ASSOCIATION OF CONSULTING ACTUARIES

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22 June 2016

Pensions Consultation Team
Department for Work and Pensions
1st Floor, Caxton House
6-12 Tothill Street
London SW1H 9NA

Dear Sir / Madam

British Steel Pension Scheme

I am writing on behalf of the Association of Consulting Actuaries in response to the above consultation document dated 26 May 2016.

We have had some difficulty in responding to this consultation given that the specifics of the British Steel Pension Scheme (BSPS) are not all in the public domain. Moreover, we have found some of the content of the consultation document hard to follow. Nevertheless, we have the following key points to make:

1. Whilst acknowledging that this consultation is driven primarily by politics rather than pensions, we are concerned that the need to respond to the crisis within the steel industry may lead to rushed changes to well-established pension legislation with the potential for adverse and as yet unforeseen consequences. Therefore our initial reaction is for any solution to be found within the current legislative framework. In particular, we suggest that consideration is given to setting up a new scheme with lesser benefits, transfer to which is with member consent and facilitated through a regulatory apportionment arrangement under which those that don't transfer go into the Pension Protection Fund.

2. Failing this we would support a very narrow adjustment to section 67 of the Pensions Act 1995 to facilitate a reduction to benefits, but only for the BSPS, given the nature of its pension increase rule, and with no precedent established that this could be extended to other schemes.

3. We are opposed at the current time for any adjustments to be made to the bulk transfer without consent legislation. We do think that the PPF compensation rules need to be adjusted to remove the bridging pension anomaly. If in future it is determined that there should be an adjustment to the bulk transfer without consent legislation, we think it should not be restricted to large schemes.

However, we do feel that it is worthy of further exploration as to whether it would be appropriate to provide for a mechanism for the 600-1,000 DB schemes whose employers have such a weak covenant they are unlikely to able to deliver on their promises, in order that there is a viable alternative to the trustees demanding cash and forcing an insolvency with the scheme ending up in the PPF. This might continue to be the regulated apportionment arrangement, which we suggest should be critically re-evaluated given concerns that the conditions that need to be met are too strict and the timescales too slow. It could be an alternative mechanism through which an appropriate compromise could be reached, so long as the revised benefits are at least as good as PPF compensation. In either case, a facility to switch from RPI to CPI is desirable given the current legal lottery.

Finally we note in passing that the conditions that TPR and the PPF have set out in documents issued in August 2010 and January 2016 are wider than that relayed in paragraph 65 of the consultation document and were announced without consultation. It may be an opportune time to formally consult on these given the greater interest being shown in such arrangements in recent years.

Our comments on the specific questions you raised are set out in the Appendix.

We hope that you find our comments of assistance and would be happy to discuss them further if that is helpful. Please contact either my colleague Deborah Cooper on 020 7178 7184 (Deborah.R.Cooper@mercer.com) who prepared this response, or me on 020 7432 6635 (david.everett@lcp.uk.com).

Yours faithfully

David Everett
Chairman, Pension Schemes Committee
On behalf of the Association of Consulting Actuaries Limited

Sent by e-mail to: bsps.consultation@dwp.gsi.gov.uk

APPENDIX

The consultation has been published following approaches made to the Government by the Trustee of the British Steel Pension Scheme (BSPS) and the proposals are supported by Tata Steel. Its stated purpose is to:

- Seek views on the proposals; and
- Gather evidence on how to bring any measures into effect.

The Government considers the situation is exceptional because it wants steel production to continue in the UK and unless BSPS can be separated from the company no sale is likely to proceed. Although not explicitly stated, it would seem that another reason is that because the BSPS is large in absolute terms (in the top 20 of occupational schemes by assets) “normal” regulatory measures might not be sufficient.

We accept the first proposition, but consider the second to be dubious. When the current regulatory regime was introduced (with effect from 2005) all the large schemes we currently have existed and no special measures were envisaged. That is, it must have been accepted that the current regulatory regime, with regard to member security, was adequate across the whole universe of schemes. There has been some turnover in Parliament since then (just over a quarter of current MPs were also MPs when the Pensions Act 2004 was debated), so we understand the decisions reached then might surprise them. However, the position reached at the time was carefully considered, recognising that it was (and is) not possible to eliminate all financial risk in defined benefit pension provision.

It seems difficult, therefore, to overturn the current regime. In particular, we are concerned that the proposals made, particularly in relation to Option 4, whilst possibly meeting the objectives of the BSPS Trustee and Tata Steel, could have unfortunate repercussions for the rest of the industry. Consequently, whilst we have addressed the suggested options and the associated questions, we are putting forward an alternative proposal.

That is, as outlined in our letter, that consideration is given to setting up a new scheme with lesser benefits, transfer to which is with member consent and facilitated through a regulatory apportionment arrangement (RAA) under which those that don’t transfer go into the Pension Protection Fund.

