement to mitigate the loss of covenant.

The group companies borrowed money to inject into the scheme, to make surplus funding on the self-sufficiency measure and the Trustee moved to a 'lock down' asset position within LDI and bonds to give a fully hedged position, given the need to protect funding due to the resulting reduced covenant. However, it was appreciated that buyout must now be put in place.

TASK FOUR: DEVELOP THE STRATEGY

Noting that they needed to move slowly to a buyout position, the Trustee used surplus assets as a small growth component in their portfolio (equity and hedge fund), plus corporate bonds rather than gilts for additional returns in addition to LDI.

Strong bond/equity performance meant funding improvements. Sighting an opportunity for a buyout, we suggested a capital injection of around £7m would be needed. We agreed to continue monitoring until the required injection reduced down to £4m, when the group (not the remaining employer) might consider further payment.

A full data cleanse and trivial commutation exercise was carried out and the former revealed unmarried members, dates of birth differences, and odd member deaths, which resulted in further improvements in funding of around £1m.

Following the sale of some group companies, which was possible following the previous restructuring that took place earlier, an amount of capital was freed up for additional payments for a buyout so it was decided to approach the insurer market in 2015. We approached three insurers, with one on an underwritten basis. A significant discount relative to the non-underwritten alternatives was received, which required a further small cash injection and the buyout process was concluded. Now the wind-up of the scheme is completed, the property company can divest its assets back to the family owners.

Key events										
Funding	2001	2002	2005	2007	2009	2011	2012	2013	2014	2015
MFR	85%	85%	83%							
Ongoing	70%	75%	70%	65%	71%	103%	105%	115%	121%	
Solvency	40%	40%	41%	45%	50%	77%	80%	90%	95%	
Action		• Closure to future accrual • Growth oriented investment Strategy: 80% Equities / 20% Bond • Sensible contributions • 12 year plan agreed		• More prudent target agreed upon: Recovery plan now 10 years	• First Transfer Value (TV) exercise: Agreed to unreduced TVs' 19% of liabilities removed Merger of the schemes: Small cash injection to do so Brought about focus and some efficiencies / cost savings	Second TV exercise with 20% of liabilities removed Owners opt out - a further 20% of liabilities removed Significant cash injection to allow group restructuring "Lock down" investment strategy: LDI 15%, Bond 70%, Equity / hedge 15%	First buy-in sighting targeted		Data cleanse, trivial commutation exercises carried out Second buy-in sighting targeted	Approached insurance market, 3 insurers, Buy-in deal done: Underwritten exercise concluded: Small cash injection made

There are, however, limitations to existing solutions for managing assets and liabilities:

- Their effect is often confined to benefits attributable to future pensionable service, only. Subject to the rules of a particular scheme, this was not always the case prior to the introduction to Section 67 of the Pensions Act 1995[15].
- They can be very expensive. For example, pension scheme buyouts although, with the benefit of hindsight, more schemes should have secured their liabilities under contracts of insurance long before 'risk transfer' became as common as it is today.
- Above all else, as evidenced by growing deficits, despite the response of corporate UK, the existing solutions to the pensions black hole are, in an environment where most schemes are already closed, not always sufficient.

15 Modification of schemes and the requirement for actuarial equivalence or member consent in relation to 'regulated modifications'

4. OUTLOOK

The time has come to start thinking more radically, if we don't, we risk undesirable consequences, including:

EMPLOYER / SCHEME FAILURES

A recent study from the Pensions Institute[16] suggests that around 1,000 of the remaining 6,000 DB pension schemes are at risk, with the employers of some 600 of these schemes likely to be forced into insolvency in the next 5 to 10 years. A further 400 could survive if relieved of their pension obligations.

RAISING CAPITAL - EQUITY AND DEBT FINANCE

A study by Llewellyn Consulting[17] found that the UK market appears to give large and significant weight to the DB pension net asset positions of FTSE 100 companies – as significant in many regards as to their non-pension related book values and earnings. This is then fed directly to the share price of the sponsoring company.

Also, the relative size of a corporation's liability compared to its market capitalisation can have an impact on how equity investors view a company's stock[18].

Research compiled by Citi's Pension Solutions team shows that companies with moderate or severe underfunding materially underperform the equity market. In addition, they tend to have a higher beta, suggesting a higher cost of equity. Survey data from equity investors suggests that an unfunded pension liability starts to become a concern when it approaches 10% of a company's market cap[19].

