



ABI RESPONSE TO WORK AND PENSIONS COMMITTEE CALL FOR WRITTEN SUBMISSIONS ON DEFINED BENEFIT FUNDS

About the ABI

The Association of British Insurers (ABI) is the leading trade association for insurers and providers of long term savings. Our 250 members include most household names and specialist providers who contribute £12billion in taxes and manage investments of £1.8 trillion.

Executive Summary

- Action based on a realistic consideration of the issues is required to ensure the right balance between the different classes of scheme members and business.
- Insurers have an important part to play in helping manage the risks posed by DB schemes and have already taken on responsibility for nearly 1m lives through buy-outs, buy-ins and longevity swaps.
- More openness is required not only about the extent of the potential issues but also to enable early intervention to allow de-risking and potentially better outcomes for the range of stakeholders as well as to ease pressure on the PPF.
- The PPF is an important safety net but there are a number of ways in which its operation could be improved.
- Trustees have an increasingly difficult role. Consideration needs to be given to ensuring they are given better and more complete information, to reduce inherent conflicts in their role and to better equip them to undertake their duties.
- The corporate viability objective not only adds to the pressure on trustees but potentially makes it less likely that 'stressed' situations will be optimally resolved.

Introduction

1. The ABI very much welcomes the decision by the Work and Pensions Committee to scrutinise the subject of Defined Benefit Funds and is grateful for the opportunity to comment. Although we expect the Committee to devote much of its attention to the lessons to be learnt from the BHS situation, we have restricted our comments to a more general consideration of Defined Benefit Funds.
2. This is an area which requires rapid and robust action to ensure the right balance between the interests of different classes of scheme members (pensioners and those with deferred benefits) and business - which can only be effective if it is based on a transparent and realistic consideration of the issues.

3. Insurers have an important part to play in helping manage the risks to DB schemes and their sponsoring employers, offering a range of solutions including 'buy-outs.', 'buy-ins' and longevity swaps. In 2015, through these solutions insurers accounted for the cover of nearly 1m lives.
4. Importantly, these are not solutions of last resort but in many cases have become the preferred way to transfer risks from a DB pension scheme. For instance a buy-out¹, is considered as the 'end step' in a phased de-risking solution, including liability management exercises (enhanced transfer values or ETV, pensions increase exchanges or PIE, and enhanced early retirement) designed to provide members with more choice and improve the funding situation for remaining members.
5. Buy-outs can be a very powerful tool in a company's and trustees' armoury to facilitate a corporate transaction and insurers can provide tailored and innovative solutions to suit the circumstances and budget of individual schemes.
6. Some companies will become insolvent. This is an inevitable and expected function of a market economy. However, whilst this is part of the natural ebb and flow of business, it is right that there should be a safety net to mitigate the loss to pension scheme members where the result of a corporate insolvency is to leave a scheme without a sponsor.
7. However, up to 1000 private-sector DB schemes are 'stressed' and unlikely to pay member pensions in full. Over half of these are unlikely to ever pay full benefits. For others the sponsoring employer may itself be viable but the scheme deficit is unsustainable². The scale of the potential problem has obviously been brought into sharp focus by recent events around British Steel and BHS.
8. Therefore, whilst the Pension Protection Fund (PPF) is 'a good thing', it is not perfect. Given the scale of the emerging problem, the operation of the PPF and the role and interaction of the various other relevant stakeholders, especially pension fund trustees, needs careful consideration if the best possible result for members of stressed schemes – and other affected stakeholders – is to be achieved. The ideal outcome has been described by the Pensions Institute as, "the greatest good for the greatest number"³.
9. The following comments broadly follow the headings set out on the UK Parliament website but place particular emphasis on the role of trustees, the context within which they must fulfil their obligations and identified shortcomings in the PPF.

¹ Buy-out is a broad term used to cover situations where the assets and liabilities of a pension scheme are taken over by an insurance company.

² Cass Business School / Pensions Institute "The Greatest Good for the Greatest Number" December 2015 page 8

³ Cass Business School / Pensions Institute "The Greatest Good for the Greatest Number" December 2015 - title