The consultation explains that the Government has other motives for making its proposals. Paragraph 28 says that its “absolute priority” is to look after the workers and the community. We understand there could be social and economic reasons for facilitating a purchase of Tata Steel. The legislation applying to occupational pension schemes enables this via a RAA associated with a with-consent transfer to a scheme paying lower benefits. It seems risky to make hasty amendments to pensions legislation, with the purpose of addressing a non-pensions related problem. It seems short-sighted to assume that changes can be made in this case that won’t affect other schemes and their employers. If the current framework of pensions legislation is to be amended, there needs to be greater deliberation about why, and how, than this current consultation would permit.

Option 1: Use existing regulatory mechanisms to separate the BSPS

Consultation question 1: *Would existing regulatory levers be sufficient to achieve a good outcome for all concerned?*

Regardless of whether the existing regulatory levers, or the other options being consulted on, are used, there are no good outcomes for "all", since pension scheme members will likely get lower benefits than they had been led to expect. The question can only be answered relative to a particular objective. For example, if the objective is to release Tata Steel from its obligations towards the scheme, then a RAA associated with a transfer to the PPF is likely to result in a "good" outcome for it. Whether it results in a good outcome for members is less certain: if the objective is to provide more than PPF compensation for at least some members, then this will not result in a "good" outcome.

Paragraph 65 of the consultation document sets out three conditions TPR and the PPF "must be satisfied" with, before agreeing to a RAA. Although the matters listed (including, "the scheme will be significantly better off than in an insolvency") might be relevant, the relevant regulations only require TPR to consider it "reasonable" to agree to the proposed arrangement.

(In passing we note that the conditions that TPR and the PPF have set out in documents issued in August 2010 and January 2016[1] are wider than that relayed in paragraph 65 and were announced without consultation. It may be an opportune time to formally consult on these given the greater interest being shown in such arrangements in recent years.)

If the objective is to enable steel production to continue in the UK, with minimal effect on the employers and without amending the current regulatory regime, then we agree that a RAA associated with PPF entry seems the most obvious solution, but only so long as the 'price' demanded by TPR and the PPF is low. We expect and (despite paragraph 65) the consultation recognises that the "employer" to whom the liability would be apportioned would be a shell company, expected to become insolvent (technically, have a "qualifying insolvency event") once it has adopted the scheme liabilities and separated itself from Tata Steel. To the extent that Tata Steel either continues to operate or sells its business on, apart from the pension scheme, its creditors should continue to trade as normal. This is likely to be a "good" outcome for Tata Steel's suppliers, their employees and the communities they are based in, but (contrary to the suggestion in paragraph 65) it does not treat the scheme "fairly alongside other stakeholders", since scheme members will receive lower benefits as a result.

Option 2: Payment of Pension Debts

This option seems to have been ruled out, on the grounds that it is unaffordable. We agree with the premise, but there should be some discussion about whether Tata Steel should be required to contribute something to the process. It might be that, given the nature of the business, the money that Tata has already invested in it, and the contributions the employer has made to the scheme, the conclusion would be that Tata (and future owners) should have no further financial obligation towards the scheme. However, whether or not this is the case should be considered as part of constructing any solution, including (for the avoidance of doubt) the Options considered in the consultation document.

[1] "Statement by the Pensions Regulator: Regulated apportionment arrangements (RAAs) and employer insolvency" and "General Guidance for Restructuring & Insolvency Professionals".

With regard to Options 3 and 4, this means that, as well as considering how benefits can be reduced to make it possible for the scheme to continue outside the PPF, the question of Tata Steel or a successor employer having a one off or ongoing financial obligation towards the scheme should be considered. In particular, if there is a viable and profitable business post sale, to what extent should some of that profit (or, more likely, equity in the business) be directed towards the continuing scheme needs?

Option 3: Reduction of the Scheme's Liabilities Through Legislation

Consultation question 2: *Is it appropriate to make modifications of this type to members' benefits in order to improve the sustainability of a pension scheme?*

Consultation question 3: *Is there a case for disapplying the section 67 subsisting rights provisions for the BSPS in order to allow the scheme to reduce indexation and revaluation if it means that most (but not all) members would receive more than PPF levels of compensation?*

We address questions 2 and 3 jointly.

There are a range of issues that need to be addressed as part of this proposal:

1. Should the scheme be able to reduce benefits, using an amended section 67?
2. How will the benefits in the amended scheme be secured?
3. How are the different parties affected?

Should the scheme be able to reduce benefits, using an amended section 67?

We understand the BSPS provides for pensions to be indexed and revalued in line with increases in the RPI, for pre and post 1997 service, but subject to affordability. It could well be that the reference in the scheme's rules to the RPI was simply the result of the RPI being the prevailing inflation index at the time (and until recently). The Government's decision to use the CPI rather than the RPI to determine the rate of statutory indexation resulted in a lottery, where employers and members were winners or losers just because of template documentation used by their legal advisors. This was not a satisfactory outcome.

