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GREATEST GOOD 2

Response to the Department for Work & Pensions Green Paper
Security and Sustainability in Defined Benefit Pension Schemes

A Pensions Institute discussion paper for DB trustees, sponsoring employers, advisers, policy-makers and regulators

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June 2017

Greatest Good 2: Response to the Department for Work & Pensions Green Paper, *Security and Sustainability in Defined Benefit Pension Schemes*

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The report is available at: http://www.pensions-institute.org/reports/GG2.pdf

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The Pensions Institute (www.pensions-institute.org) is the first and only UK academic research centre focused on pensions issues. The views expressed in this discussion paper are those of the authors and not the Pensions Institute which takes no policy positions.

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Executive Summary

Another opportunity to seek the greatest good for the greatest number

We believe the current Department for Work and Pensions (DWP) Green Paper consultation is an opportunity for the government to make a modest investment that could save many billions in pounds of lost value to society and prevent serious intergenerational inequities.

Greatest Good 2 follows-up and repeats the findings of our earlier December 2015 discussion paper[1] that 1,000 occupational defined benefit pension schemes are stressed as a result of having a financially weak sponsors.[2]

The slide of many these schemes into the Pensions Protection Fund (PPF) seems inevitable because policy and regulation demand that schemes adhere to the binary outcomes of paying full benefits or going into insolvency. We call for the government to pursue a policy of ‘second best’ outcomes allowing schemes with weak sponsors for whom insolvency is inevitable to negotiate settlements between full benefits and the benefits provided through the PPF.

The difference between the potential value of negotiated benefits and PPF benefits represents a significant destruction of value for members, sponsor organisations, PPF levy payers and society as a whole. Instead seeking ‘the greatest good for the greatest number’ would prevent the destruction of billions of pounds in economic value. It would also produce a more equitable distribution of benefits for younger members who stand to lose much more on insolvency because of the way PPF benefits are calculated.

We propose a series of measures that would help deliver second best outcomes which, by our analysis, would not be costly to implement considering the billions of pounds at stake.

The issues we considered

Our research is based on interviews with experts who identified as the most pressing issues for DB occupational pensions: affordability, information provided to trustees and members, empowering the regulator, sector consolidation, and technical provisions.

Major findings

1. **We find no evidence that deficit repair contributions are unaffordable or that there is a crisis that should permit schemes across the board to reduce indexation to the statutory minimum**

We agree with the Green Paper which finds no evidence that occupational DB pension schemes are unaffordable for the vast majority of sponsors.

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[1] *The Greatest Good for the Greatest Number.* www.pensions-institute.org/reports/GreatestGood.pdf

[2] We believe the following definition serves as a general principle of stress for all schemes: ‘where the pension scheme is significantly underfunded relative to the value of the sponsor’s business and the trustees cannot rely on the financial support they need from the sponsor because its covenant is weak’.

FTSE 100 companies have paid out five times more in dividends (£71bn) than they paid in pension contributions (£13.3bn). Some 29 companies paid dividends in 2015 that were more than double their pension shortfalls, 'suggesting that these companies could pay off their pension scheme deficit relatively easily if they wanted to'.[3]

Experts suggested that while sponsors may say schemes are unaffordable, this is due to moral hazard: 'from the outside, this usually sounds like a management preference driven by management objectives rather than facts'.

Evidence from the collapse of BHS and the use of pre-pack administrations to offload £3.8bn of pensions liabilities into the PPF suggest that such 'moral hazard' arising from sponsor behaviour is perhaps the most pressing issue behind claims of an 'affordability crisis'. We believe that current funding levels are the result of deliberate and conscious management decisions and also TPR's sustainable growth objective, effective since 2014.

A secondary factor for some schemes may be the decision by scheme trustees, often at the behest of their sponsors, not to hedge interest rates in the hope of making funding gains through interest rate rises.

Given this, it would be unreasonable to penalise members by reducing indexation for all schemes to the statutory minimum.

Recommendations:

- **The government should consider establishing a statutory minimum contribution rate for all sponsors with schemes in PPF deficit, except where there is clear evidence this would make a sponsor with an otherwise realistic chance of recovery become insolvent in the near future.**

- **We see no case for permitting pension schemes across the board to reduce indexation to the statutory minimum.**

2. The current DB system destroys economic value because it focuses on binary outcomes, and the government could rectify this by streamlining access to Regulated Apportionment Arrangements.

We believe the DB system for occupational pension system destroys economic value by steering schemes towards the binary outcomes of full benefits or PPF benefits. The value in between is lost for younger members because PPF drift [4] is occurring, even though the insolvency test may not be met for a few years, but is nonetheless looming down the road. It is currently very difficult to achieve an intermediate position between these two extremes.

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[3] Cumbo, 2016. Lesley Titcomb, chief executive of The Pensions Regulator, says that: 'Our annual funding statement for this year pointed out that in the tranche of companies due to do their [pension] valuations this year, there was a level of increased profitability'.

[4] PPF drift describes a month-by-month increase in the cost of providing PPF compensation. The most common causes of PPF drift for stressed schemes are annual pension increases for retired members that exceed the level of increases that would be granted by the PPF, and the increase in members who reach normal retirement age, at which point they qualify for higher, uncapped levels of PPF compensation. This reduces the scheme's ability to cover benefits above PPF levels unless the increase in cost is covered by investment returns or additional sponsor contributions.

'Second-best' outcomes for stressed schemes where members receive benefits above PPF levels but below full benefits would preserve significant value. Streamlining access to Regulated Apportionment Arrangements (RAAs) would make second-best outcomes significantly easier to obtain. This would require:

i) A government policy shift from full benefits in all cases to seeking the 'greatest good for the greatest number'.

ii) Weakening of the '12-month test'.

iii) TPR and the PPF signalling under which conditions they will look favourably on RAAs.

iv) Removing the requirement for an exact valuation of member benefits in RAA proposals and PPF+ buyouts.

v) Allowing trustees to propose alterations to indexation that they have agreed with the sponsor.

Recommendation:

- **Trustees should have access to a streamlined RAA if they conclude, based on actuarial and covenant advice, that full benefits are unlikely to be paid, that insolvency is likely, and that the result is better than insolvency.**

3. PPF compensation is a 'cliff-edge' that is unfair for pre-NRA members

The PPF compensation cliff-edge is unfair for pre-normal retirement age members. Phased rules for PPF entry would introduce greater equity between member cohorts and allay concerns about the gaming of the compensation rules by high-liability directors in failing businesses.

Recommendation:

- **Change the PPF's cliff-edge compensation rules for retired and non-retired members to a phased approach, based on age and length of service, and set this as a standard for the simplified benefits model.**

4. Using early warning measures to trigger interventions into stressed schemes would produce better outcomes for members, sponsors and PPF levy payers

Early warning measures should focus on schemes that are in net PPF drift or are underfunded on a s179 basis. These could trigger automatic requirements for the review of a scheme by trustees and TPR.

TPR could use mechanical measures to identify stressed smaller schemes and to serve as triggers for a requirement for trustees and TPR to review a scheme:

i) A measure that links PPF drift and profit before tax (PBT). This could be the ratio of the annual cost of PPF drift to average PBT over the past 5 years.

ii) A test that calculates s179 shortfall as a multiple of PBT or net assets

iii) Experian scores as a de facto measure of stress.

iv) Schemes with s179 funding below 75% (after taking into account contingent assets and profits before tax) and which have material PPF drift

Recommendations:

- **TPR should collect additional funding data to create an 'early warning system' of schemes in stress and, to do this, we propose it uses a general purpose measure for large funds and a mechanical measure for screening smaller funds.**

- **TPR should require trustees of all 'stressed' schemes to explain in their recovery plan submission how PPF drift is being mitigated by sponsor contributions and investment return. This information should also help inform calculations of the PPF levy.**

- **TPR should require all 'stressed' schemes to employ a professional trustee.**

5. TPR's existing powers could deliver second-best outcomes but it does not use them due to government policy and lack of funding

We believe TPR has the powers to place the pensions system on a much firmer footing (which we define as delivering the greatest good for the greatest number by allowing 'second-best outcomes') but requires a policy shift from government and additional resources.

TPR has a wide range of powers but experts believe TPR hesitates to use them to achieve second-best outcomes because doing so runs contra to government policy of pursuing full benefits for all members in all cases. Experts also felt TPR was too under resourced to contemplate a significant uptick in activity having a general levy budget of just £35m in 2015-16 which covers regulating all new and existing DB and DC schemes.

Recommendations:

- **Redirect government policy to focus on the 'greatest good for the greatest number', rather than the current focus on full benefits even where these can never realistically be paid.**

- **Provide the resources and incentives for TPR to make use of its existing powers but tie this funding to an action plan to put the DB pensions system on a footing to deliver 'the greatest good for the greatest number'.**

- **TPR should produce detailed information on how its measures have been used in its annual report.**

6. Giving TPR new powers – to alter indexation, alter benefits and interview stakeholders – would help deliver second-best outcomes.

TPR requires powers that enable it to intervene directly to alter scheme benefits when it is in the best interest of members in stressed schemes at risk of insolvency and a power to compel stakeholders to attend interviews. Experts we consulted believe TPR should have powers to take action where a scheme is experiencing significant funding difficulties and their suggested model for this is the powers of Ireland's Pensions Authority under s50 of that country's Pensions Act 1990.

Recommendations:

- **TPR should have powers to direct trustees to reduce the benefits of active and deferred members, including preserved benefits. This would also require an amendment to s67 of the Pensions Act 1995 which requires actuarial equivalence when modifying member benefits.**

- **TPR should have powers to compel stakeholders to attend interviews where appropriate for TPR as part of an investigation**

7. Full consolidation is not viable for the occupational DB pensions sector owing to high costs and limited benefits from mutualisation, but may be worthwhile for smaller schemes.

The experts we spoke with said that for knowledgeable and professional trustees, shared services, asset pooling and single governance forms of consolidation are possible within the current regulatory framework

The key issue is whether, after more limited forms of consolidation are completed, there are significant benefits of scale from merging assets and liabilities into a single scheme. These benefits would have to be greater than the considerable costs of mutualising deficits and sponsor covenant risks.

Experts said most medium and large schemes already have relatively low administration and fund management costs. This would mean full consolidation would not benefit such schemes, since this would involve additional costs associated with mutualising buyout deficits and with exposure to covenant risk (i.e,, the costs of negotiating the appropriate level of contributions from other sponsors).

Furthermore, full consolidation would not be a panacea for sponsors. Because full-buyout deficits are high, many would need to continue to provide security towards future contributions and remain bound by the covenant.

Recommendation:

- **Full consolidation should not be considered a central policy for putting the DB pensions sector on a sound footing owing to the costs of mutualising liabilities as a whole.**

Background

Our *Greatest Good for the Greatest Number* discussion paper, published in December 2015, found that 1,000 occupational defined benefit (DB) pension schemes in the UK were under stress and in serious trouble because they were underfunded and backed by a financially weak sponsor. Under the current regulatory regime, we argued that a significant percentage of these schemes could find themselves sleepwalking into insolvency with the avoidable loss in value of many billions of pounds of members' benefits, unless prompt action was taken.

The discussion paper suggested that a 'second-best' outcome was possible between the two extremes of waiting with fingers crossed for the payment of full benefits and drifting into the Pension Protection Fund (PPF). Second-best outcomes would also provide a more equitable distribution of benefits between younger and older members.