Pension Protection Fund

10. As noted above, we support the concept of the PPF but we suggest below that there are ways its operation could be improved. However, it is not just the operation of the PPF itself but how it fits in with the wider stressed scheme scenario, particularly in how it is factored into the decision making of trustees where reform might be most helpful.
11. Furthermore, although there are already some limitations on pay-outs by the PPF, a number of anomalies remain which inevitably impact on those who have to pay levies to the fund. We believe that it is possible to correct some of these anomalies without unfairly penalising those paid by the fund, consequently easing the position of the PPF and/or reducing the burden on levy payers.
12. The compensation cliff edge between those either side of Normal Retirement Age (NRA) could usefully be tackled, perhaps making any restrictions simply a function of age and service. This would also address current anomalies where different schemes for one employer have different NRAs or they differ between executives and staff. Failing that, these should be levelled up.
13. This would also remove the potential temptation for pre-NRA directors with large pension promises to allow a company to drift on into insolvency until they reach NRA, rather than managing an orderly winding up of the business at an earlier date and with a lower or no burden on the PPF. It is axiomatic that allowing this sort of drift must also be bad for other levy payers.
14. Implementation of the service dependent maximum PPF compensation already passed by Parliament will be a useful step in this direction and we are pleased to see the very recent publication by DWP of a consultation on the relevant draft legislation.
15. Anomalies around bridging pensions are an obvious area for reform. Because the PPF assessment is based on a one-off snapshot, anyone who has opted for a bridging pension with, for instance, a step down at State Pension Age, will receive a windfall, funded by the PPF. It would seem obvious to allow the PPF to apply the same step down. Similarly, anomalies around the loss of potential GMP 'step ups' could usefully be addressed.
16. Consideration could be given to restricting the level of indexation increases, for instance restricting increases to statutorily prescribed levels for funds funded below PPF.

17. An alternative might be to restrict pension increases to being statutory only for funds under [90%] and where the covenant is weak⁴. Such a restriction could be removed if companies can demonstrate their support for the fund or their covenant strength to the satisfaction of the PPF.
18. Although once PPF assessment commences pensions payable are capped, the amount to which these caps apply and hence the capped amount can still increase through the award of increases by the scheme over and above those payable by the PPF. To mitigate the consequent increased cost to the PPF (and levy payers) compensation could be frozen whilst a scheme is funded below PPF (S179). In effect the assessment date for determining PPF compensation becomes a date in the past. This is to stop PPF drift making deficits worse and increasing the burden on other levy payers. This would be a simple change that has a low impact on trustee costs.
19. Consideration might also be given to giving the PPF powers to intervene earlier where the covenant is weak. So mitigating the ultimate exposure of the PPF and the burden on levy payers – possibly giving the PPF a role in framing investment policy or even putting a scheme into assessment earlier than is currently required.

Role and Powers of Pension Fund Trustees

20. The role of fund trustees is critical in reaching an optimal solution where a scheme is under stress. However, trustees are in an increasingly difficult position and this is not necessarily fully appreciated. For instance, the Pensions Institute suggests that, “the crushing reality of the situation in which trustees of stressed schemes find themselves is not publicly acknowledged and debated. This collective ‘silence’ serves to stifle the development of practical damage-limitation strategies...⁵”
21. The primary duty of trustees is to ensure members’ pensions are paid in full. This sounds intuitive but in a stressed situation, it will not necessarily yield the best (or least bad) outcome for members or for the PPF.
22. So, arguably, the key question to be faced is whether trustees should be striving to ensure full benefits until an irrevocable crisis point is reached or in a stressed situation be enabled to act earlier when a generally better outcome (though short of full payment) may still be achieved – achieving as above, the greatest good for the greatest number and ultimately putting less stress on the PPF. In other words, whether there should be a greater emphasis on the potential to de-risk schemes at an earlier date.

⁴ The Pensions Regulator already provides guidance for employers, advisers and trustees on assessing the strength of a covenant – see <http://www.thepensionsregulator.gov.uk/guidance/guidance-assessing-monitoring-employer-covenant.aspx>

⁵ Cass Business School / Pensions Institute “The Greatest Good for the Greatest Number” December 2015 (page 5)

23. Indeed, enabling trustees to act earlier and be more open with members about the reality of their position could better enable potential opportunities to be taken for de-risking through buy-outs etc.
24. This quandary for trustees has been exacerbated by the recent explicit requirement for trustees to balance the interest of members with regard for the viability of the sponsoring employer (to which we return below).
25. This is one among a range of factors which make it difficult for trustees to act in the best interest of all the members they serve and other stakeholders:
 - Trustees are expected to act as if the PPF does not exist - as if they are 'uninsured', meaning that the PPF will potentially have to pick up more of a mess than if the inevitable were recognised earlier on allowing an optimum 'glide path' to PPF intervention or a buy-out by an insurer.
 - Trustees do not have access to all the information they need to make the necessary judgements. Not only are they not told by the Regulator if the Regulator views their covenant as weak but they may not be made fully aware of planned corporate actions which might impact any fund deficit.
 - It would therefore not be surprising if, at least some, trustees, feel out of their depth – many are unpaid volunteers. However, despite this, trustees may be uncertain about seeking professional advice in support, given that TPR requires costs to be proportionate.
26. Emphasis on full benefits at all costs may also impact on investment strategy, prompting trustees to make more risky investments (such as in equities) to try and mitigate a developing deficit. Although this may pay off, if it does not and leads to returns which are lower than gilt yields, the deficit will rise, – i.e. effectively there will be a greater unsecured debt from the sponsoring employer. Consequently outcomes for members may be further compromised and/or the risk that the shortfall ultimately picked up by the PPF is increased. As noted below this is likely to be exacerbated given the new objective for trustees of balancing the interest of members with the sustainability of the sponsoring employer.

