ASSOCIATION OF CONSULTING ACTUARIES

Association of Consulting Actuaries Limited · First Floor · Regis House · 45 King William Street · London · EC4R 9AN
Tel: +44 (0)20 3102 6761 · Email: acahelp@aca.org.uk · Web: www.aca.org.uk

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Ashok Gupta
DB Taskforce Chair
Pensions and Lifetime Savings Association
Cheapside House
138 Cheapside
London EC2V 6AE

Dear Ashok

DB Taskforce: call for evidence

I am writing on behalf of the Association of Consulting Actuaries in response to your DB Taskforce's call for evidence. I am sorry for failing to respond by your deadline.

We welcome the opportunity to contribute to this important initiative – a topic that the Government ought to be looking into, as it has the overarching responsibility to ensure that private sector DB schemes operate within the most appropriate framework. However, when you look back at the development of DB schemes over the past 30 or so years it is apparent that Government has far too often been part of the problem rather than contributing to the solution.

Our thoughts are set out in the Appendix. We have chosen not to respond directly to the various questions that you have set, but have provided some signposts in order that you can relate our thoughts back to your document.

We hope that you will find our submission of assistance and would be happy to discuss further if that is helpful.

Yours sincerely

David Everett

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

Sent by e-mail to: DBTaskforce@plsa.co.uk

APPENDIX

The DB landscape

The reality is that DB schemes are in run off – with all that this means

The vast majority of private sector DB schemes are now in run off and there is no getting away from this. It did not have to be this way, but because of the numerous factors so ably summarised in your paper (and with which we broadly agree), we are where we are and we cannot see this changing. This is important, because it severely limits the cross-generation subsidy that had been at the heart of DB provision as well as constraining the type of investments that trustees should reasonably consider. We are no longer in a world where a very useful side-benefit of collective investment via DB is to support economic growth through investment in risk-seeking assets. There was the prospect of returning to some of this world through the defined ambition agenda, but it came too late and in any event fell off the Government's priority list last autumn. Schemes increasingly need to follow an investment strategy that pays close regard to prospective benefit cash flows. Whilst such an approach may not foster long-term economic growth, it is hard to see how trustees can pursue any other course under the current regulatory regime.

It is great shame that what has been a great success in delivering stable retirement income for much of the currently retired population, conceived and delivered many decades ago with a blend of altruistic and commercial reasons, should now have become such an issue for UK plc. We will discover in the years to come that the DC replacement has as many if not more issues, when it comes to delivering stable retirement income, if it ever gets beyond the more fundamental issue of adequacy.

Why DB deficits are persistent

The fundamental reason why DB schemes remain in deficit, despite over ten years of the current regulatory regime in which many employers have put in substantial deficit repair contributions, is poor investment returns accompanied by the need to measure liabilities against an investment benchmark whose yields have fallen, especially since the 2008 financial crisis. Until there is a return to a more normal economic environment, deficits for the vast majority of schemes will not be capable of being repaired at the speed with which many desire.

There have been suggestions from a number of quarters that measurement is part of the problem. We reject the implicit suggestion that alchemy has a role to play in restoring the health of DB schemes. The cold hard reality is that DB schemes are in deficit, often by a considerable amount, because of the economic circumstances in which they find themselves, along with their room for manoeuvre being extremely limited due to successive Governments turning the pension promise into a cast iron guarantee. Private sector DB was never intended to be an insured style corporate promise, but rather a means by which a company could fund for and deliver stable retirement income for its ex-employees. In the desire to ensure that there are no losers, we have completely lost sight of this.

If DB schemes were not in run off and the economic environment was benign, then it might be possible to return to a world where a higher discount rate would be possible, but not in the situation in which we find ourselves, where, for sound reasons, equity investment is now a smaller part of most DB schemes' investment portfolio and real yields are negative.

Examining the challenges

Should changes be made to the current regulatory regime?

It seems to us that the current protective regulatory regime that has been built up over the decades needs to remain in place, because to seriously tamper with it, in the face of stubborn deficits, risks pension promises made by employers to their employees in the past and on which largely now ex-employees are relying, being seriously undermined. But that is not to say that nothing should be done – far from it.

1. Schemes should be able to switch to a CPI measure of inflation

Some flexibility does need to return to the DB system, even in run off. DB schemes are excellent at delivering stable retirement incomes, but they should not be forced to deliver against promises that are now outdated but which have been hard coded by Government action. We are thinking in particular of the inflation measure that is used to reference pension increases. The continual use of the Retail Prices Index is now an anachronism in the light of it ceasing to be an official statistic and its replacement by the Consumer Prices Index. All DB schemes should have the right to be able to switch to the CPI and no longer be held hostage by, what for many could well be an accident of the drafting approach taken by those responsible for constructing the Trust documents many decades ago. Whilst it is true that such a move will deliver a lower overall retirement income over the course of an individual’s retirement, it does seem to be an entirely reasonable compromise, and something which would likely have happened in the ordinary course of events, were it not for the blockage presented by section 67 of the Pensions Act 1995 – most recently exposed in the British Steel case.