Since *Greatest Good* was released, the regulatory regime for DB pensions has been thrust into the public eye by the insolvency of BHS and the pension troubles surrounding Tata Steel, both sponsors of large schemes with buyout deficits of hundreds of millions of pounds. After the collapse of BHS, trustees, the sponsor and regulators were questioned in a full public inquiry by the House of Commons Work & Pensions Select Committee which recommended a number of changes to the regime, and prompted the Department for Work and Pensions to release a Green Paper in February this year.[5]

While these two large schemes generated attention, with much less fanfare, a total of 124 schemes became unable or highly unlikely to meet their full obligation to members between December 2015 and March 2017. Some 77 schemes transferred into the PPF and 47 entered assessment to transfer.

Our latest research – prepared as a response to the Green Paper's request for views and based on interviews with experts in the sector – suggests around 1,000 stressed schemes remain materially underfunded and backed by weak sponsors, with 600 unlikely to ever pay full benefits.

The Pensions and Lifetime Savings Association (PLSA)'s Defined Benefit Taskforce produced a comparable estimate. Some 46% of schemes in deficit, graded 'tending to weak' or 'weak' by TPR – around 1,000 schemes – have a 50% chance of paying full benefits.[6] The Green Paper, on the other hand, paints a rosier picture: schemes representing 11% of members have affordability constraints but just 5% have sponsors where additional support is uncertain. TPR's annual funding statement for 2017 identifies 5% of schemes with doubts over sponsor support, while 85-90% of schemes have sponsors able to manage deficits without long-term sustainability issues, leaving 10–15% with issues over the sustainability of deficits.[7]

[5] Work & Pensions Select Committee, 2017; Department for Work and Pensions, 2017

[6] PLSA, 2016; PLSA, 2017

[7] The Pensions Regulator, 2017

A key finding of the Green Paper is that '…[a]s long as employers continue to meet their scheme funding requirements, even under relatively cautious future economic scenarios' funding levels will rise to a reasonably comfortable position at aggregate level by 2030'.

While we welcome the Green Paper's detailed data analysis, we believe that the assumption that 'employers continue to meet their scheme funding requirements' is questionable for a significant number of UK companies. Can we really believe that the 19% of companies which are paying 50% or more of their profits as deficit repair contributions to their DB schemes are likely to be around when schemes are expected on aggregate to hit their peak in cash outgoings in 16-19 years' time? [8] What about the further 9% that are paying 20–50% of profits? [9]

Furthermore, the Green Paper doesn't tell us what scenarios – for example, how deep a recession – would derail its 'reasonably comfortable' prognosis. Prudence suggests the DWP should follow the guidance its regulator gives to trustees: use integrated risk management to identify and mitigate exposures. This would lead to implementing a second-best solution now rather than hoping the economic outlook sticks within the bounds of 'relatively cautious'.

Finally, the Green Paper repeats a common assumption about 'PPF drift' in paragraph 232: '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 an over simplification and younger members of many stressed schemes could lose out significantly unless there is early separation of sponsor and scheme.

PPF drift describes a month-by-month increase in the cost of providing PPF compensation. The most common causes of PPF drift for stressed schemes are annual pension increases for retired members that exceed the level of increases that would be granted by the PPF, and the increase in members who reach normal retirement age, at which point they qualify for higher, uncapped levels of PPF compensation. This reduces the scheme's ability to cover benefits above PPF levels unless the increase in cost is covered by investment returns or additional sponsor contributions.

Younger members of schemes that are funded above PPF levels but below full buyout lose out from PPF drift. As PPF drift takes place, assets previously covering members' benefits above PPF levels are notionally reallocated to cover higher PPF compensation levels typically for older members. The coverage ratio of members' above-PPF benefits falls – which affects younger members more than older members.

The misunderstanding of PPF drift is exemplified by the over-simplification in the Green Paper and it is shared by some trustees who then go on to underestimate their funding requests to their sponsors, to the potential detriment of scheme members, the PPF, and levy payers in general.

PPF drift is an issue for many more schemes than it might appear. At the end of March 2016, the aggregate s179 deficit of £226.2bn was around one-

[8] PLSA, 2017, Figure 2

[9] Green Paper, Figure 10

third of the estimated s75 buy-out deficit of £779.9bn. Recovering a good proportion of the s75 debt should mean that the average scheme would in fact be able to escape the PPF on insolvency – even though it is currently funded well below s179 and illustrating the extent of PPF drift.[10]

We believe that the government has a narrowing window of opportunity to deliver second-best outcomes. The PLSA, an organisation not known for alarmism, notes 'the opportunity to fix the system and effect a material reduction in risk will disappear quickly as schemes hurtle towards maturity and negative cash flow'.[11]

[10] Pension Protection Fund, 2016. Chapter 4, para 4.1– 29% of £779.9bn is £226.2bn
[11] PLSA, 2017. P11

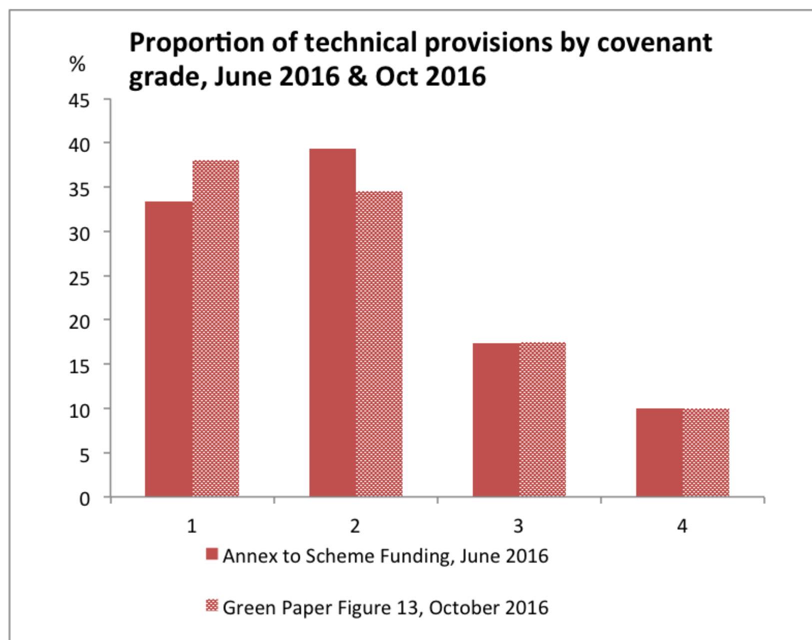
How many schemes are stressed?

On balance, we believe that 1,000 schemes representing close to 1 in 5 of the PPF Index schemes remain subject to unmanageable stresses and are very unlikely to pay future pensions in full to members and their dependants. This is the same number as given in our original discussion paper.

Of this number, we believe, 600 sponsors will never pay full pensions, a number based on PPF's own estimate, while 400 sponsors with viable businesses, also face the prospect of insolvency and this is caused largely by the pension scheme deficit.

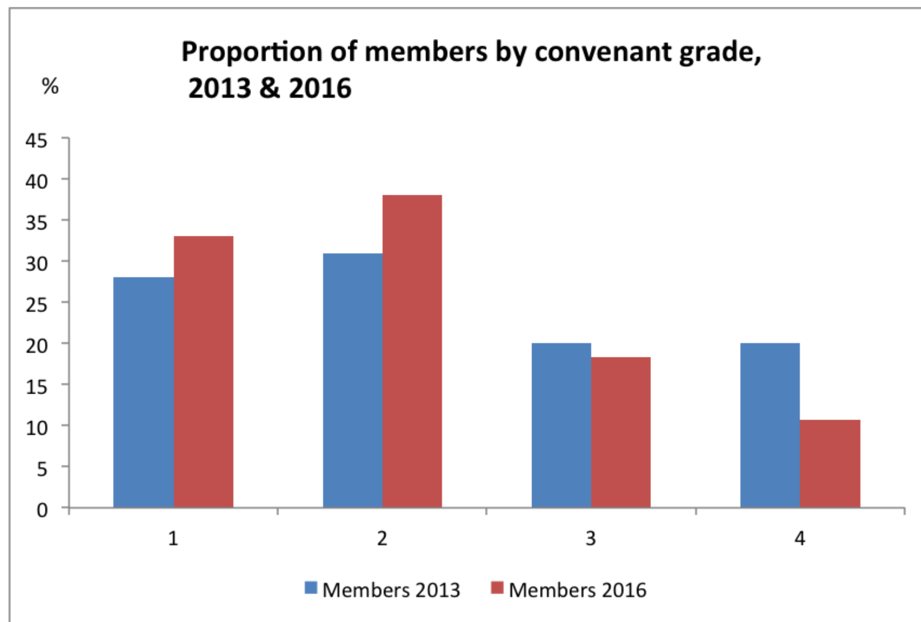
Our estimate is based on the following data points.

- An estimate by PPF that 10% of schemes in 2015 were unlikely ever to pay full benefits.[12]
- TPR's 2017 annual funding statement which identifies 5% of schemes as having doubts over sponsor support and 10–15% of schemes with issues over the sustainability of deficits.
- The proportion of schemes by technical provisions with sponsor covenants rated in grade 3, 'tending to weak', and grade 4, 'weak' in 2016. TPR data shows 17% of schemes are rated grade 3 and 10% grade 4.



[12] 'It is abundantly clear from our 7,800 index figures that there are many schemes out here currently in deficit. Some may not be able to meet the promises they've made. And there is perhaps 10 per cent, maybe more, where the chances of the shortfall ever being repaired, no matter what happens to interest rates, look decidedly bleak.' Gwyn Hacche, Head of Research at the PPF, 8 April 2015 in Pensions Expert. http://www.pensions-expert.com/CommentAnalysis/Interest-rates-and-the-PPF

- The proportion of members by covenant grade which suggests 12% of members are in schemes with grade 3 and 9% in grade 4.



- Around 880 –11% – of schemes have entered the PPF since 2010 (original universe 7,800). Even though sponsors are gradually paying deficit contributions, we see no evidence that this ratio will change in the short term.

Outline of the report

The research findings and recommendations that follow are based on the pressing issues for DB occupational pensions identified by the experts we interviewed:

- *Affordability:* Experts wanted to offer the perspectives of trustees on the debate about the 'affordability' of occupational DB pension schemes.

- *Information for trustees and members:* Experts felt many trustees, even professionals, were in the dark as to what information they should have and ask for from their advisers in order to understand if their scheme is in the 'stressed' category or heading for it. This report is an attempt to set out an information matrix for trustees, and where appropriate, members.

- *Empowering the regulator:* Experts felt that the current system favoured binary outcomes, either 'full benefits' or 'PPF benefits', and that TPR had a strong role to play in delivering more favourable second-best outcomes.

- *Consolidation:* Experts felt that the current debate about consolidation missed important regulatory issues as well as fundamental issues about mutualising benefits and liabilities.

- *Valuation:* Public discussion about valuation of DB liabilities. For example, the usage of 'gilts plus' showed there is confusion about the various measures used to assess liabilities. But this was less important for most schemes than properly allowing for the strength of the sponsor covenant.

1. Findings and Recommendations on Affordability

Finding 1.1: We find no evidence that deficit repair contributions are unaffordable.

We agree with the Green Paper's data, analysis and findings that there is no evidence that occupational DB pension schemes are unaffordable for the vast majority of sponsors.

In reaching its conclusion that there is no serious affordability problem, TPR cites a survey by LCP showing that in 2015, FTSE 100 companies paid five times more in dividends (£71bn) than they paid in pension contributions (£13.3bn). Some 29 companies paid dividends in 2015 that were more than double their pension shortfalls, 'suggesting that these companies could pay off their pension scheme deficit relatively easily if they wanted to'.[13]

TPR's most recent funding statement for Tranche 12 schemes shows the ratio of deficit repair contributions to dividends declined from 10% to 7% driven by a significant increase in dividends.[14] Some 37% of schemes have an employer covenant adequate to support the scheme but their current contribution or risk strategies pose unnecessary long-term risks. Schemes could address this risk by increasing funding.