Relationship between TPR, PPF, trustees and sponsoring employers

27. As illustrated elsewhere in this submission, there are a number of ways in which, in a stressed situation, conflicts between the interests of the various stakeholders prevent the fairest and most cost effective outcome being achieved. For instance:
 - Trustees are conflicted in their responsibility to members and in light of the 2014 objective, to their sponsoring employer.
 - Trustees are enjoined to act as if PPF did not exist, encouraging strategies which could ultimately disadvantage both members and the PPF.

28. Greater openness between stakeholders and indeed collective pragmatism about the correct objectives and optimal strategies in stressed situations is key to improving the situation. The PPF assessment period is triggered by sponsor insolvency – we have commented above about the potential for earlier PPF intervention, but short of that earlier dialogue and cooperation between the PPF, sponsors and trustees could be helpful. This is especially the case for small and mid-sized funds as inevitably the Pensions Regulator is focussed on the larger problematic cases
29. However, also key is emphasising the potential role of insurers in providing de-risking solutions such as buy-outs, buy-ins and longevity swaps as explained in our introduction.

The Balance between meeting pension obligations and ensuring the ongoing viability of sponsoring employers

30. Under the 2014 objective, TPR expects trustees to consider carefully a sponsoring employer's request to reduce contributions to the scheme in order to increase investment in the business – the basic premise being that the best way of ensuring members get full benefits is to ensure the health of the sponsoring employer. However, this is overly simplistic and makes the position of trustees even more difficult. Not only are they being exhorted to allow what is effectively a debt from an unsecured creditor to increase, it is putting an even greater onus on trustees to make effective decisions in light of not only the position of the pension fund but that of the sponsoring employer.
31. It also brings into question the action trustees should take in the best interests of all the members they serve, if “the employer is not strong, is unlikely to prosper, and cannot realistically be relied upon to pay member benefits in full”⁶?
32. As noted above, trustees do not necessarily feel equipped for their role but may feel constrained in taking professional advice. This is further exacerbated where they are having to make judgements to take into account the sustainability of the employer, and in the face of an effective requirement to allow the sponsor to retain money in the business at the expense of the pension scheme, are required to make a clear case for rejecting any request by the sponsoring employer to reduce contributions.

⁶ Cass Business School / Pensions Institute “The Greatest Good for the Greatest Number” December 2015 (page 11)

33. Inevitably, they face a conflict between prioritising members' interest (and asking the sponsor for higher premiums) or putting the sponsor's business first, potentially reducing benefits for members in the event of the sponsor's insolvency. This may also exacerbate the tendency to invest in more risky asset classes as, in the absence of further contributions from their sponsor, this may appear to be their only option to try and reduce the deficit (even though a low risk strategy might be more appropriate given their increasing exposure to a potentially unstable employer).
34. So not only is there a risk that the failing employer will hang onto and ultimately lose money which could have supported the pension scheme, the scheme itself could be forced into less prudent strategies – ultimately impacting on the PPF.

Proposals

35. We have listed above a number of issues [paras 10 to 19 above] with the PPF which we believe should be tackled. These aside the ABI is very conscious that this is a difficult area with a range of different views on appropriate measures. The following suggestions are therefore not firm proposals but more suggestions of possibilities which we believe would merit further consideration.
36. We believe measures which improve transparency about the strength of funds and their covenant with sponsoring employers would be helpful. This could enable earlier recognition of problems, providing more and timely opportunities for de-risking, better outcomes for members in the round, opportunities for buy-out etc. providers to intervene and potentially less stress on the PPF.
37. The roles and objectives of trustees should be carefully considered with a view to:
 - i. Ensuring trustees are fully informed, both in regard to TPR views of the relevant covenant and the position of their sponsor employer. For instance, UK companies could be required to provide a statement for the trustees of how they expect the covenant of the plan sponsors to evolve over the next 3-5 years and what the risks are.
 - ii. Mitigating conflicts of interest such as those created by the employer viability objective
 - iii. Allowing trustees to bear in mind the impact of the PPF and factor this in, in formulating their strategy in stressed situations.
 - iv. Introducing a requirement for pension funds' trustees to be accredited. Trusteeship has parallels to being an insurance company manager but without any real requirements on ability, skill or knowledge. Therefore requiring more stringent qualifications to be a 'professional' trustee could help raise standards.
 - v. Better equipping trustees to fulfil their roles, through training and clarifying their right to seek professional advice

- vi. Refining their core objective of ensuring payment of full benefits to allow timely consideration in stressed situations of solution which deliver the greatest benefit to the greatest number, albeit short of full payment, either through buy-outs or ensuring the best possible position on entry into the PPF.
38. It might also be worth enabling trustees to accept compromise offers from their sponsor within strictly defined parameters.