Sackers

Security and sustainability in DB schemes

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Introduction

On 20 February 2017, the DWP published its Green Paper on DB private sector pensions, "Defined benefit pension schemes: security and sustainability". The Green Paper, which sets out evidence about key challenges facing DB schemes, wrestles with a vast array of feedback from commentators, concluding that there are a lot of issues and options to contend with. As a result, there are no firm proposals put forward by the Government, not even, as expected, in relation to indexation, but rather a number of questions are posed instead. Like Kermit the Frog, the Green Paper perhaps illustrates why it is not easy being green…

Key points

- The Work and Pensions Select Committee's recommendations in its pre-Christmas report for changes to pensions law have largely been reworked into questions for consultation.
- The Green Paper addresses a number of key themes, all of which have the potential to affect security and sustainability of DB schemes:
  - funding and investment
  - employer contributions and affordability
  - "special arrangements" for stressed sponsors and schemes
  - member protection and TPR's powers
  - consolidation of schemes, with options for benefit reform.
- Whilst recognising that the single biggest risk to members is the possible collapse of a scheme's sponsoring employer, the DWP's evidence suggests that DB pensions are affordable for the majority of employers (paragraphs 102 and 106). The DWP finds that "there is no single or immediate crisis in DB funding for the system as a whole" (paragraph 138).
- In general, the DWP believes that the regulatory regime for DB schemes is satisfactory, although it notes that there may be a case for limited changes to help employers and trustees manage liabilities more effectively in certain circumstances.
- Unsurprisingly, the DWP is keen to ensure that any proposals ultimately put forward take account of the danger posed by so-called "moral hazard" risks.
- The consultation closes on 14 May 2017 (not for the first time, on a Sunday).

Background

DB schemes have been under pressure for quite some time, with the cost of running such schemes having increased considerably over the last decade alone.

As the Green Paper recognises, the years following the financial crash in 2008 have been particularly challenging, “with record low interest and gilt rates driving up the cost of scheme liabilities compared to the increases in assets, thereby leading to increases in funding deficits.” This fact, combined with the number of high profile cases in 2016, including BHS and British Steel, has led some commentators to believe “that there is a fundamental problem with the funding and regulation of [DB] schemes”.

As well as drawing on the Work and Pensions Select Committee’s reports, the Green Paper also refers to the Interim Report of the PLSA’s DB Taskforce on factors contributing towards the struggles faced by DB schemes.

Funding and investment (paragraphs 142 – 197)

The Green Paper refers to the “widespread perception that some employers are unable to sustain their contributions, that deficits are substantial, and that members’ benefits are very much at risk”. One reason for this, the DWP suggests, is because the numbers involved are very large and often quoted without context.

Recognising that the scheme funding regime “is not designed to eliminate all risk to members’ benefits at all times” (paragraph 144), but rather to strike a reasonable balance between the demands on employers and the security of members’ benefits, the Green Paper notes that this is why DB schemes are underpinned by the PPF.

On investment, the Green Paper looks at a number of factors which some suggest are leading to overly cautious approaches, such as valuation measures that lead to short termism and an overly conservative investment strategy. Suggestions for change include giving TPR a more central role in influencing or determining the appropriate level of risk for individual schemes, and mandating or encouraging alternative valuation measures.

The DWP plans to carry out further research on the quality of trustees’ investment decision making, and to further investigate the factors that influence investment strategies and the choice of asset classes.

Employer contributions and affordability (paragraphs 198 – 290)

Although DB pensions are undoubtedly more expensive than when they were originally set up, this does not necessarily make them unaffordable for employers. According to the DWP, many employers could clear their pension deficit if required. The DWP has also found little evidence that scheme funding deficits are driving companies to insolvency and, in contrast, it believes that the majority of employers should be able to continue funding their schemes and managing the risk their schemes are running.

