



Prospect submission to the Pensions Regulator consultation on the defined benefit funding code of practice

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Introduction

1. Prospect is a trade union with over 150,000 members representing specialists and managers in the public and private sectors across a number of industries.
2. This is a response by Prospect to the Pensions Regulator (TPR) consultation on its new DB funding code of practice. This response reflects the Union's position that we will campaign to keep DB schemes sustainable and open for our members that are currently in such schemes.
3. Although there has been a trend of defined benefit (DB) schemes closing and members moving into defined contribution arrangements, we still have members in private sector employers who are accruing benefits in DB schemes.
4. The proposed new code will have significant implications for many DB pension schemes in the UK therefore it is crucial that the code framework and detail is devised and laid out in the correct way. It is our belief that the current proposals are too rigid and are likely to lead to worse outcomes for scheme members, scheme sponsors and the PPF.
5. Much of the consultation is codifying best practice and this seems a sensible thing to do. However, in our view there are some important areas where there could be negative consequences for scheme members.
6. Our main concern is the proposed wide-ranging use of the fast track approach under the new code. There are positives with the introduction of a fast track valuation and these will be especially prevalent for smaller and well-funded schemes as they will be able to sign off valuations in a more effective and time efficient manner.
7. The issue that we have is with TPR's proposal that the basis and assumptions used in the fast track valuation route will be used as the benchmark for any bespoke valuations. This is likely to lead to schemes being more restricted when undertaking a valuation, than is currently the case.

Aspirations for a new DB funding code

8. We will in this response outline what we believe the DB funding code should cover. It is our strong view that the funding code must differentiate between open and closed schemes.
9. It is our aim to keep DB schemes that are open on some basis sustainable so that they can remain open. It is therefore vital that open schemes are categorised and treated differently to closed schemes to enable this to happen.
10. In absence of this happening, is it highly likely that the treatment of open DB schemes under the new code would amplify the affordability issue by contributions increasing further and employers not being able to afford to keep the schemes open.
11. In this response we will therefore differentiate between open and closed schemes when making suggestions and proposals on how a new DB funding code would work.

All Schemes (open and closed)

12. To minimise any adverse impact on the sustainable growth of an employer, a new scheme funding code must:
 - (a) Allow schemes to be run in an efficient and sustainable manner
 - (b) Recognise the need to invest in a positive and productive way
 - (c) Ensure additional value is provided for members
 - (d) Build on the existence of the PPF

Open schemes

- 13.** The new code should:
- (a) Not destroy the covenant between an employer and their past, present and future employees that exist in a scheme open to new members
 - (b) Not introduce further intergenerational inequity, and
 - (c) Not reduce the efficiency of open collective schemes.
- 14.** In our view the proposed funding code does none of these things. As a trade union we are involved in negotiations with several of our employers regarding their DB pension schemes and it is a continuous battle to keep these schemes open for our members.
- 15.** It is clear that under the proposed structure of the new DB code, some of the remaining open schemes will be forced to close unnecessarily.
- 16.** The Pensions Act 2014 gave TPR a new statutory duty of regulating funding to “minimise any adverse impact on the sustainable growth of an employer”. The wording here is very strong and was debated at length in Parliament so was certainly put in place consciously.
- 17.** When finalising the new code, this statutory duty needs to be at the forefront of TPR’s thinking. We will always push employers to keep DB schemes open but the simple fact is that if they are made unnecessarily unaffordable by a regulator; the likely outcome is that DB schemes will continue to close at an alarming rate.
- 18.** We have already seen that there has been a particularly adverse effect on employers as TPR requires funding at such high levels in combination with cautious investment strategies that accrual of pension on a DB basis cannot continue. The effect of scheme closure on employee relations and on the ability to provide pensions efficiently has affected the sustainable growth of a number of employers.
- 19.** The recent amendment¹ to the Pension Schemes Bill in the House of Lords should also be noted. The amendment was tabled to ensure that DB schemes are kept open where possible and the reason behind this is that the levels of contributions being paid into DC schemes in this country are so poor that keeping DB schemes open is vital in providing workers with a decent level of income in retirement. We wholeheartedly support this amendment and would be disappointed to see this removed as it would signal the government’s intention when it comes to keeping DB schemes open.
- 20.** We also believe that any changes made to the funding code should have tangible benefits for scheme members. We believe that the questions under the heading of question 2 (insolvency risk and reliance on covenant) of the consultation are the most important to deciding who benefits from changes.
- 21.** Amongst schemes which are big enough to run on as a closed scheme, we believe a major cause of benefits being cut after an employer’s insolvency is the legal requirement to buy out benefits with an insurer. This is because schemes which could afford to pay benefits in full in the long term are forced to cut benefits to afford insurance costs. We would argue strongly for a reconsideration of that requirement although we recognise this is out of the scope of TPR control or this consultation.
- 22.** Within the terms of this consultation, we are concerned that the overall effect of the proposal will be to protect the PPF and perhaps shield TPR from criticism without having any significant benefits to members. We believe this is an unintended consequence which requires reconsideration. This overall effect arises because TPR wants either or both of higher levels of funding and lower levels of investment risk. Higher levels of funding may not improve the long-term benefits for members whose employers fail but may well make

