PPI submission to DWP call for evidence
Defined benefit pension schemes: security and sustainability

About the Pensions Policy Institute

I. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI exists to contribute facts, analysis and commentary to help all commentators and decision-makers to take informed policy decisions on pensions and retirement provision.

Introduction

II. The DWP consultation seeks evidence on a number of suggested measures to help ensure security and sustainability in defined benefit (DB) pension schemes in the private sector, with a particular focus on the issues of:

1. Funding and investment
2. Employer contributions and affordability
3. Member protection
4. Consolidation of DB schemes

III. This response sets out key evidence from PPI research articulating what is known about the current state and projected trajectories of private sector DB schemes, which will be addressed in each of these four areas in turn (Parts A, B, C and D, respectively).

IV. The PPI does not make any policy recommendations. This response presents PPI research findings where they might help to inform the consultation.

Executive Summary

- Recent data from the Pensions Regulator suggests that aggregate private sector DB deficits declined in 2016, with the overall funding ratio improving to 97% of liabilities (on an S179 basis). However, data from the last decade illustrates the high level of volatility in funding ratios.

- Investment strategies implemented by DB schemes have evolved in recent years, with many shifting towards increasingly liability-driven strategies. However, as investment strategies change, new issues arise concerning investment decision-making and the factors that may influence this.

- For the majority of DB sponsors, research suggests that deficit recovery contributions are sufficient and do not put undue strain on the wider business, however there are some concerns that this may changes as an increasing number of schemes close to new members and future accruals, resulting in a rapid increase in maturity.

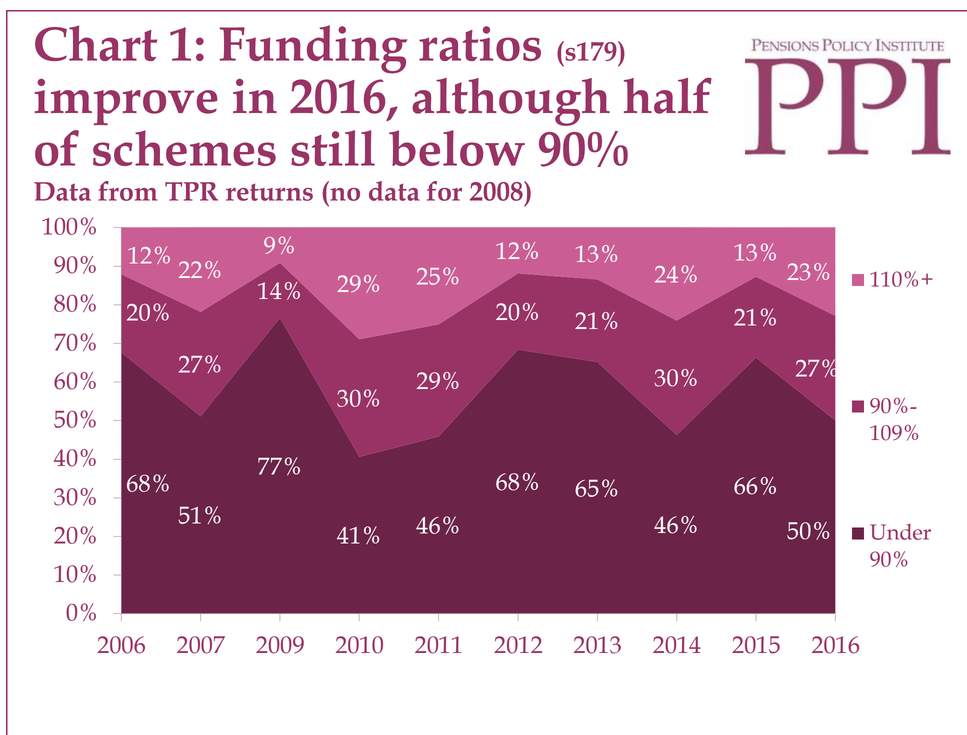
- As the complexity and uncertainty surrounding valuation methods and funding levels have increased, as well as the introduction of new pensions freedoms, there have been some suggestions that members may need to have a better understanding of the funding position of their scheme.

- Consolidation is the direction of travel in the DC market, in particular for master trusts, but it is less clear whether or how it is possible to deliver this outcome in the DB sector (beyond the consolidation of schemes that share associated sponsors).