Experts we interviewed also say they can see no evidence that deficit repair contributions are unaffordable. As one expert noted, sponsors may say schemes are unaffordable but 'from the outside, this usually sounds like a management preference driven by management objectives rather than facts.'

Such 'moral hazard' manifests itself in a variety of ways. Experts suggested sponsors have incentives to claim contributions to schemes are unaffordable as they are not penalised in terms of a share price markdown by their own shareholders when a scheme relies on a riskier investment strategy for funding. But they enjoy the upside if investments perform well and the scheme's funding position improves.

Evidence from the collapse of BHS and the use of pre-pack administrations to offload £3.8bn of pensions liabilities into the PPF suggest that such 'moral hazard' from sponsor behaviour is perhaps the most pressing issue behind claims of an 'affordability crisis'.[15]

Pre-pack administration is where the assets of an insolvent but otherwise viable business are sold to a third party or a phoenix company prior to the business going into administration or liquidation. In the high-profile Bernard Matthews case, the company owners favoured a pre-pack administration that saw the scheme apply to enter the Pension Protection Fund. This case is currently being investigated by the trustees, working with the PPF.

[13] Cumbo, 2016. Lesley Titcomb, chief executive of the Pensions Regulator, says that: 'Our annual funding statement for this year pointed out that in the tranche of companies due to do their (pension) valuations this year, there was a level of increased profitability'.
[14] The Pensions Regulator, 2017. For FTSE350 companies who paid both deficit repair contributions and dividends in each of the previous six years.
[15] Haddou & Cumbo, 2016

The Financial Times found that some 148 (17%) of the 868 pension schemes that have entered the PPF have used pre-pack administrations and around 66% of pre-pack schemes entering the PPF involved sales to existing owners or directors.[16]

Recommendation 1.1:

- **The government should consider establishing a statutory minimum contribution rate for all sponsors with schemes in PPF deficit, except where there is clear evidence this would make an sponsor with an otherwise realistic chance of recovery become insolvent in the near future.**

With no evidence of an overall affordability problem and indeed high dividends in some instances and potential evidence of growing sponsor moral hazard, we believe it is unacceptable for schemes as a whole to be funded to just 85% of the level that would be provided when schemes enter the Pension Protection Fund (PPF) or to just 63% required for a full buyout.

This places an unfair concentration of risk on members – who are being asked to rely on their sponsors to cover around 37% of full-buyout liabilities – and other PPF levy payers, as sponsors should be doing more to repair deficits when they have the resources to do so.[17] It is unsafe to assume future conditions will reduce scheme deficits by delivering more favourable economic conditions, for instance through higher interest rates.

Although a future rise in UK interest rates could improve the funding of many schemes it could conversely lead to a substantial rise in sponsor insolvencies due to higher borrowing costs. It is estimated that 139,000 UK businesses – 8% – are currently only paying interest on their debts.[18] Experts we spoke with note significant uncertainty now exists about the degree EU-based companies will be required to back the sponsor covenants of their UK subsidiaries after Brexit.

Given these uncertainties it would be prudent for the government to act now to ensure the maximum numbers of sponsors possible should restore funding to PPF compensation levels, or higher. A simple-to-calculate minimum-contribution requirement would also benefit trustees by accelerating decision making on the running of schemes and reducing advisory costs. Introducing a minimum-contribution requirement would also be more equitable to other PPF levy payers, who collectively bear the burden of PPF deficits through higher payments.

The funding rate should be based on an easy-to-calculate formula. Experts suggested taking the PPF deficit and dividing it into equal payments over a set number of years, for instance ten payments over ten years. In any instance, the requirement should only exist to stir sponsors with schemes in PPF deficit into action and not be available to influence negotiations for better funded schemes, lest it suffer the problems of the previous minimum funding requirement dropped in 2005 which were thought to have caused funding as a whole to gravitate towards the lowest setting allowed.[19]

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[16] Haddou & Cumbo, 2016
[17] Pension Protection Fund, 2016
[18] R3, 2016
[19] Thurley, 2008. We believe companies will want to be funded well over s179 liabilities to avoid the volatility that comes from mismatching assets against s179 liabilities. The original minimum funding was different because it masked the volatility.

Finding 1.2: We see no evidence that there is an affordability crisis that should permit schemes across the board to reduce indexation to the statutory minimum.

We believe that current funding levels are the result of deliberate and conscious management decisions and also TPR's sustainable growth objective, effective since 2014. A secondary factor for some schemes may be the decision by scheme trustees often at the behest of their sponsors not to hedge interest rates in the hope of making funding gains through interest rate rises. Given this, it would be unreasonable to penalise members by reducing indexation for all schemes.

As one expert put it, 'from 1990 onwards when full revaluation came in and then from 1997 when indexation became compulsory, sponsors have had many years to alter their pension promises for future accruals and should take responsibility for their choice to continue to offer these benefits.' Another noted, 'Switching from RPI to CPI is not a magic bullet. With funding levels for PPF around 85% and full buyout at 63%, it's won't produce a huge saving. Further, 'switching to CPI for indexation could cause problems as there is not a deep and liquid market of bonds that are linked to CPI.'

In our view, the sustainable growth objective eases sponsor funding requirements and so may be partially responsible for the increase in aggregate deficits. Under the sustainable growth objective, TPR expects trustees to consider carefully a sponsor's request to reduce contributions to the scheme in order to increase investment in the business.

As a consequence of this, experts believe TPR is accepting a lengthening in average recovery periods and the backloading of contributions. Since 2014, experts say they have seen plans extended to 30 years, or more in some cases, substantially higher than the most recently reported average of 10–15 years.[20]

Recommendation 1.2:

- **We see no case for permitting pension schemes across the board to reduce indexation to the statutory minimum.**

[20] Harrison & Blake, 2015 p18. Anecdotal evidence from interviewees. The latest numerical data is Tranche 9 valuations for 2013–14 which precede the changes.

2. Findings and recommendations on trustees and members

Finding 2.1: Many trustees are not clear over the funding position of schemes and may require further information from sponsors and experts.

Experts we spoke to for both our updated and original research suggest that trustees continue to have inadequate clarity over the funding of their schemes. TPR's research reveals that trustees of a significant number of schemes do not meet the regulator's standard for expertise and the regulator has admitted it is 'concerned by some of the gaps'.[21] Experts argued trustees with weak sponsors need a good understanding of:

- The extent of sponsor support (the covenant) and how this may change over time.
- The relationship between the trustees' approach to investment risk and the strength of the sponsor covenant.
- The relationship between the level of technical provisions and the strength of the sponsor covenant.
- The impact of PPF drift. Even when a scheme is funded above PPF levels,[22] the scheme's ability to cover benefits above PPF levels can be eroded over time to the detriment of younger pre-normal retirement age members. Experts say there are a significant number of trustees who do not fully understand the impact of PPF drift on their members and as a result they do not take it into account when calculating their funding request to sponsors and ask for too little, to the detriment of members.
- As a result, how 'stressed' their scheme actually is.

Our research also finds many trustees may hesitate in hiring covenant advisers because they are unsure whether the expense of hiring an adviser meets the TPR's proportionality requirements. Many are unsure where this expertise could be located. One in ten schemes tend to forgo advice because of expense and TPR says 'We are concerned that the relative poor performance of some small schemes creates a whole class of pension scheme members who may be subject to unfavourable outcomes just because of the size of scheme they belong to'.[23]

Experts note the covenant valuations will only become more important as schemes age and turn cashflow negative as benefits paid exceed contributions, creating greater reliance on the sponsor for funding. 'Getting good covenant advice and looking at integrated risk management will only get more important in the future.'

[21] The Pension Regulator, 2016. P9, 'Half of schemes with one or more non-professional trustees did not believe that all of these trustees had a level of Trustee Knowledge and Understanding (TKU) that met the standard in our TKU code of practice.'
[22] Including an estimate of any potential recovery under s75.
[23] The Pension Regulator, 2016. P17, one in ten schemes reported they could rarely or never afford to appoint advisers – these tended to be small schemes.

Recommendation 2.1:

- **As many trustees still have an inadequate understanding of the funding position of their schemes, the regulator should issue guidance on monitoring PPF drift and s179 underfunding. Trustees should be required to monitor potential levels of future PPF drift and report it to TPR in the annual scheme return.**

- **Trustees should be required to tell members and TPR if sponsor contributions plus a prudent estimate of future investment returns will be insufficient to prevent further erosion of the PPF funding level in the future, and the minimum future return on assets required to mitigate PPF drift.**

- **Alternatively, the PPF should be able to estimate future levels of PPF drift from current scheme return information. If it cannot, TPR should ask additional questions on the scheme return to enable these estimates to be made.**

- **The PPF could consider informing schemes of its estimates of their PPF drift, and include drift in the levy calculation to provide schemes with an incentive to address the problem.**

TPR should issue guidance to require trustees to monitor PPF drift. Specific measures could include:

i) The magnitude of PPF drift.

ii) The return on assets required to keep the PPF funding level from deteriorating.

iii) The maturity of the scheme's payments to members and peak outgoings, the length of recovery plan and the time horizon for asset returns to come good.

iv) Covenant risk – the chances of the sponsor becoming insolvent during the proposed recovery plan.

v) Risk analysis that shows how the scheme's position will react to changes in interest rates, investment returns, and other key economic data. The model for this could be IAS 19 disclosure requirements.

Even for smaller schemes, these actions could all be undertaken as part of the routine actuarial work with the insolvency risk being estimated based on TPR's categorisation of covenant strength.

Trustees should then be required to tell members and TPR if sponsor contributions plus a prudent investment return will be insufficient to prevent further erosion of the PPF funding level in the future and the minimum return on assets required to mitigate PPF drift.

Finding 2.2: Trustees require more information about sponsors' plans to combat moral hazards.

Trustees have far less information than sponsors about the strength of the sponsor covenant even though they depend on it. This information asymmetry puts them in a difficult position to combat the moral hazards of sponsor actions, including lowering funding levels and re-negotiating liabilities. Trustees are dependent on a sponsor's covenant strength but are unable to enforce information collection.

Recommendation 2.2:

- **Require sponsors to provide a three-to-five year business outlook as part of their annual funding review to trustees and be required to provide any advance notice of material transactions that could affect the strength of the covenant.**

- **Sponsor directors would be required to attest to the accuracy of this statement to trustees.**

- **The Financial Reporting Council and TPR should set standards for what would be considered 'material' and guide trustees on the appropriate questions they could ask sponsors.**

- **Trustees should be provided with transparency incentives to act on this information in the best interests of members.**

We believe there are three routes that the government could pursue to equip trustees with the information they need from sponsors to understand information: clarifying trustees existing powers, working with the Financial Reporting Council (FRC), and providing trustees with incentives to act on information.

a) Trustees' existing powers

Trustees may already have the right to ask the sponsor for some business outlook information through the Occupational Pension Schemes (Scheme Administration) Regulations 1996. Regulation 6 allows trustees to ask the employer for any information that they reasonably require for the performance of their duties.

TPR could offer guidance to sponsors and trustees about the information that trustees could reasonably require. But it is not clear what happens if trustees fail to get the information requested and what further steps they should take, so TPR would also need to specify and be able to enforce penalties against sponsors failing to comply.

b) Financial Reporting Council

The Financial Reporting Council requires that directors of quoted companies disclose a longer term viability statement in annual financial reports looking forward over a period 'significantly longer than 12 months' – in practice this is interpreted as three to five years. FRC should require directors of non-quoted companies to make an equivalent disclosure to trustees.