INTERGENERATIONAL UNFAIRNESS

Current employees who have never been in a DB scheme are picking up the DB deficit tab through lower earnings. In the words of Paul Johnson, Director of the Institute for Fiscal Studies[20]: "Pension promises are a burden on the young who can't hope to enjoy them".

A further articulation of this issue can be found in the research by the Intergenerational Foundation: "People in older generations have built their life plans on the assumption that these promises will be honoured, but people in younger generations are having to constrain their life plans because they have to honour them. Someone has to lose out"[21].

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[16] 'The Greatest Good for the Greatest Number', December 2015

[17] http://www.cimaglobal.com/Documents/Thought_leadership_docs/white-paper-hub/Llewellyn_report_brochure_final_visual_small.pdf

[18] Citigroup – 'The coming pensions crisis', March 2016

[19] Ibid

[20] The Times, 3 May 2016

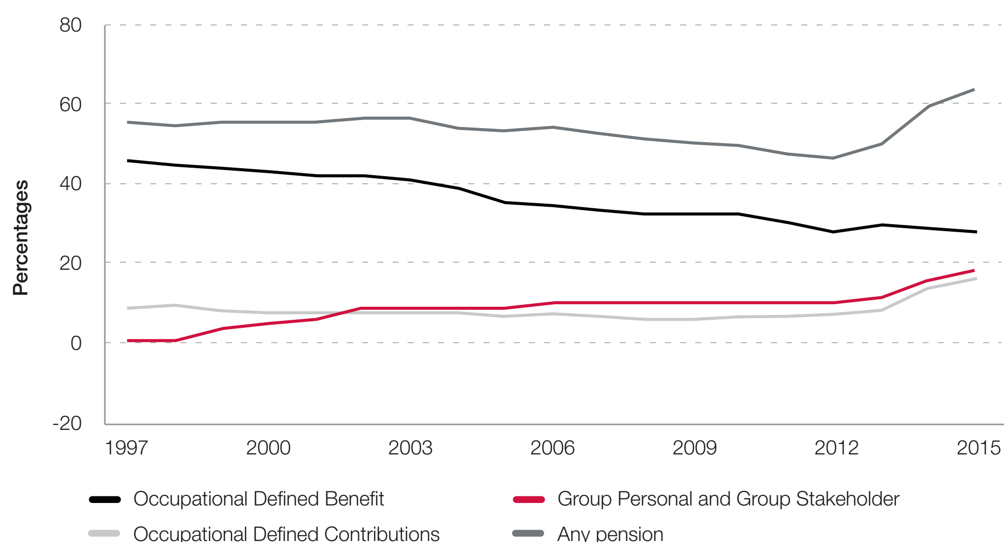
[21] http://www.if.org.uk/wp-content/uploads/2016/06/Pensions-Throttling_Final.compressed.pdf

LEGACY DB AS A DRAG ON DC

Automatic enrolment is getting more people into workplace pensions schemes (see the graph below[22]), but legacy DB pension promises are holding back the amount that employers can afford to contribute to their, usually DC, schemes for current workers.

According to the Intergenerational Foundation, if the deficit reduction contribution alone was eliminated, then £35 billion would be available to, among other things, boost the DC pension pot of each younger worker by £12,000[23].

Scheme memberships by type of scheme



[22] Annual Survey of Hours and Earnings, 2015

[23] DB Pensions: Chocking Hazard, June 2016

THE WIDER ECONOMY

The impact that funding DB schemes can have on a business's activities means that, in many boardrooms, the issue remains at the top of the agenda.

According to the Confederation of British Industry[24], the cost of DB is negatively affecting:

- businesses' ability to invest to grow (according to 65% of business leaders)
- their results in company accounts (according to 82% of boardroom leaders)
- internal reorganisations, asset sales and mergers and acquisitions (according to 56% of business leaders)

The media has recently reported on 'ballooning pension fund deficits' affecting the ability of companies to make dividend payouts to shareholders. Carclo has reportedly scrapped plans to pay a dividend as a result of an expected pension deficit[25].

In short, the pensions tail is wagging the corporate dog.

So, there are many compelling reasons for considering new solutions to the pensions black hole. The following sections consider in detail the current thinking, including the hitherto almost unimaginable case for no longer treating accrued benefits as sacrosanct.