Part A: Funding and investment

Recent data from the Regulator suggests that aggregate private sector DB deficits declined in 2016, with the overall funding ratio improving to 97% of liabilities (on an S179 basis). However, data from the last decade illustrates the high level of volatility in funding ratios.

1. The proportion of schemes with a funding ratio below 90% has fallen from 68% in 2006 to 50% in 2016, however over this period it has reached a peak of 77% (2009) but also fallen as low as 41% (2010). Similarly, the proportion of schemes with a funding ratio between 90% and 109%, while increasing from 20% in 2006 to 27% in 2016, has experienced high levels of volatility, peaking at 30% (2014), with a low point of 14% (2009). The proportion of schemes with a funding ratio above 110% has experienced similar volatility, reaching 29% in 2010, where it had been just 9% the previous year (Chart 1).[1]



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[1] PPI analysis of TPR data (2016) For more information see: PPI Briefing Note Number 86 *Defined Benefits: today and tomorrow* http://www.pensionspolicyinstitute.org.uk/briefing-notes/briefing-note-86---defined-benefits-today-and-tomorrow

2. Much of this volatility is attributed to valuation methods and discount rates used to value liabilities. In its 2016 report on scheme funding (which relates largely to 2014 valuations), the Regulator reported that schemes were using, on average, an effective nominal discount rate of 4.5% (1.06% real), lower than the previous valuations of these schemes, but higher than the average discount rates used in the previous two years.[2] Within the mix of schemes, those with a higher proportion of investments in "return seeking" assets generally adopt a higher discount rate. In practice, seemingly similar schemes can adopt very different rates depending on the sponsor's risk appetite, the strength of the covenant, the recovery plan and investment risk.

3. While trustees have a responsibility to be prudent in their assumptions, those schemes with a greater diversity of investments and a strong employer covenant who believe that future returns on the scheme's investments are not necessarily going to be lower just because gilt yields are currently lower may choose to use a higher discount rate. The extent to which an assumption is more conservative than a "best" estimate, will depend in part on the strength of the employer's covenant. A weak covenant may drive trustees towards using a more prudent and lower discount rate, while a strong covenant provides trustees with more flexibility.

Investment strategies implemented by DB schemes have evolved in recent years, with many shifting towards increasingly liability-driven strategies. However, as investment strategies change, new issues arise concerning investment decision-making and the factors that may influence this.

4. As the shift to bonds and low-risk strategies has increased, so has the demand for inflation-matching assets such as index-linked gilts. UK private sector DB schemes already own around 80% of the long-dated index-linked gilt market. With demand increasing, there are some concerns about levels of supply. Potential demand is estimated to be almost five times supply, with demand likely to increase by around a third over the next five years. Projections suggest that the supply of index-linked gilts available to pension schemes is expected to fall short of demand until at least 2038.[3] Supply of index-linked gilts is particularly scarce at the long end of the curve (gilts that will not reach maturity for a longer time), in spite of the maturity cap

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[2] TPR *Scheme funding statistics: Valuations and recovery plans of UK defined benefit and hybrid pension schemes* (2016); See also PPI Briefing Note Number 93 *Defined Benefits: valuing and managing liabilities* http://www.pensionspolicyinstitute.org.uk/briefing-notes/briefing-note-93-defined-benefits-valuing-and-managing-liabilities

[3] NAPF *DB run-off: The demand for inflation-linked assets* (2014)

on gilt issuance. The issue of insufficient supply is further exacerbated by the buy-and-hold strategy used by pension schemes when investing in long bonds, which means that they will generally hold onto bonds until they reach maturity.

5. Another aspect of bond supply that trustees must consider is the level of match between these assets and the scheme's liabilities. Index-linked gilts are currently linked to RPI, while scheme liabilities are linked to RPI, CPI and LPI. To date the Debt Management Office that issues gilts has not been persuaded to issue CPI-linked gilts. Alternative index-linked bonds, such as those issued by utilities companies, are also currently linked to RPI, but there are ongoing discussions about moving to CPI-indexation.[4]

As the decisions that trustees are required to make become more complex, there has been an increasing level of scrutiny on scheme governance.