We suggest that the FRC should also require directors to notify the trustees of any 'material' planned corporate actions in advance, so that the trustees have time to consider the implications and take advice on the impact on the covenant. The FRC and TPR should therefore set standards for what would be considered 'material'.

The FRC also requires company directors to adhere to a statutory code of practice for providing timely information and this code of practice could also apply for providing information to trustees, putting them on a similar footing to investors and general creditors.

Working with the FRC, TPR could publish a list of questions trustees should ask of their sponsors on an annual or more frequent basis. There should be a clear path to sanctions against trustees who are also directors or employees of the sponsor for failing to supply adequate reports to TPR if this leads to material detriment to the scheme.

This approach would need to resolve conflict of interest issues. Trustees may not always be able to supply TPR with information if, for example, it is covered by a duty of confidentiality to the sponsor. Such conflicts should have been addressed by the scheme, but imposing sanctions where a conflict has been resolved in a particular way might not be helpful.

c) Trustee accountability

Trustees should be provided with transparency incentives to act on this information in the best interests of members. This could be provided by requiring them to report the following information to TPR. Trustees should also report it to members in a way that preserves commercial confidentiality:

i) What the event was.

ii) The actions trustees took.

iii) Any advice trustees received.

iv) What outcome was achieved.

v) How any conflicts of interest held by trustees were managed.

We believe the recommendations suggested here should be implemented before the government consider compulsory clearance, but the government should revisit this decision in three years to see if additional action is required.

Finding 2.3: Trustees of some smaller schemes do not routinely conduct evaluations of their sponsor's covenant because it is viewed as too expensive or because some trustees believe they can take a 'DIY approach'.

Such trustees have less reliable data on which to base the 'adverse experience' component of their valuations, yet a significant number of smaller schemes rely heavily on the sponsor covenant.[24] The Green Paper's data implies smaller schemes are more likely than larger schemes to be stressed.[25]

The sustainable growth objective introduced in 2014 also makes it imperative that trustees evaluate the sponsor covenant clearly. Sustainable growth requires a clear evaluation of the rate at which the sponsor covenant is expected to change over time relative to the change in the scheme funding level arising from any change in sponsor contributions and the scheme's investment strategy.

Recommendation 2.3:

- **Require TPR to alert trustees and sponsors when it gives a sponsor's covenant its lowest 'weak' ranking or where there is a rapid downward trajectory towards this ranking. TPR could assist trustees to use Experian ratings in order to improve evaluations of sponsor covenant strength.**

- **TPR should in return require trustees of such schemes to demonstrate steps taken to mitigate the risks of reduction in covenant strength.**

We believe the benefits from TPR informing trustees and sponsors – when it gives a sponsor's covenant its lowest 'weak' ranking or where there is a rapid downward trajectory towards this ranking – outweigh the potential negative impact on the sponsor's shareholders and creditors if done as part of a robust process.

TPR should require trustees of all stressed schemes to explain in the scheme's return how covenant risk is being mitigated by sponsor contributions and investment strategy. Mitigation could include granting security over assets, obtaining third-party guarantees and de-risking the scheme's investment strategy.

Experian ratings are a key factor in setting the PPF levies for individual schemes. TPR should issue a plain-English guide on the use of the ratings including the correlation between its four covenant grades and Experian's risk categories.

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[24] Green Paper, para 114: 'there are around 450 schemes with a funding level less than 60% on a Technical Provisions basis'
[25] Green Paper, para 114: 'We can infer that on average it is relatively smaller (in terms of liability amount) schemes that are more likely to have funding levels of less than 60%.

Finding 2.4: Valuations could take considerably less time than the current allowed 15 months, but three-year valuation cycles remain appropriate.

Practitioners we spoke to suggest that the 'number crunching' part of conducting a valuation can take as little as four weeks, or up to three months for more difficult cases, although the requirement for audited accounts provides a practical limit to how quickly they can be signed off. Valuation times could be reduced to nine months, with actuaries being given guidance to produce an initial draft valuation within three months.

Experts we spoke to could see no benefit in shortening valuation cycles, in general saying shorter cycles would place trustees on a treadmill where they are 'so caught up in managing a never-ending valuation cycle that they might actually have less time to sit back and work out what they are going to do with the results.'

However, they could see benefit in requiring annual actuarial valuations of stressed schemes being submitted to TPR in case this should prompt further action from the regulator.

Experts also highlighted the difficulties faced by trustees who have their valuations queried by TPR, but have not heard back whether their query has been resolved by the time they were required to conduct the next valuation.

Recommendation 2.4:

- **Government should consider reducing valuation deadlines to 12 months to shorten the negotiation of sponsor contributions. In the minority of cases where longer negotiations are required, TPR could retain its current flexibility on deadlines but take a tougher stance on higher risk schemes.**

- **Valuation cycles should not be reduced, but TPR should require stressed schemes that pose a material risk of entering the PPF to submit annual actuarial valuations so TPR can consider whether it should take action.**

Finding 2.5: The current system destroys economic value because it focuses on binary outcomes.

We believe the current system for DB occupational pension provision destroys economic value by steering schemes towards the binary outcomes of full benefits or PPF benefits. The value in between is lost for younger members because PPF drift is occurring, even though the insolvency test may not be met for a few years, despite insolvency looming down the road. It is currently very difficult to achieve an intermediate position between one of these two extremes.

Long, drawn out insolvency is an 'open secret' for a significant number of stressed schemes – maybe 600 by PPF's estimate in 2015 – but a combination of the focus on full benefits, wishful thinking, inertia and TPR's sustainable growth objective keeps schemes and sponsors limping along, losing value by the day. TPR says it is monitoring 5% of schemes in the 2017 valuation cycle with weak employers who are struggling to support schemes, but it also says that since these schemes would not inevitably become insolvent over the next 12 months, it would not be appropriate for them to enter an RAA.[26]

This reduces the aggregate benefits members receive, produces intergenerational unfairness between members, leads to preventable insolvencies in sponsor organisations, and diminishes value in other businesses in the form of higher PPF levies.

'Second-best' outcomes for stressed schemes where members receive benefits above PPF levels, but below full benefits would preserve significant value.

Recommendation 2.5:

- **Trustees should have access to streamlined Regulated Apportionment Arrangements (RAAs) if they conclude, based on actuarial and covenant advice, that full benefits are unlikely to be paid, that insolvency is likely and that the outcome for members would be better than under insolvency.**

The following adjustments would allow better access to RAAs and make second-best outcomes significantly easier to obtain:

i) The government – in practice the DWP – must embrace a cultural shift from a stance that full benefits must be pursued in all cases towards a more nuanced policy that seeks 'the greatest good for the greatest number'. Furthermore it must signal this to TPR, which hesitates to use its powers to achieve second-best outcomes because 'second best' is not government policy.

ii) The '12-month test' for RAAs should be eased. The current test stipulates schemes must already be under assessment for entry to the PPF, or be likely to begin a PPF assessment period – face insolvency – within the next 12 months. This would require amendement to regulation 7A(1)(a) of the Occupational Pension Schemes (Employer Debt) Regulations 2005.

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[26] The Pensions Regulator, 2017

iii) TPR and the PPF should jointly signal to schemes the conditions when they will look favourably on requests for RAAs and weaken guidance that 'insolvency is inevitable' as this test is often only passed when it is too late to seek a second-best outcome. Experts suggested that an approach similar to one the PPF took in its *General Guidance for Restructuring & Insolvency Professionals* could be used for this purpose. One test could be that the scheme's deficit is significantly beyond the sponsor's prospects for future cash generation, including that from realising assets. Further, having guidance over what kind of streamlined RAAs would be accepted would make trustees more likely to use them. This would be particularly appropriate for small schemes and those significantly above the PPF level of funding. A similar approach could be taken to requests for clearance for PPF+ buyouts if an RAA is not required.[27]

iv) TPR should drop its requirement that trustees submit an exact valuation of member benefits when submitting RAA proposals and clearing PPF+ buyouts. An exact valuation can only be given based on the annuity rates and market value of assets on the day when the proposal is put into effect. Experts we spoke to say the long length of time between proposal submission and agreement by TPR has scuttled several RAAs as market valuations had moved unfavourably in the meantime. 'Even where this requirement has been complied with, it creates additional complexity and cost with no real benefits which ultimately comes out of the pockets of members or the PPF. It effectively rules out RAAs as an option for smaller schemes.

v) As part of their RAA submission, trustees should be able to propose alterations to indexation that they have agreed with the sponsor (see Finding 2.8).

Such streamlining of the RAA process would require amendments to the Employer Debt Regulations, Regulation 7A which sets out the conditions for a RAA.

[27] The Pensions Regulator, 2017

Finding 2.6: Scheme members receive too much information that they don't understand.

Practitioners we spoke with believe members are 'deluged with information, 50-page reports no one reads' of a difficulty level few are equipped to understand. They believe that root and branch examination of current information disclosure guidelines should be undertaken before any new information is added.

According to the FCA, customer communications from some financial firms are 'so technical that even the most astute consumer would struggle to understand'. The same applies to DB pensions, despite the fact that summary valuation statements have improved in recent years.[28]

Recommendation 2.6:

- **The government should improve the quality of information provided to members by looking at work done by the FCA which is addressing similar issues, rather than simply requiring trustees to provide members with more information.**

We believe the government should look at whether current information sent to members is fit for purpose and inform this review through a close examination of the work that the FCA itself has done on this subject in recent years. The information that trustees must provide to members is set out in the Occupational Pension Schemes (Disclosure of Information) Regulations 2013.

If the government considers new standards, practitioners we spoke with suggested members would be 'well served' by being provided with information that describes the nature of their DB promise and how their promised benefits will only be paid in full if the scheme has not wound-up with an insolvent sponsor by the time they retire.

Some went further suggesting specifics:

i) The amount of benefits the scheme could pay today, including potential s75 recovery if the sponsor became insolvent and how this has changed since the last valuation.

ii) The Experian rating of the sponsor and what this implies about the likelihood of the sponsor going insolvent. For example, 'organisations with this credit grade are the least likely to go insolvent – 1 in every 5,000 organisations'. Alternatively, provide the non-confidential parts of any covenant reports in a format understandable to members.

iii) The compensation members would receive at PPF levels of funding.

iv) The current transfer value of the pension and the explanation that transfer value can only be realised if the sponsor remains solvent.

But it was recognised that any policy considered by government should recognise that providing more information to members is a double-edged sword. It is wrong to keep members in the dark, but the issues are complex. Supplying 'unduly

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[28] FCA, 2016. In our original research, one interviewee said he had seen only one request from a member for a valuation report in 16 years.

scary' information could cause members to take decisions that are not in their best interests. Such information could also be used by unscrupulous sponsors to encourage members to unnecessarily transfer their benefits out of the scheme.

Finding 2.7: The public is not sufficiently aware that DB schemes may only deliver full benefits to all members if sponsors remain solvent.

As one expert put it: 'It's the trustees' job to keep members informed about the specifics of their scheme, it's the government's job to educate people about the law.'

Members who have not reached retirement age and especially young scheme members need to be given the opportunity to change their plans if they realise they are unlikely to receive the full benefits.

Despite the well-publicised problems of schemes like British Steel and BHS, research by the PLSA suggests members of DB schemes have unrealistic expectations that their sponsor won't fail and that their scheme is guaranteed to deliver full benefits.[29]

The funding position of a scheme ultimately determines the benefits that members will receive and some high profile cases have seen schemes with no ongoing sponsor at all. But for most schemes, the strength of the sponsor covenant will play a strong role in the pension that pre-retirement age members will receive. We believe the benefits from informing members of this fact outweigh potential negative impacts if communicated clearly.