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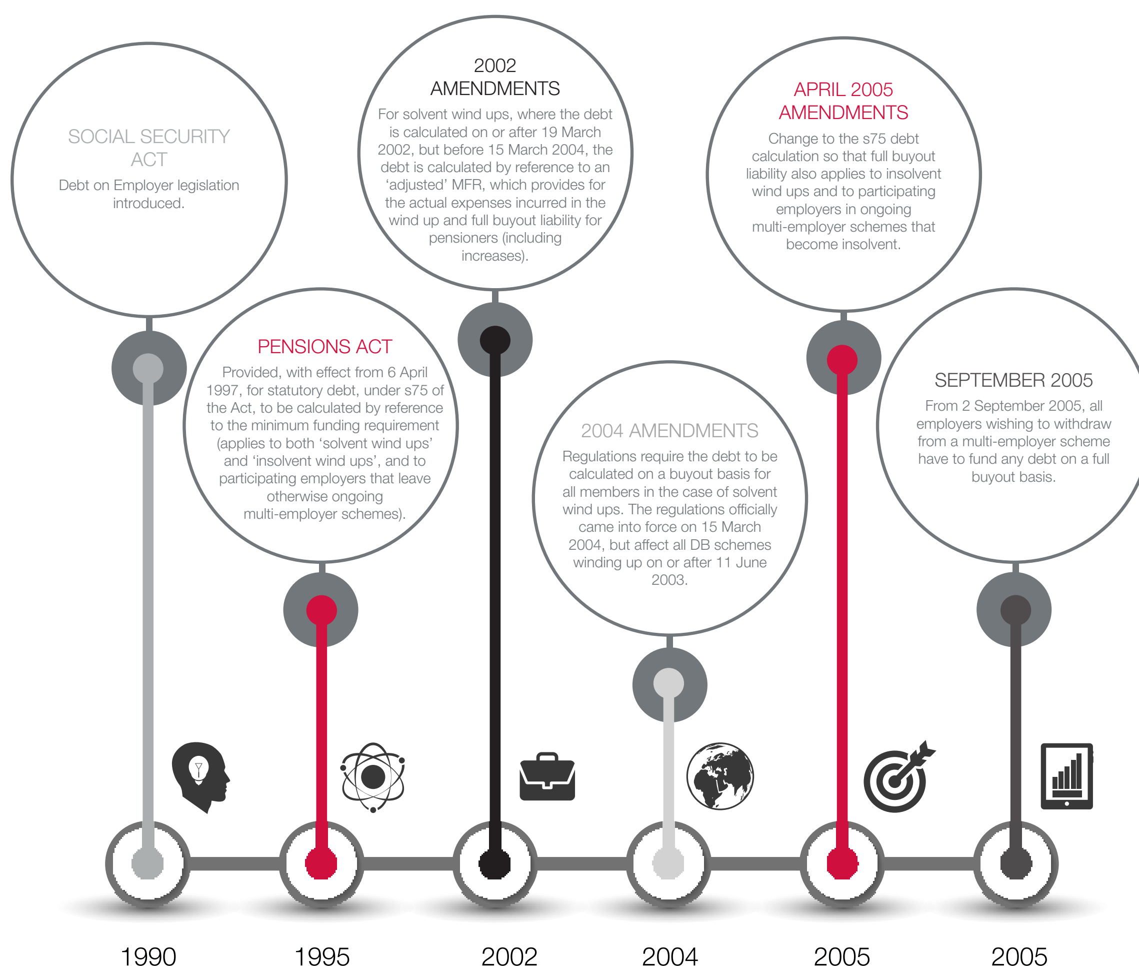
[24] http://www.cbi.org.uk/news/cbi-mercer-pensions-survey-2015/a-view-from-the-top/

[25] The Times, 4 September

5. NEW THINKING

Employers were not always required to effectively underwrite their DB pension schemes. Until fairly recently, through the strengthening of pension deficit legislation (see the box below), members could not be certain that pensions would be paid in full on the winding up of their DB pension schemes, even if their sponsoring employer was solvent and able to fully secure accrued benefits.



Over the past 25 years, successive governments have turned employers into insurers of their DB pension schemes. They've also introduced legislation to stop employers reducing accrued benefits (unless member consent is obtained).