The proposal here is that, for future increases, RPI should be replaced with "statutory increases" which we understand means CPI for post 1997 service and none at all for pre 1997 service (other than on the GMP). Our view is that the ability to replace the RPI with the CPI should be made available to all schemes. This meets the intention of providing increases to compensate for rises in inflation, and addresses the increasing neglect by the National Statistician of the RPI, which at some point is likely to make it an entirely inappropriate index. Although the consultation document is silent on using section 68 to achieve the change in indexation required in relation to the BSPS, we do wonder whether it would be possible to use it to affect a change from RPI to CPI.

It is a bigger step for any scheme to remove pre 1997 indexation entirely. Unless there is something in the rules that suggests there was no intention to always provide the indexation currently expected under the rules, providing for one scheme to ignore its rules and not others seems an arbitrary step.

However, if a scheme's rules include (for example) a provision that enables its trustees to decide not to pay increases if the scheme were underfunded (a Financial Times article suggested this was the case for the BSPS and this has subsequently been broadly confirmed), then this would be a good reason to decide that there ought not to be a "subsisting right" to a particular level of indexation, as defined in section 67, and the legislative provision can be amended.

Section 67 does provide for benefits to be reduced with member consent. As the consultation document suggests, gaining consent from BSPS members could be difficult. However, although the size of the scheme affects the logistics, it does not make it, relatively speaking, any more expensive. The main problems would be that it could take some time to achieve and numbers consenting might be low, and the delay might discourage Tata Steel and any potential purchasers from taking part in the process. There is also no fall back to deal with the non-consenters. Since the Government acknowledges these are exceptional circumstances, perhaps it could provide temporary guarantees whilst the consent is being sought, to give potential purchasers comfort that they will not face unanticipated liabilities. A precedent has been set for this in the case of the banking sector and the quasi nationalisation of Lloyd's bank and RBS.

How will the benefits in the amended scheme be secured?

The objective behind Option 3 seems to be to keep the whole scheme out of the PPF, as far as possible. Although, superficially, reducing benefits appears to make the scheme's future seem more viable there is more to it than that, particularly since it seems unlikely the scheme will have material access to a new employer's covenant. Even after the proposed amendment, the scheme will still be massive relative to the business being sold, and if the business's future is not strong, the new employer might not remain solvent, in which case the objective will not have been met.

Thus, if the objective is also to facilitate a sale, an alternative employer will have to be found. That is, questions that only seem to be considered in relation to Option 4, about the employer in relation to the scheme, are also relevant to Option 3.

So the question remains: who underwrites the risk of adverse experience in relation to the scheme? As discussed, it seems futile for this to be Tata Steel's purchaser, although in the event that the new employer is profitable that might need to be revisited. Nonetheless, in our view some entity separate from steel production would need to be established. The BSPS Trustee is already incorporated: it is possible that its functions could be extended to include this responsibility, for example, in which case, effectively, the PPF would directly underwrite the arrangement. Alternatively, another financial sector organisation, with appropriate expertise and a financial interest in managing the assets, might be interested, subject to certain agreements and controls.

In that case, what would PPF (and TPR's) involvement be with the arrangement, given there would not be a third party with access to separate assets (that is, an employer in the 'traditional' sense) to act as buffer? In particular, what reassurance could be made to the solvent employers of DB schemes, which support the PPF, that the BSPS will not subsequently enter the PPF, possibly with a larger deficit?

How are the different parties affected?

In our view, the considerations listed in paragraph 65 are equally relevant for Options 3 and 4. Under Option 3, the consultation document particularly considers the benefits that would be provided in the amended scheme relative to the compensation that the PPF would provide. Although broadly relevant, certain aspects of it seem specious. Particularly when considering whether all stakeholders are being treated "fairly", the primary concern should be how the revised benefit structure compares to the benefits members could have expected had the scheme continued to run but not been amended. The answer is "not well", since they will all, almost certainly, be worse off, whereas if the company is sold and the successor company manages to survive, its employees, shareholders and creditors will not be worse off.

Although we agree the relative value of PPF compensation should not be ignored, since this is more likely than a continuing unamended scheme, the fact that PPF compensation for members with bridging pensions at an assessment date is overly generous is an unfortunate distraction which we believe requires attention by adjusting the PPF compensation provisions so that temporary scheme pensions are mirrored by temporary PPF compensation. The fact that some members will be better off if they enter the PPF should not be used to influence a decision in relation to the other members: it only indicates that there are areas of PPF compensation that should be amended, for the contract between it and the employers that fund it, and between the members that are unfortunate enough to fall into it, to be considered fair.