Recommendation 2.7:

- **The government should better educate the public about how the strength of the sponsor covenant can affect their pension and that they may not always receive the full value of the benefits they have been promised.**

[29] PLSA, 2017. P10: '…despite the well-publicised travails of other employers' schemes, members of DB schemes start from a presumption that their employer won't fail and their scheme is guaranteed to deliver benefits in full '

Finding 2.8: Altering indexation could help some stressed sponsors and schemes avoid insolvency.

Altering indexation would help reduce PPF drift, which for stressed schemes funded below PPF levels with little prospect of recovering assets from sponsors, would reduce the burden on the PPF and the levy payers. It could also lead to a fairer and more equitable allocation of finite pension scheme funding between the generations.

Recommendation 2.8:

- **Allow alteration of indexation for stressed schemes facing inevitable insolvency only, by making non-statutory pension increases contingent on the scheme's funding level.**

Alterations to indexation should be introduced by giving trustees the statutory power to apply to TPR or by giving TPR the power to direct trustees to restrict pension increases to statutory levels. The condition would be when the scheme is significantly underfunded below a threshold percentage of the PPF funding level, say in a range between 80–100%. Conditional indexation would apply to both pensions in payment as well as to revaluation of deferred pensions.

Alterations to indexation should only be an option for stressed schemes where it is in the interests of members to agree to a reduction to the rates set out in the scheme's governing documentation. This test would need to balance the interests of current pensioners who are entitled to higher rates of indexation and younger (pre-retirement age) members who stand to lose benefits due to PPF drift. Sponsors should be required to honour their promises until it is clear that either they can't or the future of the sponsor is threatened and there is value in avoiding insolvency.

Finding 2.9: PPF compensation is a 'cliff-edge' that is unfair for younger pre-NRA members.

Experts were unanimous: the PPF compensation cliff-edge is unfair for younger pre-NRA members. Given the maturity of many closed schemes, the majority of members might be within five or 10 years of retirement, depending on when the scheme closed. They might also face unemployment post-insolvency, which means that their presumed ability to make good any pension shortfall through future earned income is illusory.

Recommendation 2.9:

- **Change the PPF's cliff-edge compensation rules for retired and non-retired members to a phased approach, based on age and length of service.**

Phased rules for PPF entry would introduce greater equity between member cohorts and allay concerns about the gaming of the compensation rules by directors with high pensions in failing businesses. Provisions exist in the Pensions Act 2014 to help address this situation, but are not currently in force and would anyway have a limited impact on the cliff-edge.

3. Findings and recommendations on The Pensions Regulator

Finding 3.1: Additional monitoring and early warning measures that trigger interventions would produce better outcomes for stakeholders.

In the view of experts, additional early warning measures on scheme funding could help TPR and PPF produce better outcomes for members, sponsors and PPF levy payers.

They suggested early warning measures could focus on schemes where members are exposed to benefit reductions due to PPF drift, or on schemes which are underfunded on a s179 basis. These could trigger automatic requirements for the review of a scheme by trustees and TPR.

In order to monitor schemes, experts suggested TPR needs different working measures of stress for different types of scheme: a 'I know it when you see it' general principles definition and a mechanical definition to enable mass screening of smaller schemes which TPR isn't resourced to examine individually.

Once schemes are determined as being stressed, experts suggested triggering automatic requirements, reducing the burden on TPR to manually evaluate each scheme.

Recommendation 3.1:

- **TPR should collect additional funding data to create an 'early warning system' of schemes in stress, and to do this, we propose it uses a general purpose measure for large schemes and a mechanical measure for screening smaller schemes.**

- **TPR should require trustees of all 'stressed' schemes to explain in their recovery plan submission how PPF drift is being mitigated by sponsor contributions and investment return. This information should also help inform calculations of the PPF levy.**

- **TPR should require all 'stressed' schemes to employ a professional trustee.**

We believe the following definition serves as a general principle of stress for all schemes: 'where the pension scheme is significantly underfunded relative to the value of the sponsor's business and the trustees cannot rely on the financial support they need from the sponsor because its covenant is weak'.

But this definition requires evaluating each scheme in detail. Experts we spoke with suggested mechanical measures that TPR could use to identify stress in smaller schemes and serve as triggers for a requirement for trustees and TPR to review a scheme:

i) A measure that links PPF drift and profit before tax (PBT). This could be the ratio of the annual cost of PPF drift to average PBT over the past 5 years. For a charity sponsor, PBT could be replaced with surplus funds generated.

ii) A test that calculates s179 shortfall as a multiple of PBT or net assets.

iii) Experian scores as a de facto measure of stress.

iv) Schemes with s179 funding below 75% (after taking into account contingent assets and profits before tax) and which have material PPF drift.

Using these measures, TPR should be required to monitor whether schemes are failing to mitigate PPF drift or are underfunded on an s179 basis.

Once a scheme is determined as being stressed, TPR should consider the appointment of a professional trustee who can then take expert professional advice and decide on what is in the members' best interests.

It should require trustees to explain in their recovery plan submission how PPF drift is being mitigated by sponsor contributions and investment return. This information should be used by the PPF when calculating the PPF levy.

Finding 3.2: TPR's existing powers could deliver second-best outcomes, but it does not use them due to government policy and lack of funding

We believe TPR has the powers to place the pensions system on a much firmer footing – which we define as delivering the greatest good for the greatest number by allowing 'second-best outcomes' – but this also requires both a policy shift from government and additional resources.

Experts we interviewed believe TPR hesitates to use its powers to achieve second-best outcomes because it runs contra to government policy of pursuing full benefits for all members in all cases. Unless this policy changes, providing more resources will have limited impact – more noise, but not much action.

TPR has a wide range of powers and experts we interviewed felt TPR could deliver significantly better outcomes were it minded to use them, but it is too under resourced to contemplate a significant uptick in activity.[30] Most of the recommendations we give involving TPR would be difficult to implement unless additional funding were made available to TPR.

TPR does not currently produce a detailed report on how its measures have been used.[31] But evidence that suggests under-resourcing is not hard to find. Smaller schemes are the riskiest but when they approach TPR for help, the regulator is quite open about the fact that its resources are limited, and that it focuses on the largest schemes, as these pose the most risk to the PPF if the sponsor became insolvent.[32]

Experts report cases where TPR has queried scheme valuations but has not reported back to trustees on the nature of its query by the time the next triennial valuation is due, leaving trustees uncertain whether their valuation basis is acceptable or how to proceed.

RAAs are failing because TPR has been unable to process them swiftly enough. Experts we spoke to say the long length of time between proposal submission and agreement by TPR has scuttled RAAs as market valuations have moved unfavourably in the meantime.

But that's unsurprising when you consider that TPR had a general levy budget of £35m in 2015-16 which covers regulating the many millions of members of new and existing DB and DC schemes.

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[30] For a listing of the powers see Green Paper, p18 and http://www.thepensionsregulator.gov.uk/regulate-and-enforce/our-powers.aspx#investigating.

[31] The Pensions Regulator, 2016, p56 TPR's Determinations Panel (8 panellists). During 2015-16, the Panel made 10 determinations and exercised 12 powers – six DB, two DC and two hybrid schemes.

[32] 'Defined benefit funding regulatory and enforcement policy', June 2014, TPR explains the factors it considers before engaging with what we identify as a stressed scheme. These include: 'the size of the scheme's liabilities; the potential complexity and resource intensity of our engagement compared to the impact and the value we can add through further engagement; and the overall resources we have available'. www.thepensionsregulator.gov.uk/docs/db-funding-regulatory-enforcement-policy.pdf

Recommendation 3.2:

- **Redirect government policy to focus on the 'greatest good for the greatest number', rather than the current focus on full benefits, even where these can never realistically be paid.**

- **Provide the resources and incentives for TPR to make use of its existing powers, but tie this funding to an action plan outlined below to put the DB pensions system on a footing to deliver 'the greatest good for the greatest number'.**

- **TPR should produce detailed information on how its measures have been used in its annual report.**

The government must embrace a cultural shift from a stance that full benefits must be pursued in all cases towards a more nuanced policy that seeks 'the greatest good for the greatest number' and signal this to TPR.

The government should then provide TPR with new funding for an action plan to ensure the pension system is on a sound footing. This plan would operate using TPR's existing powers and within existing legislation so it could begin once funding was awarded:

i) TPR would review all large schemes with 1,000 or more members – effectively those which pose material risk to the PPF – on case-by-case basis. This exercise would cover 1,175 schemes accounting for 90% of s179 liabilities.

ii) Trustees and sponsors of all schemes which pose material risk would be put on one-year notice that TPR will be minded to use its existing powers to intervene. After one year, TPR will begin to act more assertively such as modifying benefits, stopping accrual and winding-up schemes.

iii) TPR would subject all small schemes with fewer than 1,000 members to a new technology- based screening programme to identify those that pose a risk to member benefits. This exercise would cover 4,619 schemes accounting for 10% of s179 liabilities. The screening process would take data from scheme submissions and automatically earmark those where further action is required based on rules below.

iv) All smaller schemes with s179 funding below 75% after taking into account contingent assets (potentially 44% of schemes between 100 and 1,000 members) and who have material PPF drift would automatically receive further attention for intervention by TPR unless they had robust proof they had taken independent advice on covenant, funding and investment.

v) Intervention could include immediate cessation of future accrual or curtailing pension increases to statutory minima under a Freezing Order.

vi) After two years, the government would review the results of the plan and decide whether or not further legislative change is required. In the meantime, it would work with industry to smooth the route to the wind-up of schemes identified through the process above to enable their transfers to insurers or the PPF. This would help reduce uncertainties for sponsor costs on factors such as data, due diligence and benefit transformation.

Experts we spoke to suggested that the plan could cost as little as £10m spread over two years.[33] The funds should be raised partially through an increase in the general levy on DB occupational schemes used to fund TPR's regulatory activities and partially through a new grant-in-aid from DWP's budget specifically for the purpose. Experts suggested the government would need to consider how well schemes were able to cope with a levy increase, given as many as 1,000 are stressed by our estimate.

Indeed, it was suggested by some that asking for the full £10m from the government was 'chump change' considering that future member benefits worth £2.1trn, around 110% of UK GDP, were at stake. Even if the plan described here saved members losing only a one quarter of one per cent of their benefits as a whole, they and the UK economy would be £5.2bn better off and the government would be getting very good value for money.

[33] Hire 10 senior employees to deal with high profile/hard cases at an average £100,000 per annum – total £2m for two years. Hire 40 IT and case manager support staff for hard cases at average £60,000 per annum for two years – total £4.8m. Purchase of systems plus additional costs and manpower to deal with smaller schemes – £2m. Two-year contingency – £1m. Total c.£10m.

Finding 3.3: Giving TPR new powers to alter indexation, alter benefits and interview stakeholders would help deliver second-best outcomes.

In our view, TPR requires two powers that enable it to intervene directly to alter scheme benefits when it is in the best interest of members in stressed schemes at risk of insolvency and a power to compel stakeholders to attend interviews.

Experts we consulted also believe TPR should have powers to take action where a scheme is experiencing significant funding difficulties and their suggested model for this is the powers of Ireland's Pensions Authority under section 50 of that country's Pensions Act 1990. We explain our rationale for suggesting that TPR have the power to direct schemes to restrict pension increases in Recommendation 2.8.

Experts suggested TPR should also have powers to direct trustees to reduce the benefits of active and deferred members, including preserved benefits. The model for this is once again s50 of Ireland's Pension Act. This power would be available as a last resort where trustees and sponsors have been unable to agree a viable plan to prevent insolvency and reducing benefits would be a better outcome for members as a whole.

Experts believed that TPR is constrained in investigating cases because it doesn't have the power to call stakeholders for review: 'It is a key weakness right now in their position'.