6. A combination of growing environmental complexity, volatile and sustained deficits and high profile corporate failures has led to an increase in government and regulatory scrutiny of DB pension scheme governance. Several research studies have pointed to a number of weaknesses in the governance of pension schemes internationally, including issues of competency, planning, leadership, and selection and evaluation.[5]

7. One area of weakness cited in research is overall board diversity, competency and the competency of individual trustees/board members in particular in relation to investments and risk management. In the UK, many pension scheme boards consist of mainly non-professional trustees drawn from the sponsoring employer and scheme membership. While many have gained considerable pensions experience, some find themselves with limited support and training to equip themselves with the required knowledge and skills. Where trustees lack knowledge and confidence, decision-making can be poor or trustees may find themselves unwilling to make decisions or fail to appropriately challenge professional advisers.

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[4] For more information see PPI Briefing Note Number 94 *Defined Benefits: managing assets and investment strategy* http://www.pensionspolicyinstitute.org.uk/briefing-notes/briefing-note-94---defined-benefits-managing-assets-and-investment-strategy

[5] Ambachtsheer, K. & McLaughlin, J. *How effective is pension fund governance today? And do pension funds invest for the long-term? Findings from a new survey* (2015); Stewart, F. & Yermo, J. *Pension Fund Governance: Challenges and potential solutions* [OECD] (2008); See also PPI Briefing Note Number 89 *Defined Benefits: the role of governance* http://www.pensionspolicyinstitute.org.uk/briefing-notes/briefing-note-89---the-role-of-governance

8. Research by the Pensions Regulator in 2015 highlighted particular knowledge gaps with half (51%) of schemes with non-professional trustees reporting that not all of their trustees had the levels required by the Regulator's Trustee Knowledge and Understanding (TKU) code of practice. 5% reported that none of their trustees had the required knowledge, while 10% had not heard of the code. The same report indicated a lack of training, with trustees not taking up opportunities to update their knowledge and a third of schemes not having either a training log or plan.[6]

9. Strategic planning and the ability to step back from day-to-day management decisions have also been highlighted as one of the weaknesses of some boards. Strategic focus can get squeezed out by the sheer volume of day-to-day matters. Some boards report not having goals and objectives against which to assess strategy and performance.

10. Professional trustees and chairs of UK pension schemes have traditionally been in the minority in private sector schemes. However, by 2015, 52% of all schemes had either a corporate or professional trustee on the board.[7]

11. The debate about professional trustees is not one-sided. The Regulator's response to its governance consultation stresses the important role that lay trustees play.[8] However, some commentators have suggested that the role of DB scheme trustee has become too complex for lay trustees drawn from the workforce and that only professional trustees have the experience and knowledge to provide the governance required; others continue to support the role that lay trustees have in adding to the diversity of the trustee pool.

12. The Regulator's research also revealed that boards made up of only professional trustees:
    - Spend more time on trustee duties
    - Have a better (self-reported) knowledge of pensions
    - Feel better able to assess value for money for the scheme

    To date, these self-reported improvements have not been validated by independent research and other research suggests that having member representation can strengthen boards in other ways.[9]

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[6] TPR *Trustee Landscape Quantitative Research. A report on the 2015*
[7] TPR (2015) The data include some DC only schemes.
[8] TPR *21st Century Trusteeship and Governance, Discussion paper response* (2016)
[9] McKell Institute (2014) *The success of representative governance on Superannuation Boards*

Part B: Employer contributions and affordability

For the majority of DB sponsors, research suggests that deficit recovery contributions are sufficient and do not put undue strain on the wider business, however there are some concerns that this may change as an increasing number of schemes close to new members and future accruals, resulting in a rapid increase in maturity.

13. Although increasing deficits have become commonplace among many private sector DB schemes, only a minority of schemes and sponsors are having difficulty making a sufficient level of deficit recovery contributions, with these struggling schemes accounting for only around 10% (£30-35 billion) of the total DB deficit.[10]

14. However, as an increasing number of schemes close to new members and in many cases future accruals (Chart 2), many schemes are maturing rapidly. Immature funds tend to be more cash positive, meaning that they have adequate contributions, being continually paid in by active members and their employers, which can more than cover the cost of pensions in payment for members who have already reached retirement. As an increasing number of members gradually reach retirement, the ratio of pensioners to active members increases, and the scheme becomes more mature and, eventually, cash negative. This is exacerbated when the scheme is closed to new members, as there comes a time when there are no funds being paid into the scheme by active members. Rapid increases in scheme maturity may lead to an increase in Deficit Recovery Contributions required from the employer, as well as the scheme potentially being forced to sell assets in order to fund pensions in payment.