The tide, however, is turning. Very recently, the consequences of DB pensions policy over the past 25 to 30 years have received considerable press attention due to the different fortunes of British Steel and BHS and the implications for their respective DB schemes.

These cases, reported in the media, have prompted a wide ranging debate about DB regulation, including consultations and inquiries from the Pensions and Lifetime Savings Association[26], the Work and Pensions Committee[27] and the Government[28].

As a result, new solutions for getting out of the black hole are being put forward. These include:

- Allowing pension schemes to reduce pension increases, for preserved pensions and pensions in payment, in respect of benefits attributable to past as well as future service
- Contingent increases to pensions, dependent on a pension scheme's funding level
- Allowing employers to do bulk transfers, without member consents, from their current DB pension scheme to a new scheme that provides lower benefits than the current scheme (but is more generous that Pension Protection Fund benefits[29])
- Moving away from market accounting[30]
- Changing the approach to technical provisions funding
- Ceasing all deficit reduction contributions[31]
- Changing the composition of trustee boards[32]
- Giving employers more input on investment strategy.

Our view is that finding a lasting settlement depends on focusing on what is possible. Depending on the solutions adopted, it might also mean employers have to give something in return. If employers are allowed to reduce accrued benefits, any solution should not simply be a 'get out of jail free card' for all sponsors with legacy DB pension schemes.

Against this backdrop, our conclusions and recommendations are set out in the final section of this report.

[26] DB Task Force call for evidence, June 2016

[27] http://www.parliament.uk/business/committees/committees-a-z/commons-select/work-and-pensions-committee/news-parliament-2015/defined-benefit-pensions-16-17/

[28] https://www.gov.uk/government/consultations/british-steel-pension-scheme

[29] http://www.pensionprotectionfund.org.uk/Pages/compensation.aspx

[30] Where current interest rates are used to estimate how much of today's money will be needed to pay a debt in, for example, 20 years time

[31] See the Intergenerational Foundation paper, DB Pensions: Chocking Hazard, for more detail of this very radical solution

[32] Ibid

6. CONCLUSIONS AND RECOMMENDATIONS

Given everything that we have said and, in particular, our comments on the DB deficits in the last ten years, we hope that we are not alone in reaching the unequivocal conclusion that we cannot continue to follow the same path for the next ten years or longer.

Without more drastic action, there could be a 50 to 60 year run off for existing DB pension schemes and, quite frankly, continuing to just 'kick the can down the road' is not an option.

So, we need to take a fresh look at how DB deficits are tackled. This is the time to do so, for at least two reasons:

1. The bright spotlight cast on high profile cases such as BHS and British Steel
2. The UK's decision to leave the EU. Whilst this decision, in some ways, compounds the problem, it also creates the prospect to reconsider legislation around the funding, investment and compensation for members of failed pension schemes without having to take into account EU pension directives and decisions made by the Court of Justice of the European Union.

For some examples of recent suggestions for changes to the DB pensions framework, which precede the EU referendum, see the OECD paper on counter-cyclical scheme funding regulations[33] and the Pensions Institute Paper on the Pension Protection Fund (PPF) compensation structure being arbitrary and unfair on younger members[34].

Our own thoughts, on future change, are included in our recommendations.

We also need to decide whether the most radical solutions, if implemented, should apply to all or just some employers. For example, if we allow schemes to reduce accrued benefits, should we only do so if the employer is otherwise likely to fail and its scheme to be transferred to the PPF?

This approach has already been mooted by the Pensions Institute[35]. The first appendix to this report contains our own variation on the proposal. However, the rules of the game already change when a company is in distress and options that fall short of securing all liabilities in full are available in these circumstances and have been used[36].

In any case, restricting solutions to some employers or schemes would not necessarily resolve all of the issues this report identifies, such as the intergenerational unfairness of companies putting aside £23,600 per DB member p.a. and only £1,200 per DC member p.a[37].

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[33] http://www.oecd.org/finance/private-pensions/45694491.pdf

[34] http://www.pensions-institute.org/reports/GreatestGood.pdf

[35] Ibid

[36] See, for example, how pensions and jobs were protected at Halcrow - http://www.thepensionsregulator.gov.uk/press/pn16-33.aspx

[37] Intergenerational Foundation, DB Pensions: Chocking Hazard

So, there is a case for solutions to be available to all sponsors of legacy DB pension schemes provided that, if employers avail themselves of the new solutions, they give something in return.