The Green Paper does, however, acknowledge that there is a wide range of circumstances for sponsors and schemes within the DB sector and that a tailored approach, targeting different measures at stressed schemes and sponsors in contrast to those where there is more affordability, may be appropriate.

Therefore, the Green Paper highlights a number of measures that have been suggested to help stressed schemes and their sponsors, including:

- allowing struggling businesses to separate from their sponsors more easily
- cutting or renegotiating benefits

- giving TPR a more workable power to separate the scheme from the sponsor or to wind up schemes in certain circumstances.

The DWP notes that all of the above options would need to be carefully policed. Allowing stressed employers to renegotiate pensions and potentially reduce benefits would, it states, "be a radical move and highly contentious, as it undermines the nature of the hard promise of a pension as deferred pay".

Indexation (paragraphs 271 – 285)

A further suggestion put forward by the Green Paper, and one which was greatly anticipated, is to review the current rules on indexation. Whilst the DWP does not find strong enough evidence to suggest that indexation should be abandoned or reduced across the board, it thinks that there may be a case to suspend indexation where an employer is stressed and its scheme is underfunded. Not for the first time, the possibility of conditional indexation is mooted, with a view to allowing indexation to be suspended in years when the scheme is in deficit and the employer is "unable to make up the deficit", with increases being restarted once the employer has recovered its resources.

Noting that some schemes have been left with indexation rules which may now be "anachronistic", having very little to do with protecting members' benefits against inflation, the Green Paper also looks at ways of rationalising indexation so as to "level [the] playing field across the sector". It therefore asks (at question 4(h)) "Should the Government consider a statutory over-ride to allow schemes to move to a different index, provided that protection against inflation is maintained?"

Member protection and TPR's powers (paragraphs 291 – 343)

Whilst protecting members' interests is at the heart of Government policy, the DWP stresses once again the need to strike a balance between the interests of members, sponsoring employers and PPF levy payers. However, it acknowledges concerns (shared by TPR) "that the current regime is not working as well as it could".

Options on the table include:

- strengthening TPR's powers – either explicitly in legislation, by giving TPR the power to set binding standards, or by TPR setting out its expectations in detailed codes or guidance

- requiring clearance to be sought in certain specified circumstances, whilst avoiding a blanket requirement

- strengthening the position of trustees – for example, by requiring employers and trustees to publish a joint statement of objectives for the pension scheme or requiring formal consultation with the trustees when a sponsor with a severely underfunded scheme is considering making dividend payments, and

- improving the language of member communications (including the annual benefit and funding statements) "to help members understand the risks and what might be done to mitigate them" in a DB scheme.

Consolidation of schemes (paragraphs 344 – 410)

The Green Paper outlines a number of potential advantages of consolidation, including:

- efficiencies and lower costs per member due to economies of scale

- access to more investment opportunities and a more sophisticated investment strategy

- improved standards of governance and trusteeship
- a more cost effective approach to buy-out for smaller schemes
- providing a potential solution to stressed schemes and sponsors.

Despite these potential benefits, the DWP notes that there are “significant issues that would need to be overcome in order to achieve meaningful consolidation, and the scale of the challenges should not be underestimated”. Considerable upfront costs, the need to improve data quality and the difficulties linked to consolidating schemes with different benefit structures, are just some of the hurdles highlighted.

Nonetheless, the DWP believes there is a strong case for voluntary consolidation and, whilst it is not minded to set up a “Superfund” to facilitate this, it is open to the possibility innovation in the market.[1]

Next steps

The consultation closes on 14 May 2017. The Government wants to hear from as many people as possible. This timing fits well with the PLSA’s DB Taskforce final report, which is due to be published in March. With the DWP prepared “to continue the debate and to start building a consensus”, it will be interesting to see what, if any, changes the Government ultimately makes to further support DB schemes.

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[1] The interim report of the PLSA’s DB Taskforce in October 2016 flagged consolidation as an area it would look at in its final report.