[10] House of Commons Inquiry BHS (2016)

Chart 2: Scheme consolidation, winding up / PPF entry could reduce number of schemes to 3,500 by 2030

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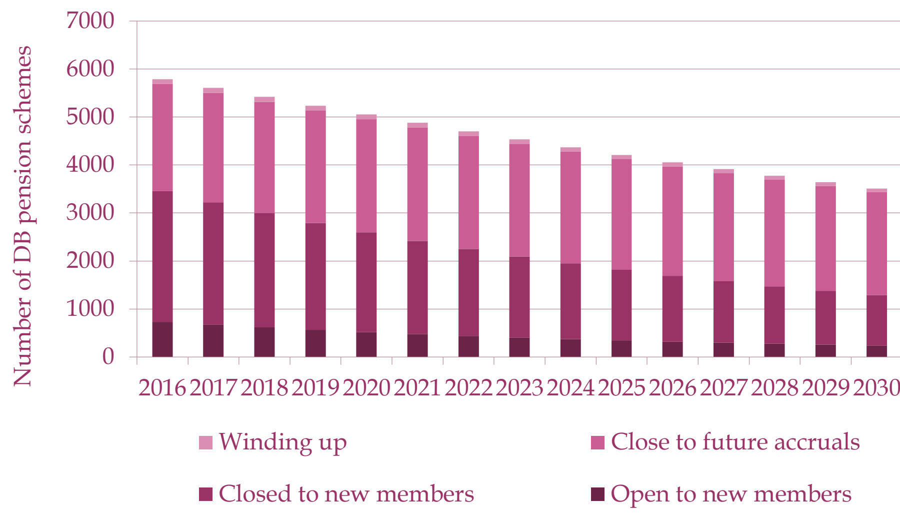


Part C: Member protection

As the complexity and uncertainty surrounding valuation methods and funding levels have increased, as well as the introduction of new pensions freedoms, there have been some suggestions that members may need to have a better understanding of the funding position of their scheme.

15. With the introduction of Freedom and Choice, the option of transferring out of a DB scheme into a DC scheme in order to take advantage of new flexibilities may be more attractive to some members. Examples of schemes transferring to the PPF (resulting in reduced benefit payments for some members) have featured prominently in the media in recent years, and this may further prompt members to engage in transfer exercises, particularly in cases where enhanced transfer values are offered by the scheme's sponsor.

16. There are some concerns that incentive exercises may not be in the best interests of all scheme members. While such exercises are understandably appealing to scheme sponsors, they may leave some members who agree to them with lower and potentially inadequate pension income. However, in some cases the increased flexibility and perceived security of a DC pension may mean that they are a preferable option for some DB scheme members even if they result in a financial loss.

17. Individual members' decisions to engage in a transfer exercise can be affected by information asymmetry between sponsors on the one hand, who can more accurately put a value on future payments and members who often cannot. On the one hand, attempts to ensure that scheme members have a better understanding of scheme funding, including deficits and funding objectives, could potentially reduce this information asymmetry and help members to make more informed decisions in regards to transfer exercises. However, issues surrounding DB funding are complex and may be misinterpreted by members. For example, an insufficient understanding of the volatility of funding ratios may cause undue concern to members about scheme deficits and the security of their benefits.

Part D: Consolidation of DB schemes

Consolidation is the direction of travel in the DC market, in particular for master trusts, but it is less clear whether or how it is possible to deliver this outcome in the DB sector (beyond the consolidation of schemes that share associated sponsors).

18. Consolidating schemes can be achieved in a number of ways, but none is without some complexity, particularly where benefits offered to members differ and different sponsors bring different strengths of covenant. It is possible to achieve some of the benefits of a merger by pooling just some of the activities of the scheme with another, such as pooling assets and establishing a joint investment management mandate, sharing administration or shared governance. These mechanisms would not require merging the liabilities of the scheme or standardising benefits.