The task now is for all stakeholders (employers, trustees, members, policy makers and the pensions industry) to, together, explore the options and achieve a consensus that gets us out of the black hole.

In terms of what is possible, realistic, and arguably fair to previous, current and future generations of members, our recommendations for achieving a lasting settlement can be split between those that will entail an actual reduction to accrued benefits and solutions that could help without any such diminution; at least not to the value of these pension promises (although, the form and security of them would change).

RECOMMENDATIONS THAT MEAN REDUCING THE BENEFITS PEOPLE HAVE ACCRUED

- Change bulk transfer regulations, so transfers to new schemes are possible without consent in more circumstances – not just where the benefits in the new scheme are largely the same. For example, a member interest test could be applied[38].
- Allow schemes to reduce pension increases for preserved pensions and pensions in payment, in respect of benefits attributable to past and future service, to reflect prevailing rates of inflation as measured by the Consumer Price Index.

In return, employers should commit to improving their workplace pension arrangements for current workers. One way to do this would be through the Pension and Lifetime Savings Association's Pension Quality Mark[39].

RECOMMENDATIONS THAT DON'T REDUCE THE BENEFITS PEOPLE HAVE ACCRUED

- Introduce regulations similar to those for conversions of Guaranteed Minimum Pensions (GMPs)[40], to allow wider simplification of complex benefit structures on a nil consent basis. For example, employers could be allowed to consolidate many complex benefit structures into one simple one on a 'broadly actuarial equivalent basis'. This could lower the ongoing costs of administration and reduce the scope for errors. It could also lead to more efficient liability management and greater ability for members to 'self-service' their benefits and options.
- Reintroduce State Scheme Premiums for formerly contracted-out schemes, allowing members' SERPS benefits to be reinstated with corresponding reductions to DB pension promises.
- Remove obstacles to liability de-risking (such as trivial commutation, enhanced transfer values, retirement options and pension increase exchanges), whether in scheme rules or otherwise, through statutory overrides. This would mean that all options would be available to all scheme sponsors.

[38] See the decision of the High Court in the Halcrow case (http://www.bailii.org/ew/cases/EWHC/Ch/2015/3685.html) for a detailed consideration of some of the difficulties arising from the current regulations

[39] http://www.pensionqualitymark.org.uk/

[40] The Occupational Pension Schemes (Contracting-out) (Amendment) Regulations 2009

The Trustees' role would be confined to making sure members can make informed decisions – they would not be able to prevent or unnecessarily frustrate any option.

- Review the rules around transfers and conversions and, in particular, partial transfers / conversions. For example, if employers were permitted to transfer out members' tax-free cash entitlements, then there would be an improvement in funding levels, in schemes without assumptions for commutation in actuarial valuations.
- Amend funding regulations so that advance funding is required only in respect of pension promises up to the level of PPF benefits. Allow promises in excess of PPF level benefits through unfunded 'top-up' schemes[41].

By changing the form of pension promises so that they are delivered partly through funded DB pension schemes and partly through unfunded contractual commitments[42], the value of the promise is still the same from an accounting perspective (so there is transparency in company financial statements). However, given that 25% of DB liabilities exceed PPF benefit levels (see the graph, below[43]), there would be a huge and immediate impact on measured deficits, the amount employers have to contribute to their schemes and the capital available to grow their businesses.

Key funding statistics as at 31 March 2015

	s179	Full buy-out
Total number of schemes	5,945	5,945
Total assets (£ billion)	1,298.3	1,298.3
Total liabilities (£ billion)	1,542.5	2,099.2
Aggregate funding position (£ billion)	-244.2	-800.9
Total balance for schemes in deficit (£ billion)	-285.3	-804.9
Total balance for schemes in surplus (£ billion)	41.1	4.0
Funding ratio	84%	62%

[41] In HMRC terms, unfunded employer finance retirement benefit schemes

[42] Insurance could be purchased or assets charged to provide additional security

[43] Purple Book 2015

- Consideration also needs to be given to a prospective change in direction of the funding regime alongside increased responsibility from the PPF. For example, imagine pension schemes across the country no longer needed to invest in gilts and could take a genuinely long-term view. They would then start to invest in growth assets like equities and infrastructure projects. We would have the benefit of harnessing pension scheme assets to improve the UK economy long-term.