Recommendation 3.3:

- **TPR should have powers to direct trustees to reduce the benefits of active and deferred members, including preserved benefits. This would also require an amendment to s67 of the Pensions Act 1995 which requires actuarial equivalence when modifying member benefits.**

- **TPR should have powers to compel stakeholders to attend interviews where appropriate for TPR as part of an investigation.**

4. Findings and recommendations on consolidation

Finding 4.1: The existing regulatory structure does not prevent limited forms of consolidation – shared services, asset pooling and single governance – but does prevent full consolidation.

The experts we spoke with said that for knowledgeable and professional trustees, shared services, asset pooling and single governance forms of consolidation are possible within the current regulatory framework. But a wholesale review of trust law, and s67 and s75 of the Pensions Act 2014, would be required if a policy of full consolidation – merging all member liabilities in a single book – was considered desirable.

TPR's research suggests there are substantial cost savings to be made from limited consolidation, particularly for smaller schemes of 12–99 members. For example, the highest administrative cost for smaller schemes at £1,125 per member are more than 10 times more costly than the cheapest schemes at £108 and twice as expensive as the average scheme at £432.[34] The average total cost per member of smaller schemes at £1,054 per member is close to six times as expensive as larger schemes at £182.

However, legal experts we spoke with suggested full consolidation would be very difficult because of the following laws and regulations:

i) s67 of The Pensions Act 1995, amended by the Pensions Act 2004, requires actuarial equivalence when modifying member benefits. This section would need to be quite considerably amended to allow full consolidation if a standardised benefit scale was envisaged. The need to comply with the requirements of s67 would minimise the economies of scale that can be won from lesser forms of consolidation by making it difficult to standardise benefits. Without standardised benefits, consolidated schemes would find it difficult to produce consistent actuarial calculations for their total 'second pension' (survivors' pension) liability.

ii) s75 governs the funding of deficits in pension schemes which are being wound-up where sponsors are exiting the scheme or where sponsors have become insolvent. It could potentially allow that one sponsor might become liable for the debts of another, depending on the structure of any consolidation scheme.

iii) Trust law gives trustees an over-riding duty to exercise the powers they are given for a proper purpose which is often expressed in shorthand as requiring them to act in the members' best interests. Trustees would need to ensure that the position of their members is protected on consolidation particularly in relation to trustee powers, maintain benefits and funding. So it would be very difficult to satisfy this requirement for consolidation between schemes that have different balances of power and funding positions.[35]

[34] The Pensions Regulator, 2014

[35] Recent case law in Merchant Navy Ratings Pension Fund Trustees Ltd v Stena Line Ltd (2015) held that best interests of beneficiaries' should not be regarded as a paramount stand-alone duty but is simply an expression of a trustee's duty to promote the purposes for which the trust was created

Recommendation 4.1:

- **A full regulatory review encompassing sections 67 and 75 of the Pensions Act 1995 and trust law would be required if full consolidation of DB pensions was considered a desirable policy.**

Finding 4.2: Without a complete overhaul of legislation, encouraging consolidation of multi-employer schemes would yield few results.

Legal experts said that a root and branch review was needed for the rules governing multi-employer schemes as years of legislative amendments mean the existing system is 'extremely difficult to operate under and produces a number of undesirable consequences'. These rules would prevent full consolidation and experts suggested further piecemeal changes would make the situation worse: 'The section 75 regime is already mired in complexity. Sponsors and trustees need greater clarity than the current legal regime provides. Wholesale clarification is required'.

The review would need to encompass the entire existing employer debt regime including calculation and triggering of debts, and allocation of orphan liabilities. Existing rules produce perverse outcomes in some cases where employers can wind-up or exit a scheme leaving a disproportionate burden on the remaining employers, who effectively end up holding the can. As one expert noted: 'Look at the high profile cases involving industry-wide schemes where employers have inherited vast liabilities for employees who were never theirs'.

In fact, experts suggested that multi-employer schemes should serve as a 'cautionary tale' when policy makers consider options for consolidation of single employer pension schemes.

Recommendation 4.2:

- **A full regulatory review would be required if full consolidation of multi-employer DB pensions was considered a desirable policy.**

- **The government should consider carefully before making further minor amendments to the section 75 regime and instead consider wholesale clarification of the regime.**

Finding 4.3: Full consolidation is not viable for the occupational DB pensions sector owing to high costs and limited benefits from mutualisation, but may be worthwhile for smaller schemes.

The key issue is whether, after more limited forms of consolidation are completed, that there are significant benefits of scale from merging assets and liabilities into a single scheme. These benefits would have to be greater than the considerable costs of mutualising deficits and sponsor covenant risks.

There were differences of view about the size of potential cost savings. One expert suggested people in the industry were hoping schemes as a whole might make savings of 15% through consolidation. But this expert thought that consolidation is comparable to an insurance buyout, so that cost savings of around 5% were more realistic: 'The price entry point for a Superfund may not be so far away from an insurance buyout price, once profits are removed but running costs are included.' Other experts told us that most medium and large schemes were already being run relatively efficiently, so full consolidation would not greatly benefit such schemes, as mutualising buyout deficits and exposure to covenant risk is very difficult and costly, in their view. While we were unable to garner a reliable estimate, some experts suggested the cost saving could still be substantially higher than 5%.

It was also pointed out that the sector may not have the expertise to manage portfolios of sponsor covenant risk. As one expert put it: 'The covenant industry is only a decade old and there is risk in relying on it to accurately price the value of 'selling' the covenant support for a fixed sum today. Firms conducting covenant valuations would need to be regulated by someone – the FCA or TPR – to avoid the massive risk of cowboy operations giving low values to the sponsor because it suits commercial interests'.

Furthermore, full consolidation would not be a panacea for sponsors. Because full-buyout deficits are high, many would need to continue to provide security towards future contributions and remain bound by the covenant.

Recommendation 4.3:

- **Full consolidation should not be considered a central policy for putting the DB pensions sector on a sound footing owing to the costs of mutualising liabilities as a whole.**

Finding 4.4: The case for mandatory consolidation is marginal, so it would be counterproductive to require trustees to justify why they do not consolidate. We find no reason to believe that consolidation would be materially cheaper than a buy-out.

For underfunded schemes with insolvent sponsors, mandatory consolidation is appropriate as a matter of policy and PPF currently serves as the mandatory consolidator for such schemes, providing a simplified benefit structure. Schemes that can afford more than PPF compensation can turn to the regulated insurance market which provides highly efficient and competing consolidation vehicles in the form of bulk annuity providers.

But there could be a case for mandatory consolidation for stressed schemes facing high costs when there is a high risk of the scheme entering the PPF and it would reduce the potential future burden on the PPF. In practice, this would most likely be smaller schemes, which could reduce costs, get access to more sophisticated investments and improve their pooling of longevity risks, experts suggested.

However, we believe many of these cases are likely to be better dealt with by allowing or encouraging trustees to enter streamlined RAAs (see Recommendation 2.5) which would require less legislative change to implement than consolidation.

It would also avoid the thorny issues consolidation brings up relating to mutualisation and management of sponsor credit risk, which RAAs resolve through their established process.

Because of the difficulties inherent in consolidation we also find no reason to believe that consolidation would be cheaper than buyouts, which are provided by large insurance companies offering significant economies of scale, unless they were operated on a basis which represented an unacceptable level of risk to the PPF and its levy payers.

In the same vein, we believe encouraging transparency, enabling comparison and providing negotiation tools would be a more effective to help trustees understand when their costs are excessive and rein them in.[36] We suggest the TPR could collaborate with the FCA to replicate work being done on asset management costs.

Recommendation 4.4:

- **A policy of pursuing mandatory buy-outs and consolidation should be considered counterproductive.**

[36] TPR's cost comparison calculator is a good example. http://www.thepensionsregulator.gov.uk/trustees/db-scheme-costs-tool.aspx

Finding 4.5: Pursuing 'Superfund' consolidation is unlikely to be viable owing to high costs, limited benefits from mutualisation and difficulties implementing the required regulatory framework.

We already find that pursuing full consolidation is unlikely to be viable for the occupational DB pensions sector as a whole owing to high costs and limited gains to be made from the mutualisation of benefits.

We believe that the 'Superfunds' proposed by the PLSA's DB Taskforce would face the same problems as well as additional constraints from the likely regulatory framework required.

PLSA's DB Taskforce has proposed the use of 'Superfunds' that are run on a 90% probability of delivery of full benefits and that are regulated robustly by TPR.[37] This would create vehicles that appear similar to regulated annuity providers but provide different levels of security.

We believe the only way to achieve this outcome would be to pass regulatory oversight of Superfunds to the Prudential Regulatory Authority, as this is the only government agency with the required skillset. This would immediately pose consistency problems as the PRA is unlikely to allow insurers to provide two kinds of annuity with different probabilities of full benefits.

Creating Superfunds would also require an overhaul of the entire occupational DB regulatory framework. They would need to resolve the tension between requiring sponsors to retain their covenant yet effectively removing their influence over funding decisions.

To achieve consistency, this overhaul would need to align rules for entering the PPF, introduce new rules under which member benefits can be altered and a simplified benefits structure for the sector. These rules would be highly desirable in their own sake. If properly implemented, they might produce the kind of 'second-best' outcome we suggest needs to solve the current crisis in the sector. But they would also negate the need for Superfund vehicles.

Superfunds would also need their own rules, which would not be easy to determine, including:

- Required funding level for entry.
- Determining the credit risk present in shortfall payments that are being deferred.
- Fair sharing of risk between Superfund members.
- Equitable treatment of younger and older members.
- Sharing of gains and losses and how these affect the cost of entry to new members.

Recommendation 4.5:

- **Superfunds and consolidation should not be considered policies for putting the DB pensions sector on a sound footing ahead of less complex measures.**

[37] PLSA, 2017

5. Findings and recommendations on valuation

Finding 5.1: Some schemes could use more appropriate valuation methods to estimate liabilities for the statutory funding objective, but properly incorporating the sponsor covenant is a more important issue.

Experts we spoke with identified a number of issues relating to discount rates and usage of valuation methods for setting technical provisions under the statutory funding objective, but said incorporating the strength of the sponsor covenant was most important:

- For very strong covenants, the pace of funding is virtually irrelevant to the members.
- For the weakest covenants, the value of the sponsor's support becomes critical to the level of pension that can be provided, but there will be a limit to the affordable contributions that can be extracted regardless of valuation basis used.
- A fund with no sponsor should have buy-out or absolute self-sufficiency as its target and ensure it can cover expenses and PPF levies.
- The cost of buy-out adjusted to reflect the strength of the sponsor, should be the formal benchmark for determining technical provisions. Strong covenants would pass this benchmark easily and the sponsors would have more flexibility on funding.
- In practice, trustees will look at the gap between buy-out and technical provisions and judge whether the sponsor is worth that much, prompting action if they are not comfortable. Some prudence would be needed to allow for the risk of deterioration in covenants in the future.

Issues with valuation methods cited were:

- *Integrated risk management (IRM):* IRM is a hugely helpful concept, but a 'mind shift' is required by trustees and actuaries in order to make the best use of IRM's full potential. Experts report many schemes are struggling to put IRM into practice and require more detailed guidance from TPR. This included usage of interest-rate hedging, swap rates instead of gilt rates for hedged bonds, employing worst-case scenario analysis and risk budgeting.
- *Governance:* Valuation issues are caused by the trust system as a whole in which neither trustees nor sponsors are directly accountable for investment management decisions. Government policy also plays a role by requiring trustees to make subjective assumptions about investment returns rather than prescribing a particular approach to risk. It was noted that this approach differed to regulation of the insurance and banking sectors.[38]

[38] Lundberg & Rosenberg, 2017

- *Herding around gilts-plus valuation:* Trustees, actuaries and sponsors are encouraged to gravitate towards gilts-plus valuations because these are close to the basis of buyout measures, company accounting valuations and TPR's historical benchmarking of scheme's discount rates against gilts. But gilts may not yield appropriate discount rates at current interest rate levels. Gilt linkers are also indexed to RPI which is believed to overstate inflation.[39]

- Adjustment of discount rates to avoid the appearance of inevitable insolvency, or large contribution requests that would result in flat refusal from sponsors. This was characterised as 'altering the thermometer scale when the temperature was too hot.'