19. A step further for some might involve transferring the scheme into a multi-employer trust, allowing them to benefit from cost savings and wider investment choice but maintaining the same scheme rules, sponsor commitment and benefit structure. Where two schemes are sponsored by the same company, a 'merger' can be achieved by standardising benefits and moving the members of one scheme into another along with the assets of the scheme. However, merging schemes can be complex and, in itself, a costly exercise.

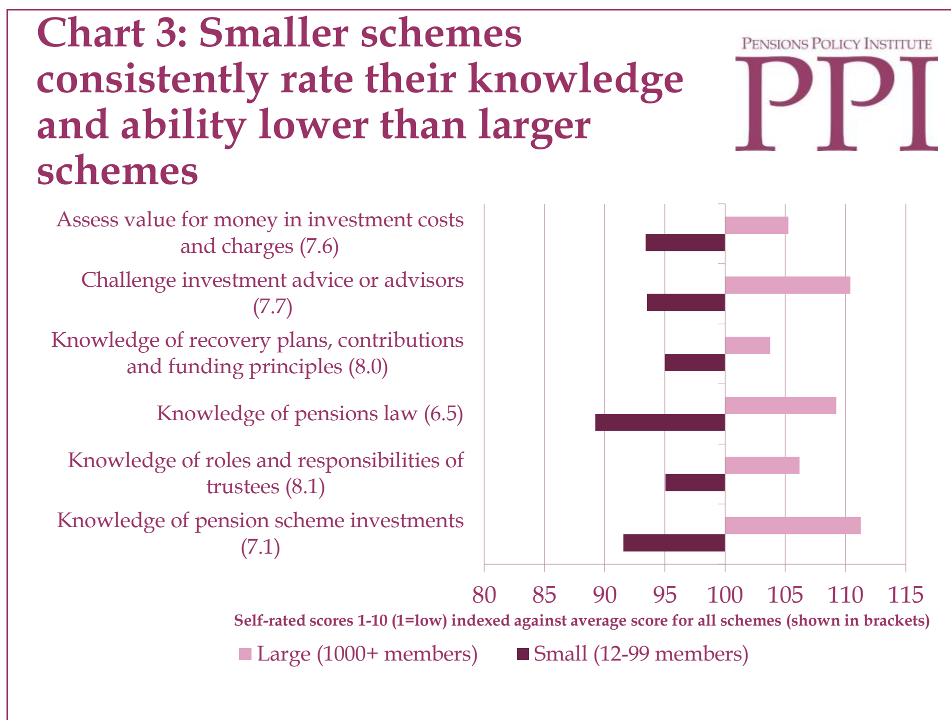
Merging two or more schemes to produce one larger scheme could have considerable benefits.

20. Governance and administration costs can be reduced, while there is evidence to suggest that governance standards can also be improved. There is a correlation between the size of a pension scheme and its quality of governance. The relationship is not absolute, with some small schemes

having good governance and some large schemes exhibiting signs of poor governance.

21. On average, smaller schemes (12-99 members):
    - Meet less frequently than larger schemes (1000+ members)
    - Have fewer trustees
    - Spend less time on trustee duties
    - Are less likely to know how funds are invested
    - Are less likely to have sub-committees
    - Tend to consist of less qualified trustees
    - Can have more limited access to professional advice (legal, actuarial, and investment) which can hamper decision-making.

22. Smaller schemes (when compared to large schemes) score less well on a number of self-rated competencies, including knowledge of pensions and investments, their ability to challenge investment advice, and assess value for money of investment costs and charges (Chart 3).



23. In general smaller schemes reside with smaller sponsors and face a number of challenges, namely:
    - Good governance comes at a price (both the direct costs of paying for trustees and the indirect costs of support for the trustee board).

Sponsors can be reluctant to fund governance costs in addition to contributions, leading boards to meet irregularly and having less access to good data and information about the scheme.

- Recruiting high quality trustees with appropriate knowledge and understanding, particularly member-nominated trustees, can prove harder for schemes with very few members.

24. If the argument that good standards of governance for DB schemes is becoming ever more critical and the evidence is that smaller schemes struggle to deliver strong governance both hold true, then it should follow that encouraging better governance standards amongst smaller schemes or having fewer, larger schemes should deliver better outcomes to members and to other stakeholders. However, at present evidence to support this position is somewhat limited.