  It is expected that, over the long run, this would reduce the cost of providing pension benefits for most companies. Using significantly higher discount rates would take away the burden of an underfunded pension scheme and give many companies a new lease of life. Contributions to defined benefit pension schemes would fall and so would the government cost of tax relief associated with it.

  Of course, the issue with this is that some companies will fail and the PPF will have to step in. We would expect fewer companies to fail if this policy were adopted, at least in the short-to-medium term. We'd need to consider the effect on PPF levies, but the PPF might be able to stand behind the full pension promise. Even if PPF levies had to rise it would potentially still result in a net saving for employers.

The reforms we suggest may mean reconsidering the role of The Pensions Regulator too, which in turn affects sponsor and trustee relationships. However, as the Pensions Institute has said, revising the Regulator's remit could be a simple as changing their duty from protecting members' 'benefits' to 'interests'[44].

In all events, the potential benefits of a lasting settlement for the pensions black hole extend far beyond a 'let off' for scheme sponsors. Potential benefits for stakeholders include:

- For members of legacy DB pension schemes, greater sustainability of past pension promises (which may be lower than original expectations, but are more likely to exceed PPF benefit levels)
- For trustees of these schemes, less dependency on sponsoring employers and whether or not they will still be around in decades to come
- For current workers, more generous contributions in respect of current workplace pension arrangements and higher wages
- For companies, more resources available for research, investment and business activity
- For the economy, a boost from increased business confidence and enterprise.

For all these reasons, this opportunity to get out of the pensions black hole is one that we cannot afford to miss.

There should now be an open and transparent debate about which solutions will work best. We must recognise that it is not heretical to talk about removing guarantees that will never be delivered and that the status quo is not in the best interests of all stakeholders.

[44] 'The Greatest Good for the Greatest Number', December 2015

APPENDICES

APPENDIX 1

A GOING CONCERN TEST, OR 'THE POINT OF NO RETURN'

How do we know when a pension scheme is no longer sustainable on a 'going concern' basis?

We present a proposal for a 'going concern' test that aims to allow Trustees, sponsoring employers, advisors and regulators to evaluate whether a pension scheme has passed 'the point of no return'.

We propose that, if a pension scheme fails this test, the stakeholders would be able to engage directly with both The Pensions Regulator and the PPF to discuss potential solutions. These solutions might include:

- compromising on benefits – with the scheme paying a lower level of benefit
- cutting the pension scheme free from the employer
- the pension scheme going into the PPF, with the PPF taking control of the sponsoring employer.

THE TEST WOULD HAVE TWO PARTS – THE 'BALANCE SHEET' TEST AND THE 'CASH GENERATION' TEST.

We understand that some sponsoring employers will be asset rich but cash poor and vice versa. That's why a scheme would have to fail both parts for the overall test to fail.

The responsibility for carrying out the tests could fall to either the principal employer or the pension scheme Trustees. We recommend that the company directors are responsible for the test, which would be carried out every year as part of producing the company accounts. The directors would have to sign an annual 'going concern' statement confirming whether the test has been met or not.

THE BALANCE SHEET TEST

This checks whether the participating employers have the resources they need to fund the scheme if the employer becomes insolvent.

There is a definition of "insufficiently resourced" which is already used by The Pensions Regulator to decide whether a corporate group is able to support a scheme . We suggest that this could be used as a starting point for the balance sheet test:

A company is insufficiently resourced if it is unable to meet 50% of the scheme's liabilities (calculated on a full buyout basis) in circumstances in which one other group member, whether on its own or collectively with any connected and associated entities, can bridge that gap from its (their) available resources. If that is the case, each and every such associated or connected person is susceptible to a financial support direction.

THE CASH GENERATION TEST

This checks whether the employer can support the scheme on an ongoing basis through cash contributions.

The participating employers would need to identify the maximum cash funding (MCF) that could be directed towards the scheme. This could be defined in various ways, but the establishment of the maximum measure would need to take into account the need for the employer to be able to survive (but not necessarily grow) on a going concern basis.

We then need to identify an objective measure of self-sufficiency. This could be a prescribed set of assumptions, like the ones the Pension Protection Fund issued for carrying out section 179 valuations. The current deficit on a self-sufficiency basis would be estimated at the test date.