Option 4: Transfer to a New Scheme

Consultation question 4: *Is there a case for making regulatory changes to allow trustees to transfer scheme members into a new successor scheme with reduced benefit entitlement without consent, in order to ensure they would receive better than PPF level benefits?*

Assuming it is agreed that the employer under Option 3 will not be Tata Steel's purchaser, Option 4 and Option 3 are broadly similar. The only material difference is that, by creating a new scheme and introducing the opt-out process, Option 4 directly enables some members to receive PPF compensation instead. The only reason this is being considered is to give those members with bridging pensions and aged less than state pension age access to PPF compensation, since it will be better for them than the alternatives (potentially also including the scheme benefits without amendment). This is absurd. If "fairness" is to be a consideration, then (apart from the members with bridging pensions) the groups immediately affected, including Tata Steel and any successor company, are likely to be neutral about this, but those employers that continue to support defined benefit schemes should not be, since they will be required to pick up the cost.

If the transfer were to take place on a no consent basis, then this objection would go away, since bridging pensions would no longer be over protected relative to other benefits (although the trustees might have difficulty in convincing themselves that is was in members' interests to use this power). Since this seems unlikely, before proceeding with this option PPF compensation should be amended (as it should in any event) so as not to result in (at least relatively speaking) windfall gains to a significant class of member.

In addition, if legislation is used to facilitate this route, we think it should apply to all schemes meeting the criteria, regardless of size.

Governance of the New Scheme

Consultation question 5: *How would a new scheme best be run and governed?*

This question is not only relevant to a "new" scheme, but also applies to the existing scheme under Option 3. The Trustee is being expected to run the scheme on in a way that provides the (adjusted) benefits with a high degree of probability and without posing undue risk to the PPF.

Although not identical, these objectives are similar to those insurance companies have. However, there are differences:

- Insurance companies can raise capital from shareholders or other sources in the event that experience is adverse.
- Insurance companies carry reserves to protect against adverse experience that their investors expect to be released as profit if experience is favourable.

Normally, employers act as "reserve capital" for their occupational pension schemes, but the revised BSPS presumably will not have access to such an employer. We discuss treatment of surplus under question 6.

We expect the members would want the scheme to be run similarly to an insurance company. However, because of the differences mentioned and the absence of regulatory capital at the outset, this is unlikely to be possible. Nonetheless, similar considerations could apply:

- The Trustee board could be required to meet stronger competence standards than currently apply under pensions legislation. Advisors also should be subject to regulatory scrutiny.
- Any discretion permitted under the rules should be appropriately constrained and option factors reviewed.
- Investment strategy should be mindful of member security and should ideally aim for reduced volatility.
- If thought necessary, TPR and the PPF could be given enhanced oversight responsibilities in relation to the scheme.

Consultation question 6: *How might the Government best ensure that any surplus is used in the best interest of the scheme's members?*

The proposal is that the "cash equivalent" value of members' revised benefits would be transferred to the new scheme. We expect this would be a weaker basis than the technical provisions. In that case, the funding level of the new scheme might be weaker than the BSPS, which would benefit the PPF should the "rump" BSPS fall into the PPF. It also places the trustees of the new scheme in a relatively precarious position, since they only have "best estimate" rather than "prudent" reserves to finance the benefits. In this position, worrying about distribution of surplus seems premature. However:

- There is no entirely fair outcome. The scheme is so large and covers a wide range of members, so some forms of cross subsidy (intergenerational in particular) are likely to be inevitable.
- The status of "surplus" should depend on the governance structure of the scheme. To the extent that someone other than the members take risk (for example, the PPF and other DB sponsors) there is a case for surplus to be distributed more widely.

What the Draft Regulations Would Say

Consultation question 7: *What conditions need to be met to ensure that regulations achieve the objective of allowing TSUK to reduce the levels of indexation and revaluation* *payable on future payment of accrued pension in the BSPS without the need for member consent, balancing the need to ensure that member's rights are not unduly compromised?*

Consultation question 8: *What conditions need to be met to ensure that regulations achieve the objective of allowing trustees to transfer members to a new scheme without the need for member consent, balancing the need to ensure that members' rights are not unduly compromised?*

The key consideration in relation to any regulatory change is to ensure that the members' access to PPF compensation is not compromised. Provided the changes are sanctioned by TPR, so a "qualifying insolvency event" can still occur in relation to the scheme, and are restricted to indexation and revaluation, we expect that, if a PPF assessment period was subsequently triggered then the benefits used to establish compensation at that point should be no lower than the benefits that would now be used to establish compensation – that is, the "back stop" remains the same. Apart from that, the matters to take into account relate to ensuring the Trustee cannot act in a way that increases the risk exposure of the PPF and those employers that continue to support it via their schemes' levy payments.

We disagree with the premise that legislative changes should be restricted to the BSPS or to a subset of large schemes.

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