- Self-sufficiency funding targets. Trustees may not understand that 'self-sufficient' investment strategies, designed to mirror the approach used by insurance companies, still leave the scheme reliant on the sponsor in practice. Trustees may not realise that the sponsor covenant becomes equivalent to the insurance company capital allocation, so in fact they are 'self sufficient' only as long as they are able to call on the sponsor for funding.

But these findings didn't lend themselves to recommendations because they tended to affect schemes differently on a case-by-case basis and relate to trustees', sponsors', and, sometimes, actuaries' specific understanding of 'risks'. It was also felt that the unintended consequences of specific recommendations would likely outweigh the benefits. For example:

- *IRM:* Enforcing strict rules on the use of IRM and hedging without ensuring trustees and sponsors properly understand its use and implications risked turning it into another costly report that schemes produce, and then table with no effect.

- *'Gilts-plus' valuations:* Although there are other credible methods trustees could use, such as intrinsic- and inflation-plus valuations, which might indicate schemes could take more risk,[40] these also require trustees to make assumptions about the world that, like gilts-plus, are an awkward fit to current economic conditions to some degree. Furthermore, adding risk only becomes possible when the sponsor covenant is sufficiently strong and requires confidence that sponsors could support any higher deficit if experience was worse than assumed.

- *Discount rates:* Although this could be an idiosyncrasy of particular sponsors and trustees, it is partially a structural problem caused by the conflicting priorities in member interests and sponsor interests which is reinforced by TPR's sustainable growth objective. We believe discount rate is less relevant to payment of benefits than the level of sponsor funding and the strength of the sponsor covenant.

Recommendation 5.1

- **Government should avoid mandating specific measures to calculate technical measures but should consider measures that help trustees incorporate the best possible evaluations of sponsor covenants when determining scheme funding requirements.**

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[39] Johnson, 2015
[40] Jones FIA, Parlour FIA, & Skinner FIA, 2017

2020 TRUSTEES

2020 Trustees Ltd is delighted to be a main sponsor of the Pensions Institute's *Greatest Good 2* report. The report discusses the challenges faced by trustees of private-sector defined benefit (DB) schemes who are faced with extremely difficult decisions and is an important document for everyone working in the industry.

2020 Trustees is an independent trustee company with offices in Manchester and Nottingham. The company is one of the largest professional independent trustee companies in the UK with a portfolio of over one hundred pension schemes benefitting from our high quality, cost-effective, pragmatic and commercial approach to trusteeship.

2020 Trustees provides independent trusteeship to the full spectrum of pension schemes. Services offered include establishing effective governance frameworks, developing funding strategies and leading discussions with sponsors. 2020 Trustees is renowned for its management of complex and distressed situations, regularly working with sponsors undertaking M&A exercises and finding bespoke funding solutions for those sponsors in financial distress.

Indeed, it is this latter cohort which has lent much of the inspiration to the report here and there are clearly situations where all major stakeholders (members, trustees and sponsors) can benefit from recognising the inability to provide full benefits from the scheme, and in turn looking to provide an alternative solution based on some form of compromise arrangement. The authors of the report should be commended for pushing this firmly up the agenda of the pensions industry and we look forward to industry developments from here.

2020 Trustees is pleased to have been able to share its knowledge with the authors of the report in bringing the issue of schemes that are in deficit back on to the table and how the pensions industry can work to broker a better deal for pension scheme members whilst also helping keep UK businesses solvent.

Doing nothing is not an option and 2020 Trustees is proud to be part of a report that has asked difficult yet essential questions.

2020 Trustees Ltd – Independent Trustees with a different outlook

www.2020trustees.co.uk

Cardano is excited to be a sponsor of the Pensions Institute report *Greatest Good 2* because finally getting to grips with the issues raised will help the pensions industry to deliver better and more secure financial outcomes for beneficiaries, sponsoring employers and society as a whole.

We agree with the authors that it is clear the status quo in the industry is not delivering on its contractual agreements to beneficiaries and there is a need to rethink the conventional approach to managing pension scheme risk. With many schemes becoming cashflow negative and increasing uncertainty over sponsors' ability to fund deficits, the industry can no longer afford to continue to repeat the mistakes of the past and expect different outcomes.

As the pensions problem becomes more urgent, we need to work together with all industry participants to better protect the beneficiaries we serve. This report is a crucial step in bringing this discussion to the fore, and it is now up to us, as part of the industry, to ensure that effective and lasting change happens.

The approach to pension scheme risk management which we encourage the industry to adopt and discuss in more detail is 'Integrated Risk Management' (IRM). This considers investment, funding and covenant risks in the context of a company's overall risk budget. The approach has been promoted by the Pensions Regulator, but there is still no regulatory guidance on the overall risk level and parameters to be used when calculating risk. If adopted and used effectively, IRM could be a valuable tool in helping to solve many of the issues raised in this report.

We are especially passionate about this topic as part of the reason we exist as a firm is to help solve the issues raised. Our mission is to help pension funds and the people they serve achieve their financial goals in a more resilient, realistic and responsible way. Our deep understanding of the causes and impact of risk, and how this can be managed to significantly improve financial performance and resilience, enables us to deliver planned and controlled performance for our clients, irrespective of economic conditions. The certainty over outcomes we provide is of significant value for trustees, sponsoring employers and members.

Founded in 2000, Cardano is a purpose-built risk and investment specialist, and financial pioneer. We are widely recognised as being the market leaders in the provision of specialised fiduciary management and investment advisory services.

EVERSHEDS
SUTHERLAND

Eversheds Sutherland has sponsored a second Pension Institute report – *Greatest Good 2* – because we believe there is a need for further debate on the position of stressed schemes.

This has been brought into focus in the last eighteen months, during which we have seen a number of high profile cases where pension liabilities have affected the viability of a sponsoring corporate entity (for example British Steel, BHS and Halcrow), with the result that solutions had to be considered for restructuring the pensions liabilities or, alternatively, the members transferred to the PPF.

The Government has engaged with this problem in the form of a Green Paper on the security and sustainability in DB pensions. This raises many of the issues that were considered in the first Greatest Good report and a second report provides the opportunity to develop those thoughts and consider where the Government might go after the Green Paper.

Inevitably, any changes to the existing regime will have a degree of controversy associated with them, as they will involve allocating the increasing cost burden of defined benefit schemes to either employers or members. There is no perfect solution but the authors are to be applauded for raising the issues for discussion. By bringing the question into the open in this way, the report facilitates the development by the pensions industry and by policymakers of new and practical options.

Eversheds Sutherland was first established in 1988 and has since grown to become a leading global law firm, with 61 offices in 29 countries. Our team of over 70 pensions lawyers is the largest of its kind in the UK and it is supported by a network of pensions specialists in other jurisdictions around the world. Our pensions lawyers work closely with our corporate, employment, financial services, banking, tax and insurance teams to deliver a full service to clients.

Our client base includes multi-national employers and some of the world's largest pension plans. We also advise national governments, public authorities, insurance companies, banks and fund managers.

Our approach is always to provide practical, commercial advice and to find solutions that work for our clients. We strive to find innovative approaches and sensible answers to difficult questions.

Our ethos is therefore very much in keeping with the key drivers behind the Pension Institute's report, and we are pleased to have been able to contribute to the ongoing debate on this particularly difficult question through sponsorship of this research project.

Lane Clark & Peacock (LCP) is delighted to continue our sponsorship of the Pensions Institute's *Greatest Good* series of discussion papers. We want to encourage the current debate within the pensions industry on the challenging questions facing stressed pension schemes – a debate which began with the initial paper in 2015 and which has now led to many of the themes within the Green Paper consultation.

Case studies such as Uniq and MIRA show that trustees and sponsoring employers of stressed pension schemes can achieve a positive solution both for members and for the business, by working with experienced advisers and taking a collaborative approach.

Often, however, the challenges are put into the 'too difficult' box. Perhaps that is not surprising, as the regulatory environment is focused on perpetually targeting full benefits – however unlikely that outcome might be. Currently, left unchecked, a stressed pension scheme and its members can face a slow descent into the PPF. Together, we can do better. We hope the Green Paper consultation will lead to positive change.

LCP is a leading firm of financial, actuarial and business consultants, specialising in the areas of pensions, investment, insurance and business analytics. Our pensions de-risking team has a wealth of experience in helping trustees and sponsoring employers to deliver bespoke solutions to challenging pensions issues, and is widely recognised as the leader in the field. LCP has advised on many high-profile PPF+ cases and we pride ourselves on taking a creative and innovative approach.

www.lcp.uk.com

Lincoln Pensions Limited ('Lincoln Pensions') is delighted to have co-sponsored this follow-up report from the Pension Institute – having also co-sponsored the initial *Greatest Good* report in December 2015.

Stories about defined benefit ('DB') schemes seem to consistently appear in the press. It is generally accepted these types of schemes are in crisis; however, there continues to be considerable debate around the level of this crisis, the scale of the problem and what options may be available to deal with it. We hope that this important report will help to further stimulate ongoing discussion among not just those who work in the complex world of occupational DB pensions but also among government bodies, regulators, employers, unions and those who ultimately benefit from such schemes – the DB scheme members themselves.

Much has been achieved in the UK over the last 10 years or so to bolster the protections given to DB member benefits, including the establishment of the Pensions Regulator and the creation of the PPF safety-net to deal with the unfortunate cases when sponsoring employers become insolvent, leaving behind underfunded DB schemes.

Properly understanding and managing the employer covenant of sponsors supporting DB schemes is now firmly at the core of pension risk-management – it is the capacity of a given employer to stand behind risk (its 'covenant') that enables trustees to take investment risk on their scheme assets in anticipation on favourable investment returns, which in turn informs the level of funding required to deliver member benefits in the future. If things do not go as planned, it is the employer who is required to increase cash funding support to the scheme. Therefore, the concept of employer covenant is fundamental and we have seen more trustees and sponsors seeking external, independent covenant advice in recent years.

For a variety of reasons, well-articulated by the authors, considerable challenges remain for those responsible for running or sponsoring DB pension schemes in the coming years. The authors suggest that a high proportion of DB schemes may find themselves simply unable to deliver on the DB benefits promised in the years ahead unless trustees take unjustified levels of investment risks with the scheme assets.

We commend the authors for throwing light on these issues, especially when they involve very technical points. However, at their heart, they do need tackling if the UK DB pensions framework is to remain fit for purpose, transparent and fair for 'the greatest good'.

About Lincoln Pensions

Lincoln Pensions has been working to deliver safer financial futures since we were founded in 2008. We are the UK's leading independent, award winning, covenant advisor for DB pension schemes of all sizes. We are the covenant advisory business of The Cardano Group, the purpose-built investment and risk specialist, operating in the UK and the Netherlands.

We have grown over recent years with professionals from backgrounds in credit risk analysis, corporate finance, corporate banking, actuarial, legal and regulatory advice. This diversity enables our team to focus on client's covenant issues from different angles, adding breadth and value to clients.

We help our clients by delivering a full range of covenant advisory services including covenant reviews, affordability analysis, scheme funding advice, corporate transactions, regulatory issues and counterparty assessments.