¹ Amendment 71. Clause 123, page 118, line 4 Pension Schemes Bill

ongoing accrual unaffordable. Lower exposure to productive investments may reduce the likelihood that benefits will be paid in full, wipe out the potential to pay discretionary increases which are a legitimate benefit expectation for many members and again make ongoing benefits unaffordable.

23. As stated in the consultation, Government have noted that the DB funding framework is working largely as intended. That would suggest any change to funding caused by a code intended to back up legislation should be limited.

Allowing schemes to be run in an efficient and sustainable manner

24. In the consultation document, it states that views are sought on the principles and on “workability issues or unintended consequences”. In our opinion, the current proposed plans are very likely to result in:

- Schemes adopting a lower risk investment strategy and achieving lower returns
- The lower return on investments will result in higher contributions being required of employers
- Higher contributions from employers will have a damaging effect on their businesses and likely lead to further scheme closures
- The overall impact on society as a whole will be added inefficiencies in pension provision.

25. It is vitally important that the employer covenant is correctly and fairly judged and that contingent funding arrangements are supported by TPR. In the likely event that the new code results in increased funding demands on employers, non-traditional funding methods such as the use of escrow accounts, parent company guarantees and charges over assets should be supported by TPR so that employers and trustees can come to arrangements that maintain the efficiency and sustainability of the pension scheme.

Recognising the need to invest productively and positively

26. Pre-funding pensions has two purposes: the provision of funds for the pension promise and earning a return on investments which makes pension accrual affordable.

27. It is very common for DB schemes to provide a level of pension that costs more than the contributions being paid into the scheme. This funding gap is plugged by the scheme investing productively and receiving a good level of investment returns. It would be counterproductive to work against this principle by forcing schemes to invest in assets that are guaranteed to lose money in real terms.

28. The importance of productive investment is particularly important as the current drafting of the Pension Schemes Bill requires that the funding and investment strategy should be agreed with the employer. This is a significant change in the balance of power which introduces employer consent over investment strategy

29. There are positive aspects to this change in that employers are likely to want to see pension scheme assets invested more productively rather than less in an attempt to keep contributions at an affordable level. We feel that this is an important issue that needs engagement from TPR.

Ensuring additional value for members

30. As noted above, we believe there is a real danger that the proposals outlined in the consultation may well raise scheme funding without producing any additional benefits for scheme members.

31. The interplay between funding full benefits at current average funding levels and funding PPF level benefits at full buyout costs is very scheme dependent. We believe that there is a potential issue where schemes may well increase their funding to the low dependency level but it would still leave them underfunded on a PPF basis. In this scenario

members would not receive any benefit from the higher level of funding. However, the diversion of employer funding away from shareholders, investment in the business and spending on pay increases could well have significant downsides for those same members.

32. If employers are to be required to fund benefits at higher levels, there should be some possibility of these extra funds remaining in productive investments with the additional returns flowing at least in part to members. An alternative would be to change legislation to allow schemes that are able to pay their benefits long term to continue after an employer insolvency with members able to share in both upside and downside risk.

Building on the Existence of the PPF

33. The introduction of the Pension Protection Fund was a significant step forward in the protection of DB pensions. The system of providing DB pensions either from employer sponsored schemes or from the PPF should be a powerful combination which results in the avoidance of the need to fund and invest DB pension schemes to a self-sufficiency-in-bonds level.

34. It is better for employers, and therefore for the economy more widely, to pay PPF levies than to pay for excessive funding due to overly cautious investment strategies of schemes while they are outside the PPF. It is inefficient in the extreme for employers to be required to fund their scheme to self-sufficiency in bonds level and also to pay PPF levies.

Open Schemes

35. As has been recognised by the House of Lords in their consideration of the Pensions Act, open schemes are different and should not therefore be treated in the same way as closed schemes.

