PensionsWorld

ROUND TABLE DB - a way out of the morass?

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A panel of experts chaired by editor Stephanie Hawthorne give their reactions to the DB Green Paper and the DB crisis**. Ceri Jones** reports

Left to right:

Stephanie Hawthorne, chair and editor, *Pensions World*

Paul Feathers, partner, Gowling WLG

Chris Martin, managing director, Independent Trustee Services

Sammy Cooper-Smith, co-head, business development, Rothesay Life

Francis Fernandes, actuary and senior adviser, Lincoln Pensions

Pensions World *Perhaps we could start with how many defined benefit (DB) schemes the panel believes are stressed with a weak covenant?*

Francis Fernandes It all depends on the definition of "stressed". Just over a year ago, Lincoln Pensions co-sponsored some research by the Pensions Institute (*The greatest good for the greatest number*), which found that of the 6,000 or so DB schemes, around 1,000 were under stress – materially underfunded and backed by weak employers. Of these, some 600 are in serious difficulties, with the prospect of never being able to pay full scheme benefits to their members.

PW *Has the recent Green Paper added anything to how we can put DB pensions on a sustainable footing?*

Sammy Cooper-Smith What the Green Paper has added is focus. Whether it gives rise to meaningful change, only time will tell, but the industry is now talking about it. It seems that the Green Paper starts off from the premise that there is no systemic problem and that no fundamental change is required. But not all the issues we have spoken about at Rothesay Life have been discussed, such as the anomalies in the structure of Pension Protection Fund (PPF) benefits and the Pensions Regulator's conflicting priorities between employers' interests and members' interests, between sustainable growth allowing employers to fund their own business and protecting members' interests. The PLSA Taskforce is focusing on gaining economies of scale for smaller schemes, but there are real issues as to how this idea would work over time.

PW *With your experience at BHS, Chris, do you agree with Steve Webb that the Green Paper is too timid?*

Chris Martin It is helpful in pulling together ideas that have been around in the industry for a few years, but I don't necessarily think it gives us any new direction. There is a great debate about how distressed DB schemes are, whether these amount to a thousand or a few hundred as the DWP says. The PLSA Taskforce is working on the basis of 50% of stressed schemes ending up not paying the full benefits members expect. However, perhaps we need to look at it differently.

Companies often fail for business reasons. We should focus attention on schemes where the scheme itself is the likely cause of failure. These are the ones we should be addressing.

PW *Richard Harrington says there is no systemic failure of DB. Would you go along with that?*

Paul Feathers I agree that the number of stressed sponsors depends on the meaning given to that term. The point Chris makes is a powerful one, which is whether the focus should be on addressing situations where the burden of funding the scheme is potentially going to cause the failure of the company.

When it becomes clear that this is a possibility, all stakeholders should be intervening to prevent that happening.

Fernandes There are so many moving parts, but I'm sure all of us around this table have seen many DB schemes that are like elephants supported on a rowing boat. By this, I mean schemes that are much, much larger than the sponsoring company and many of these companies are operating in a sector experiencing decline – for example, many in the industrials. I think there's often an obsession with binary outcomes – full scheme benefits or PPF compensation; whereas in many cases, scheme members might have been better served by securing something in between from a strong insurer.

Martin The law unfortunately drives us to binary outcomes. We have to pay full benefits or drive the scheme to the point where it fails.

PW *Should the law be changed? Is there a way around this?*

Feathers There have been cases where there has been some flexibility in terms of outcomes, but stakeholders have had to work really hard to get to these outcomes. It seems to have been more difficult than necessary. There need to be legislative changes. I was disappointed with the number of references in the Green Paper to moral hazards or the risk of flexibility being exploited. It seems to start from the position that it is all too difficult to make changes, but it cannot be beyond the wit of the pension community to help the government to find a route through for dealing with exceptional cases where the traditional solutions won't work well.

Fernandes What the Department for Work & Pensions (DWP) seems to be saying in many places in the Green Paper is that nothing extra really needs to be done. I would say that the DWP has a valid point because the Pensions Regulator does seem to have the powers, and the mechanics are there already. But it takes a brave Regulator, and a brave set of trustees and advisers to use all the tools, call time and set these mechanics in motion.

Martin The tools are in the toolbox, but some of them cannot be used until the sponsor becomes insolvent. If the Regulator and the PPF want to agree a Regulated Apportionment Arrangement (RAA), they have to wait for the employer to be inevitably insolvent. By this time, most of the value in the business has been destroyed.