In 2016, we were delighted to win two industry awards for recognition as top employer covenant providers: The Professional Pensions UK Pensions Awards, Sponsor Covenant Provider of the year; and the FT Pension & Investment Provider Awards, Covenant Review Provider of the year.

Rothesay Life was delighted to have been a sponsor of the original Pension Institute report *The Greatest Good for the Greatest Number* that was published in December 2015. The report initiated a discussion in the pension industry about the issues facing stressed schemes and their trustees and the potential benefits of early intervention in some situations.

This theme was discussed throughout 2016 and formed a key part of the Green Paper consultation. As a result we are once again delighted to be a sponsor of this updated report on the topic and responses to many of the questions posed in the Green Paper. We very much hope that this report and the Green Paper consultation will lead to regulatory changes and better outcomes for members of stressed schemes.

Rothesay Life was established in 2007 and has become one of the leading providers of regulated insurance solutions in the UK market for pensions de-risking, making payments of over £1,300m a year from over £26 billion of insurance contracts.

Existing Rothesay Life clients include the pension schemes and members associated with such names as RSA, British Airways, Lehman Brothers, Rank, Uniq, General Motors, the MNOPF (Merchant Navy Officers Pension Fund), InterContinental Hotels, Philips, GKN and the Civil Aviation Authority.

Rothesay Life is a secure long-term provider of pensions, focused on

- a flexible and committed approach to execution;

- ongoing risk management to maintain balance sheet strength; and

- robust operational processes.

Rothesay Life is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

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Appendix 1: Original *Greatest Good* proposals

The Pensions Institute's report *The Greatest Good for the Greatest Number,*[41] published in December 2015, found a pension system facing a 'clear and present danger' that required government and stakeholders to work together to produce a 'second-best' outcome, defined as providing practical support to trustees with stressed schemes so that trustees can act in the best interests of all scheme members, and meet, as best they can, the demands of the scheme's wider group of stakeholders.

Aims of the proposals

The report's proposals were given with two objectives in mind:

1. To equip the trustees of stressed schemes with the know-how to have a discussion about securing less than full benefits through a PPF+ buy-out with a bulk-purchase annuity insurer, where this is in the interests of the members overall and, in particular, for younger pre-NRA members.

2. To enable trustees of stressed schemes that cannot match or beat PPF compensation benefits to maximise scheme assets before entry to the PPF, in order to reduce the burden on the industry compensation scheme and on the remaining PPF levy payers.

Issues that must be addressed

In order to accomplish the report's objectives, we argued that the Government and regulator would need to address four issues:

1. The need for an acceptance of the fact that stressed schemes require improved access to negotiated agreements that deliver less than full member benefits, but which are nevertheless 'for the greatest good of the greatest number'. This is a new, more realistic and more practical interpretation of the sustainable growth objective.

2. The manifest inefficiencies and inequities in the law and regulations that govern closed DB schemes.

3. The dynamics and tensions of a market in which participants – trustees, sponsors, and their various advisers – are anxious to avoid stepping out of line, resulting in herd-like institutional behaviour.

4. The need to disseminate this new interpretation of sustainable growth across the DB scheme community, particularly to the advisory community, which would need to develop an appropriate set of skills to meet the needs of trustees of schemes of all sizes. At present, it appears that the expertise and demonstrable experience in dealing with stressed schemes is concentrated in too few firms.

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

Proposals

The report offered specific proposals to address these issues:

1. Change TPR's remit for trustees of stressed schemes from 'protection of member benefits' to 'protection of member interests'.

Protection of members' benefits means doing everything possible to ensure members receive full benefits. This makes it difficult for trustees to acknowledge that, in reality, full benefits may never be delivered by the scheme. Protection of members' interests is more practical and could be defined as 'doing the right thing in the financial and economic circumstances', which might mean reducing indexation and/or capping benefits, for example. To make such actions available would require statutory change. If adopted, this would:

i) Enable trustees, sponsors, TPR, and the PPF to take a more realistic view of their options and facilitate 'second-best' outcome negotiations that could result in better pensions for pre-NRA[42] members in particular than would be paid by the PPF.

ii) Enable trustees to be more candid with their members about the true state of the scheme.

iii) Reduce trustees' incentive to take excessive investment risks in order to increase the chances – however small – of paying full benefits, even when this gamble may not be in the interests of the employer, the members, and PPF levy payers in general.

2. Make non-statutory pension increases contingent on the scheme's funding level, i.e., introduce conditional indexation.

Following on from proposal 1 above, non-statutory pension increases should be made contingent on the scheme's funding level. There are two possible ways of doing this: either trustees are given the ability to apply to TPR for such a power (as in Ireland), or TPR should have the power to direct trustees to restrict pension increases to the statutory minima where the scheme is significantly underfunded – for example, where it is lower than a specified percentage of the PPF funding level. Some interviewees suggested the trigger should be 100% of the PPF funding level, as at the last levy assessment reporting date. Others suggested percentages lower than this, for example, 80%.

If adopted, the restriction on pension increases to the statutory minima should apply to pensions in payment as well as to deferred pensions, as is the case with PPF compensation increases.

The ability to restrict increases already applies in Ireland and in the Netherlands (where it is known as conditional indexation).

[42] Normal retirement age.

3. Introduce a PPF 'pre-assessment' period to facilitate early intervention.

Where the covenant strength does not improve and the funding position continues to deteriorate, TPR could intervene and require trustees to take appropriate advice and action. This might be denoted as a 'PPF pre-assessment'.

In fact, TPR already has the power and obligation to intervene and has a formal appeals process, which is necessary for regulators to have such powers in the first place. The PPF does not have intervention powers, but its influence in cases that present a risk to the PPF compensation scheme could be enhanced if it had the right to formally request TPR intervention in particular cases.

4. Change the PPF's cliff-edge compensation rules for pre- and post-NRA to a phased approach, based on age and/or length of service.

This would introduce greater equity between member cohorts. It might also eliminate concerns about the potential gaming of the compensation rules by high-liability directors in failing businesses, who are holding on in order to reach NRA. The Government has already considered changing the rules to soften the effect of the cliff-edge for pre-NRA members with long service, but the provision in the Pensions Act 2014 had not come into force at the time of writing. Moreover, experts said that even when it is introduced, it will have a very limited effect on the impact of the cliff-edge.

5. Provide specific guidance for trustees of stressed schemes on the appointment criteria for specialist advice, and provide a rapid fee-check calculator to reassure trustees that they will not contravene the regulator's guidance on 'proportionality'.

Telling trustees of stressed schemes to appoint an adviser is of little use if they don't know how to identify the right firm from among the many that practise in each relevant field. Moreover, it's not just about identifying the right firm: interviewees said that trustees need to find the right individual or team within a firm.

We propose that the PPF sets out the criteria trustees of stressed schemes might apply to the selection process, based on its own criteria for appointments to its Trustee Advisory Panel (members of which are commonly appointed to guide schemes through the PPF assessment period). We would expect the guidance to emphasise the importance of demonstrable experience and the need to request references based on relevant previous case work. The PPF and TPR should also clarify the order of priority of appointments. Certain appointments, such as the scheme actuary, are statutory requirements, but many are not.

Interviewees from across the professions said that trustees and/or sponsoring employers of stressed schemes should start with the appointment of a professional trustee with experience in corporate debt restructuring, turnaround management, and insolvency. The individual or team should have a proven track record in managing conflicted and fraught trustee-employer negotiations, and in negotiating successful outcomes with TPR and the PPF.

Trustee training is also important, of course, but interviewees said that

standard trustee training programmes can be ineffective, because the training is often just too generic. We suggest the PPF is best-placed to run or to facilitate online training. It already offers seminars on contingent assets, for example. Of course, one of the most pressing problems for trustees is time. Trustees of large schemes typically spend more time on their duties than those in medium and small schemes (a mean of 16, 12 and 9 days per year respectively).

Professional fees are a big concern for trustees of stressed schemes, as resources are limited. TPR stresses the importance of professional advice, but says the cost should be 'proportionate', an ambiguous term that trustees do not know how to interpret in relation to the financial resources of the scheme and the employer. We propose that TPR provides some form of quick and simple fee-check service to enable trustees and sponsors to secure the help of a specialist professional trustee which has the necessary expertise in restructuring and turnaround management.

6. **Introduce a requirement for TPR to alert trustees and sponsors when it identifies that a sponsor's covenant is 'weak' (its lowest ranking), or is on a rapid downward trajectory towards this ranking.**

Trustees and sponsors could be made aware if the regulator has categorised the sponsor covenant as weak. We appreciate that TPR might be reluctant to issue such information, as, if leaked, it could have a negative impact on the confidence of shareholders and creditors. That said, we believe that the regulator, in conjunction with industry experts, could develop an effective process.

In return for providing regular details about the covenant rating, TPR could require trustees to demonstrate over time a positive overall net improvement in the sponsor's covenant strength. This could be in relation to TPR and Experian's ratings, the length and terms of the recovery period, and the scheme's funding position.

Initially, the covenant strength might improve and the scheme's funding position might deteriorate, but the requirement should be that the net effect is expected to be positive for the members or on a trajectory that will become positive over a relatively short period. TPR and the PPF should consult with the industry to develop a metric that facilitates an evaluation against this expected improvement. In particular, interviewees stressed that the measure of an improvement in the business prospects relies on much more than an increase in the company's short-term trading performance, since the risks in the scheme may have outpaced any apparent trading upturn during this period.

An alternative to TPR providing covenant grades would be to facilitate trustees' use of the Experian rating, which is a key factor in setting the PPF levy. However, sample Experian rating reports on the PPF website suggest that at present this information is directed largely at professional advisers. Trustees would need a plain-English guide to the data and a clear explanation of the correlations between TPR's four covenant grades and Experian's 10 risk categories.

Trustees should be required to monitor potential levels of future PPF drift and report it to TPR via the annual scheme return.

7. As part of each funding review, employers should be required to provide an annual statement to the trustees about the prognosis for the business over the next three to five years, including any plans for corporate actions. This would align the regulation and governance of sponsoring employers with the concerns of trustees.

At present, TPR tends to take a fairly short-term view (e.g., 12 months) of impending insolvency, as one of the triggers for regulatory engagement or intervention. Trustees need a longer period over which to assess the sponsoring company's prognosis. The Financial Reporting Council's (FRC's) new governance code for quoted companies applies to directors' disclosure of the business's prognosis in the corporate annual report and accounts and requires a medium-term outlook, which is taken to mean three to five years.

We propose that TPR and the FRC jointly introduce an equivalent requirement for directors' disclosure to trustees who, as we have mentioned, are often the biggest unsecured creditors by far.

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- to undertake high quality research in all fields related to pensions.
- to communicate the results of that research to the academic and practitioner communities.
- to establish an international network of pensions researchers from a variety of disciplines.
- to provide expert independent advice to the pensions industry and government.

We take a fully multidisciplinary approach. For the first time, disciplines such as economics, finance, insurance and actuarial science through to accounting, corporate governance, law and regulation have been brought together in order to enhance strategic thinking, research and teaching in pensions. As the first and only UK academic research centre focused entirely on pensions, the Pensions Institute unites some of the world's leading experts in these fields in order to offer an integrated approach to solving the complex problems that arise in this field. The Pensions Institute undertakes research in a wide range of fields, including:

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The actuarial and insurance issues related to pension schemes, including risk management, asset liability management, funding, scheme design, annuities and guarantees.

Pension law and regulation
The legal aspects of pension schemes and pension fund management.

Pension accounting, taxation and administration
The operational aspects of running pension schemes.

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The practice and ethics of selling group and individual pension products.

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