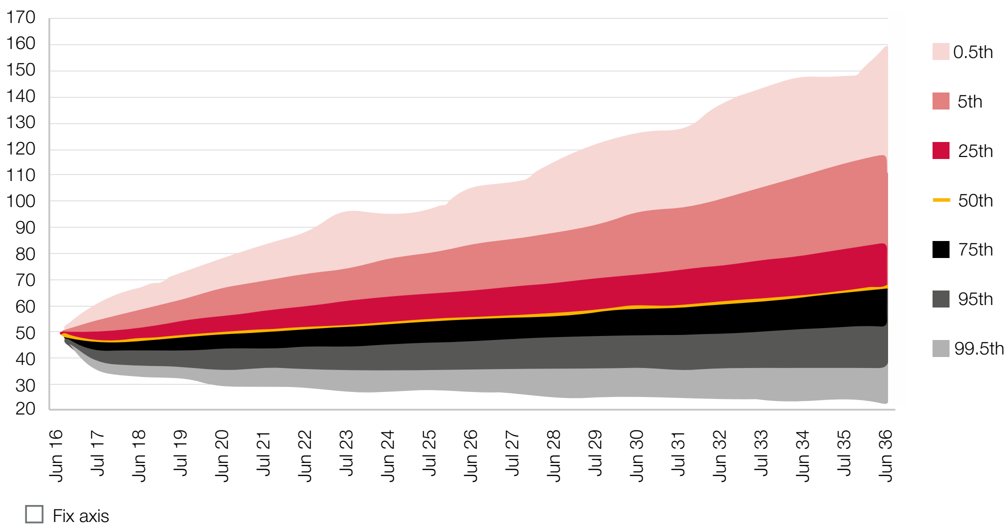
The next step would require projections of the funding position which incorporate the MCF contributions. This would be carried out using a stochastic asset liability model.

The assumed investment strategy is a key component of this analysis, in particular when projecting the position over a long period of time. The current strategy could be used, but this might encourage pension schemes to take more risk in their strategy – we recognise that this is not necessarily an unsuitable strategy to follow depending on the specific situation. A maximum level of investment risk could be established. This might be set to ensure that the probability of the strategy leading to a failure, or further deterioration, of the balance sheet test is limited (say less than 33%). Or it could be set to limit the risk that funding levels on a PPF measure deteriorates over time (including an allowance for PPF drift).

We would then calculate the probability of success under the model at different time horizons. If the probability of ever reaching self-sufficiency is below a specified threshold (using a maximum period of, say, 25 years) then we would say that this part of the test is failed.

An example scheme is shown below. This scheme is currently 50% funded today on a self-sufficiency basis.

Funding Level, %



Measurement period	10 years	15 years	20 years	25 years
Median funding level	56%	60%	68%	74%
Probability of reaching self-sufficiency	1%	5%	13%	20%

As the probability of this scheme ever reaching self-sufficiency is very low, we would likely say that it fails the cash generation test.

COMBINING THE TESTS

The proposed test is either a pass or a fail, so there is clearly a cliff edge beyond which a scheme would be justified in approaching tPR and the PPF. This is illustrated in the diagram below. However, the progression against this test would be monitored under our proposed approach so that schemes in the amber area can consider remedial action before the 'point of no return' is passed.

APPENDIX 2

ACT	BRIEF SUMMARY	BROAD IMPACT
Finance Act 1970	Creation of New Code Approval for occupational pension schemes	Pension schemes provide mainly discretionary benefits with no minimum funding or security requirements.
Social Security Act 1973	Creation of the Occupational Pensions Board, introduction of preservation requirements for early leavers (with more than five years' service), introduction of provisions for the financing and security of minimum benefits	Guarantees and minimum funding requirements typically relate to less than 10% of liabilities.
Social Security Pensions Act 1975	Introduced State Earnings Related Pension Scheme (SERPS) and contracting-out via Guaranteed Minimum Pensions (GMPs), extension of adequate financing provisions to include GMPs	Improved level of guarantees and minimum funding requirements maybe extend to 20% of liabilities.
Social Security Act 1985	Introduced anti-franking and statutory revaluation of deferred pensions, also introduced a statutory right to a cash equivalent transfer value	Early leaver benefits become much more valuable, and now have a guaranteed transfer option. Level of guarantees now represents maybe 50% of liabilities.
Social Security Act 1986	Extended preservation requirements to early leavers with more than two years' service and reduced future SERPS and GMP benefits by 20%, introduced personal pensions	
Finance Act 1986	Introduced overfunding regulations and taxation of excessive pension scheme surpluses	Companies are discouraged from overfunding.
Finance Act 1989	Introduced new Inland Revenue limits (the earnings cap) and the creation of funded and unfunded retirement benefit schemes (FURBS and UURBS)	Company management start to look elsewhere for separate pension provision
Barber v GRE 1990	E.U. Court case requires equalisation of benefits for men and women	Forces equalisation of retirement ages and some improvements in benefits. Effect still being felt, with unresolved issues such as equalisation of Guaranteed Minimum Pensions
Social Security Act 1990	Extension of provisions for the revaluation of early leaver benefits to cover all service. Also introduced enabling legislation for debt on the employer regulations and guaranteed pension increases (but these were delayed until the introduction of the Pensions Act 1995).	Significant (and retrospective) increase in level of guarantees for early leavers.
Pension Schemes Act 1993	Consolidation Act	N/A