Fernandes The Green Paper refers to all the powers available to the Regulator – personally, what I would have liked to have seen listed is how often the Regulator has actually used them! They seem to be infrequently used – perhaps due to a lack of resources or maybe even expertise. Critics might say it's simply a lack of guts. The Regulator will be forced to be more of a player than a referee.

Cooper-Smith Unless they have been involved in a previous process to compromise the Section 75 debt, then I am not sure that all trustees would know how this process works. There is training from the Regulator on various topics, but I am not sure if there is training available on RAAs and compromise agreements.

Martin There may be an education issue here, particularly for smaller schemes. The behaviour that the industry tries to shape is in the opposite direction. The industry is focused on how to carry on collecting the contributions as long as possible, rather than stepping back and considering if there is a better way to optimise member outcomes.

Feathers How clearly do trustees understand that PPF drift is good for their members? The more members that will not have their core benefits scaled back, the better from a trustee and deferred member perspective.

Martin And there is the issue of intergenerational fairness.

Cooper-Smith It is better for all members if the scheme is below PPF funding levels, so that every year people get another increase. The problem I have is that not all schemes know whether they are or not, because they may be ignoring the recovery from the insolvency of the employer. If you are above PPF funding, then PPF drift is no longer a universally good thing; it is just a re-allocation of scheme assets from younger members to older members.

Fernandes Some trustees are not aware of the importance of PPF drift for stressed schemes and have not been asking their actuaries to calculate it (perhaps because it will incur an additional cost!). So how can they assess the options to protect the interests of all scheme members? Many non-pensioners in schemes funded in excess of PPF but sponsored by weak employers are the ones bearing most of the risk in any risky investments that trustees are making. If they knew this, many of these deferred members might be better advised to take transfers out.

Feathers It is hard enough for professionals, let alone lay trustees. And let’s face it, the Regulator and the PPF are, quite reasonably, not going to be educating trustees about drift as a positive thing. It would be turkeys voting for Christmas.

Fernandes PPF drift should really be part of the triennial valuation reporting process by actuaries to trustees. Personally, I’m quite disappointed that this simple change has not yet been made by the actuarial profession.

***PW** What should be the role of the government, the Regulator and the PPF in all this? Are they doing a good job?*

Fernandes It is all about being proportionate, recognising the Regulator’s resources and the costs attached to advice, especially for smaller schemes.

There are a lot of small schemes and one question is how can the Regulator really keep an eye on them? Larger schemes have access to good advice, but perhaps a more mechanical solution is needed for smaller schemes, such as requiring a floor to PPF funding levels before non-statutory benefit increases can be awarded.

***PW** Is there anything more these bodies should do?*

Martin There is a lot the government could do. We have talked about some of the barriers to effective member outcomes because of the law.

We have heard a lot about switching from the Retail Prices Index (RPI) to the Consumer Prices Index (CPI) as a statutory override. We need to give proper empowerment to trustees to drive these processes and to make these decisions, if it means getting an outcome that is higher than PPF compensation.

Feathers The government must be brave. Changing pension legislation has never been a vote winner, but the government needs to do some of the things Chris has been talking about. How indexation is defined was not something that was much thought about when the scheme rules were written to incorporate post-1997 pension increases; it is now a lottery as to whether members receive RPI- or CPI-related increases. Draftsmen wouldn't have considered that defining the obligation by referring to the relevant statutory provision or to RPI would have a completely different outcome in the future. The government should accept that looking again at post-1997 pension increases is an easy win. Legislation adopting a single index in respect of statutory increases, regardless of the drafting in the rules, would restore the intended position and potentially relieve the financial strain on many schemes.

***PW** Should these measures be limited to stressed schemes?*

Feathers Therein lies the challenge! As soon as you start to apply a test, you get back to the original problem of how to define a stressed scheme. I would make the change across the board.

Martin Someone has to make a value judgment and I would put trustees at the front of that decision-making process.

***PW** Could this lead to a situation where sponsors are allowed to get out of their liabilities when they are perfectly viable?*

Fernandes To be sure that calling time is best for members when an employer is still solvent – that is the challenge. Stressed schemes, by their nature, are likely to be closer to the precipice than those backed by strong employer covenants. For stressed cases, hopefully, such action could enable trustees to secure benefits with an insurer that are better than PPF compensation. I'm not convinced that a simple change from RPI to CPI indexation will be the magic bullet. At the moment, securing CPI benefits with an insurer is a lot better than it used to be, but without enough CPI paper in issuance, insurers and banks will have to charge more to take on limited price indexation (LPI) benefits based on CPI. This means there could be a transfer of value from the member to the insurer or bank and it may not represent as good a deal as the trustees might have thought.