2. Schemes should be able to provide for accrued benefits to commence from a later retirement age

The Government was able to adjust the State Pension Age in order to keep the cost of its DB state pension system within what it felt to be affordable limits. We see no reason why employers should not be permitted to do the same, subject to the necessary safeguards being in place. It is far more important that DB schemes deliver a stable retirement income when it is needed than be artificially constrained to deliver against promises made decades ago when the outlook for longevity was not as promising as it has become in recent times.

Such adjustments to DB provision could well have happened in the normal course of events, were it not for the imposition of Section 67 of the Pensions Act 1995 – a Government-imposed solution to a problem that many thought did not exist given the pre-existing more general protections of trust law.

3. The Government should not add further costs and constraints to the current regulatory regime unless absolutely necessary

The Government should make an early announcement that it is not going to proceed with legislation that will force nearly all DB schemes to submit to an expensive, time-consuming and for many members, largely irrelevant exercise under which accrued benefits need to be adjusted to compensate for the sex-based inequalities introduced into them as a direct result of Government legislation in relation to GMPs dating from the mid-1970s. The legal basis for introducing such legislation has always been doubtful and now that the UK is on a firm path to leaving the European Union, most likely through an arrangement that will see it placed outside the single market, within a handful of years it will no longer be subject to future decisions of the European Court of Justice, still less feel under an obligation to gold plate decisions taken over 25 years ago.

Such an announcement would not only lift the prospective burden of having to carry out this exercise; it would also deliver much-needed certainty to the marketplace, including to buyouts.

The Government should also choose not to implement IORP II, but instead analyse which aspects are genuinely in the UK public interest in relation to both DB and DC schemes and bring forward separate UK legislation when appropriate.

4. The Government should prioritise subjecting the regulatory regime of its own making to regular health checks

There have been a handful of cross-Government red tape initiatives in the past, all of which have failed. The Department for Work and Pensions consulted recently of its own volition, on which subsequently there has been silence. The essential problem with these initiatives is that they are run by politicians whose time in office is short, backed up by civil servants who will be reluctant to take down edifices that they have so painstakingly constructed. The red tape initiatives themselves only come along because of a desire by senior politicians to be seen to slay dragons and they develop their own curious measurement processes under which anything that is despatched (no matter how trivial) counts as a fabled beast.

It needs a different approach in order to achieve success in this area. All of a regulatory regime needs to be kept under review and as time passes, adjustments made to it, which means losing things as well as adding. But under the Westminster model, resource is allocated only to shiny new initiatives, or in response to problems that have blown up. No-one is charged with assessing the health of the established regime on an on-going basis and making necessary and largely uncontroversial changes to it. Still less does it seem possible to take some piece of law that has unwittingly caused untold damage and ask that with the benefit of hindsight was it ever necessary to introduce it in the first place and what public good has it actually achieved?

Dealing with stressed schemes

It is clear to all that there are a number of DB schemes that are most unlikely to ever return to a position where they will be able to meet the pension promises that have been made, even if the UK returns to more normal economic circumstances. It does seem that the regulatory regime needs to acknowledge this fact and instead of waiting for the sponsoring employer to experience an insolvency event, some other solution should be found under which the pension promises can be reduced, or otherwise adjusted through a compromise that has as an important part of it a far greater likelihood that the benefits that have been reset will be delivered.

The Pension Protection Fund should continue to provide the backstop for the unexpected insolvency of employers with underfunded DB schemes, but should have removed from it the prospect of having to pick up those schemes that can be restructured. Quite how this is built into the current protective regulatory regime is worthy of separate exploration. At the current time, such restructurings are only possible through creative (for which read expensive and time-consuming) use of regulatory tools that were not designed for this purpose.

Consolidation of DB schemes is a topic worth exploring

There is indeed something about the contention that now we are in run off, having many relatively small schemes is sub-optimal in terms of governance and quite possibly investment performance, let alone regulatory oversight. In other market sectors there would be scope for consolidation (for example in with profit funds), but it seems to have not got beyond the talking stage with DB schemes.

It seems to us that it would be possible to set up multi-employer schemes on a cross-industry basis, either on a segregated or non-segregated basis. But rather than just let this happen, as has been the experience with DC master trusts, with the Government belatedly waking up to the attendant risks, there should be a proper exploration of the idea by interested parties, with the possibility of such structures being subject to special regulatory considerations. One possibility would be for legislation to facilitate conversion of historic benefit structures to a simplified scale, perhaps mirroring the treatment undertaken when a scheme enters the Pension Protection Fund.

The PPF is, of course, the one consolidator already in existence, so were new consolidators to be facilitated, how they would co-exist alongside the PPF would need to be established.