Pensions Act 1995	Introduced statutory minimum funding (the Minimum Funding Requirement or MFR) and guaranteed (Limited Price Indexation or LPI) pension increases for future service benefits, as well as many provisions on the governance and management of pension schemes	Level of guarantees now 70%-80% of liabilities; changing economic climate and extension of guaranteed LPI increases to all service, raises level of guarantees to almost 100% of liabilities for most schemes; MFR funding requirement typically covers 80% of guaranteed benefits.
1993 and 1997 Budgets	Pension schemes no longer able to claim tax credits on equity dividends	Makes equities less attractive to pension schemes
MFR changes (1998 and 2002)	On 15 June 1998, changes to the MFR formula reduced MFR liabilities by up to 19%. On 7 March 2002, changes to the MFR formula reduced MFR liabilities by up to 8%.	By 2004, the MFR funding requirement typically covers no more than 50% of the guaranteed liabilities.
11 June 2003 Government announcement	The debt on an ongoing employer if a pension scheme winds up is the deficit on a 'buyout' basis	Significant increase in the level of security attaching to guaranteed benefits.
Finance Act 2004	Single tax regime and introduction of Annual and Lifetime Allowance for pension savings	Amended in every year since introduction making regime hugely complicated, and reductions in AA and LTA making pension provision less attractive to higher earners
Pensions Act 2004	Abolition of MFR and creation of scheme specific funding. Creation of PPF and Pensions Regulator.	
IASB introduces IAS19	Full balance sheet recognition of pension scheme assets from 1 December 2005	
Pensions Act 2007	State Pension and State Pension Age reforms	
Pensions Act 2008	Workplace Pension Reforms	Employer automatic enrolment duties commence from October 2012
Finance Act 2011	High Earner pension tax changes reduce Annual Allowance to £50,000 and Lifetime Allowance to £1.5 million.	
Pensions Act 2011	State pension age equalisation and increase to age 66; amendments to automatic enrolment; amendments to existing pension legislation which contains indexation and revaluation requirements; and a new definition of money purchase benefits.	Attempt at reducing increases to pensions, but only for future service and not overriding
Finance Act 2013	Reduction of LTA to £1.25m and AA to £40,000, from April 2014.	
Pensions Act 2014	New flat rate State pension, and the ending of DB contracting-out, from April 2016	
Finance Act 2014	New drawdown and trivial commutation limits from 27 March 2014.	
Taxation of Pensions Act 2014	New flexibility for DC savers from April 2015.	
Pensions Schemes Act 2015	Conversion of benefits and transfers. Definition of 'money purchase scheme'.	
Brexit	On 24 June 2016, the UK voted to leave the European Union	It has been estimated that the outcome of the referendum, combined with the decision of the Bank of England to cut interest rates to 0.25% and start a new quantitative easing programme, has increase DB liabilities by £70bn.

CONTACTS

JOHN WILSON
Head of Technical
+44 (0)131 456 6850
john_wilson@jltgroup.com

MURRAY WRIGHT
Consultant
+44 (0)131 456 6868
murray_wright@jltgroup.com

JLT Employee Benefits
The St Botolph Building
138 Houndsditch
London EC3A 7AW
Tel +44 (0)20 7528 4000
Fax +44 (0)20 7528 4500
www.jlteb.com

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