Feathers I am not suggesting that there should be an absolute requirement to secure CPI-related increases if CPI is the statutory measure, but adopting a single index for post-1997 pension increases could prevent some schemes from failing.

Fernandes A flat fixed increase could be more beneficial to members, as it's a formula that is far more straightforward for insurers to hedge in investment markets.

Cooper-Smith Scheme actuaries have been pricing CPI at, for instance, RPI less 70 basis points – and over the last few years the market derived cost, as in hedging, has not been at this level. I think over the last few months and looking forward that this perceived lack of value is reducing. This does not change the fact that if your increases are based on an index, then you need to hedge it, and there are trading costs. If you have a fixed increase, there is no hedge and no transaction costs required, so by definition going for fixed increases means that more money from the buyout cost is going to the member. That does not mean that over a member's lifetime they will be better off having fixed increases, because we do not know what will happen to inflation.

It is a hobby horse of mine that there is a cliff edge regarding PPF benefits, depending on when the member's birthday is. If you happen to pass normal retirement age (NRA), then for some people the benefits they receive change dramatically. There are other anomalies. British Steel made public, for example, that in its scheme higher pensions are paid prior to the state pension and then step down, but in the PPF that step down never occurs. Measures could be taken to change some of these issues. I might be doing people a major disservice here, but there are instances where some members are a lot better off if they can eke it out for just a few more months and cross NRA.

Feathers The PPF itself does not have any flexibility and is hidebound by legislation, so as regards Sammy's point change would need to be driven by the legislature.

Fernandes Perhaps it's time for the other levy payers to enter the fray to voice their concerns. If risk starts to really build up in the PPF system, then it will be the stronger employer-backed schemes that will pay the price through higher levies in the future. The prospect of hikes in cash calls might influence the more switched on stronger employers to close out their own risk and take their schemes to an insurance company, thereby removing themselves from the pool of future levy payers.

Cooper-Smith I believe a levy payer made the point in the consultation on their own behalf that they were not keen on schemes carrying on without a sponsor and still having access to the PPF, because ultimately if the scheme failed and entered the PPF, then the deficit would have to be paid by somebody – and that "somebody" is other healthy DB schemes and their employers.

It is a hobby horse of mine that there is a cliff edge regarding PPF benefits. Sammy Cooper-Smith

***PW** Turning now to de-risking, is the advice that nine times out of ten it makes sense to stay in a DB scheme still valid in the light of the high transfer values offered?*

Fernandes As a result of ultra low gilt yields, dizzying transfer value figures have been handed out to scheme members, making the transfer option very tempting. I think the decision to transfer also depends on the sponsor's covenant, but members and their IFAs are rarely given any information on this. The average person is led to believe that DB scheme benefits are 100% secure, whereas DC members bear all the risk – but this depends on just how strong the sponsor backing the DB promise is. If it's very weak, members should be thinking more about the PPF and any differences compared with the scheme, eg in benefit indexation – where a scheme promises attractive pre-1997 increases, these are incredibly valuable relative to PPF compensation increases which are zero on pre-1997 accruals. If the employer's covenant were very weak, so that the comparison is with the PPF, then a transfer might start to make sense.

Martin If the covenant is weak and the scheme underfunded, then the transfer may be scaled back anyway.

Cooper-Smith I would be surprised if nine out of ten would be better off staying put. This is because of selection issues. The transfer will pay a value based on a proportion of members being married. If members are single, then they might well be able to purchase a higher single life benefit than that being provided for by the scheme.It is the same with short life expectancy, as schemes pay on average life expectancy. So I am not sure that nine out of ten members are being paid less than fair value, but that does not mean they should take it. That is why people have to take advice. Sometimes it will be clearly in their interests but not for reasons of the discount rate.

Martin We also tend to forget that retirement is not the concept it was 20 years ago. Most of us expect to work in some form or other way beyond age 65 and to receive our retirement income from a mix of different sources.

Cooper-Smith Another consideration when you move your money to DC is that it is outside inheritance tax limits. So if you don't touch your DC pension, then under the new rules you may pass it all on to your estate. In DB, if you die, you lose it, although to plan on the basis that this will always be the case would be brave. Currently, we have a situation where for some people the money in their pension is the last pot of money they would use to fund their retirement.

***PW** There has been a call for partial DB to DC transfers. Is that fairly easy for a scheme to manage?*

Martin Some schemes have been doing it for years. It is more a trustee and sponsor policy point. They may, of course, want to encourage members to transfer all of their benefits.