36. The time horizon of an open DB scheme is longer than a closed one; they have better cash flow and can invest with a longer term perspective. This means that open schemes can adopt different investment strategies to a closed scheme and invest in assets that are expected to produce a higher return.

37. As a trade union our focus is on the interests of our members and clearly benefit security is a high priority. However, our members realise and appreciate the value of an open DB scheme and want their scheme to remain open. We therefore disagree with the proposed approach which would require open DB schemes to fund their accrued benefits in the same way as a closed scheme. In this response we will outline why we think this is the case.

38. In an open DB scheme, the purpose of the assets is to generate income with which to pay benefits, rather than being sold to pay benefits with the additional disinvestment risk. This means an open scheme can invest for the long term without focussing on day to day fluctuations in asset values. This allows for pensions to be provided in an efficient manner.

39. It is also important to note that one of the statutory objectives of the Pensions Regulator is “to protect the benefits of members of occupational pension schemes”. It is our view that this objective is not limited to past service and that TPR should consider the way in which its actions impact on the ability of employers to provide employees with a high quality pension scheme.

40. Prospect has long been campaigning to reduce the gender pension gap and as part of our research for this year’s report, we have looked at individual contribution levels. Our findings are that the average amount being paid into a pension scheme is shockingly low; it is not much above the minimum levels required under automatic enrolment.

41. It is not only important to safeguard the accrued benefits of members, it is also vital and we believe part of your statutory duty to ensure that DB schemes can remain open for future generations. The current mix of DB schemes closing and people paying insufficient amounts into a DC scheme means that future pensioners are going to have a far less comfortable retirement than previous retirees and the chances of pensioner poverty are greatly increased.

Protection of the employer covenant

42. The employer covenant is an important element of funding a DB scheme. We believe that with the correct control measures in place, the use of the employer covenant in determining the level of investment risk is key and should continue.

43. A recent TPR webinar strongly suggested that there will be less reliance on the employer covenant going forward with an example being that it should not be relied on for more than 3-5 years as it is difficult to foresee beyond this.

44. We believe this to be a somewhat cynical view and a discredit to specialist covenant advisors. Whilst the current pandemic has highlighted the weakness of certain industries, it should not be read across that all schemes can only place a short term reliance on the employer to fund the scheme.

45. Providing that a robust analysis of the employer covenant supports this, we believe that schemes with a strong employer covenant should be able to take a longer term view and rely on the covenant. To reduce this reliance on top of the other proposed changes will only lead to one outcome, which is the closure of DB schemes.

No introduction of further intergenerational inequity

46. By proposing that open DB schemes should fund past service benefits in a different manner to those currently accruing benefits, those past generations of workers are being given a higher priority over active members and we disagree with this approach.

47. As previously outlined, we believe that DB schemes need to remain open for all generations in order to provide them with sufficient income in retirement. Sacrificing the future worker by laying down overly prudent regulations that aim to protect past service is simply wrong.

48. It is not right that pensions accrued to active, deferred and pensioner members should suddenly require funding to an extremely high standard while being invested in real loss making assets which results in a closure of the scheme to new members and a massive cost to the sponsoring employers, damaging their businesses.

49. We believe the current proposals are likely to result in further scheme closures, and intergenerational inequity will be increased as resources are put into more expensively providing the pensions of past generations at the expense of current and future generations.

No Reduction in Scheme Efficiency

50. As noted above, the specific cash flow characteristics of open schemes make them significantly more efficient than closed schemes. As well as reducing or removing the need to liquidate assets, incoming contributions in a collective scheme avoid the need to pay the expenses of liquidating assets or of investing incoming assets. Scheme closures reduce the ability of society as a whole to provide pensions efficiently.

Conclusion

51. Whilst we support the aspiration to secure members accrued benefits as much as possible, there has to be a balance to ensure that good, well run DB schemes can remain open for future accrual and new members.

52. The proposals outlined in the consultation are too rigid and not enough account has been taken of the different nature of open DB schemes and how these can and should be run differently to a closed scheme.

53. Our priority, which we believe you should share, is for people to be able to retire with enough income to provide a comfortable retirement. The current rate of DB scheme

closures is too high as it is and as a trade union we are fighting to keep these schemes open.

54. The DB code being proposed would hasten the rate of DB scheme closures and add to ticking time bomb of a problem which is the poor average level of pension saving across the UK. Unless action is taken and DB schemes are protected, the current and future generations will simply not have enough pensions saving to fund their retirement and the level of pensioner poverty will increase.