Cooper-Smith There is a funding issue for trustees to consider here. Many schemes use a different transfer value basis from their cash commutation basis, with the transfers usually having a higher value to the member than the cash commutation. If I were a member being offered, for instance, 16:1 for cash commutation and 20:1 for transfer, I would consider taking 25% of the transfer into DC and then take it as cash. I have then improved my cash commutation basis and the saving that the scheme makes by not having cash commutation at the same level disappears. So there is a slight downside to partial transfers on the funding of the scheme.

Martin Yes, agreed, and particularly where transfers are now part of the normal set of retirement options.

***PW** There was a lot of controversy a few years ago about pension increase exchanges (PIEs) and enhanced transfer values (ETVs). Are we revisiting that?*

Cooper-Smith It is absolutely still being done. There was more controversy around ETVs, but I believe that today the E has been dropped and they are just transfer value exercises. Happily, the days are long gone of members being offered inappropriate incentives to transfer out. PIEs are common and can make sense as a way of reducing risk by offering a higher starting pension in lieu of some of the inflation protection. This can also allow pensions to be reshaped to better suit the individual.

Martin We are still seeing PIE exercises. The alternative to PIE is to tell your member to transfer the whole thing out and give up DB, which is very difficult for the member.

Feathers The demand for PIE comes from younger pensioners, who still have financial obligations and would prefer a higher pension at the expense of inflation protection. There is a selection risk point, but I don't think it is massive.

Fernandes Employers should go down these incentive routes with their eyes open. I've seen a lot of schemes enter into an arduous and expensive process, only to see extremely low take-up rates and the savings hoped for are not generated.

Cooper-Smith PIE can make sense when buyout is imminent. Offering the membership a market derived value for their CPI benefit means that some of that perceived loss of value can be shared between the scheme and members.

Fernandes Going back to the Green Paper and aggregation and efficiencies of scale,
I think one of the biggest nuts to crack is the administration of so many different benefits structures. Without harmonised benefits, efficiencies of scale can only get you so far. I think what you need is a standard benefit structure that would be easier to manage and hedge risks.

Feathers That is the challenge underlying much of what we are talking about – disturbing accrued benefits.

Fernandes When we sponsored the Pensions Institute's paper, some lawyers talked a lot about how accrued benefits could not be touched. However, a few other EU states have done it; Ireland brought in Section 50 and 50A orders where trustees can apply to the Irish Regulator to reduce increases and accrued benefits for schemes in stress. It seems to be the way that the UK government has interpreted the human rights legislation here, rather than the legislation itself, that has resulted in accrued rights being untouchable.

Feathers Has the Netherlands done it?

Fernandes Yes, although the Netherlands is a little different – the award of pension increases is generally conditional on higher funding levels. However, poor funding on a statutory basis can result in accrued rights being scaled back.

Martin A single benefit structure could make it easier. I struggle with the concept of finding a number of schemes capable of being funded to a similar level without varying levels of additional sponsor contribution. Otherwise, there is potentially a transfer of risk. A scheme that could aggregate and drive cost out is a nice sound bite, but when you work through the practicalities and risks for members, trustees and sponsors, then it is a little more difficult.

Martin Would you, as a trustee, put yourself in a pool with weaker schemes or would you buy yourself out?

The demand for PIE comes from younger pensioners, who still have financial obligations.
Paul Feathers

PW *Will buyouts and buyins set a record in 2017 and is there enough capacity in the market?*

Cooper-Smith There are plenty of schemes in the pipeline to secure, and a number of providers, such as ourselves. There is plenty of capacity now, but as demand grows and funding improves, then now will probably prove to have been a good time to do it.

Martin Most trustees will have a long-term ambition of risk transfer, but clearly conditions have been and remain very challenging. That shouldn't stop the appropriate framework and planning being put in place, though.

PW *As a member, I am concerned you might find your pension provided by a Bermuda reinsurance fund.*

Cooper-Smith As a member, you would still face an insurance company regulated by the Prudential Regulation Authority (PRA) with capital requirements. There is a lot of protection. Insurers cannot sell your liability on to another company without PRA approval and a court sanctioning the transfer.

Fernandes Trustees always need to consider the financial strength of a counterparty in the same way that they assess the employer covenant. At a time when there may be opportunities for trustees to take advantage of favourable positions, yet more proposed changes create a distraction for trustees and sponsors away from the really important decision of de-risking and securing benefits and thereby reducing the future reliance on the sponsor covenant.

Martin We try not to let this background noise distract trustees. We focus on how we get from where we are today to the endpoint.

Ceri Jones

Ceri Jones is an award winning financial journalist. She has edited several publications including the *Investors Chronicle*, *Financial Adviser* and *Pensions Management*.