

Submission to DWP Select Committee: Pension Protection Fund and Pensions Regulator

Submission by Prospect

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1. This submission to the DWP Select Committee is from Prospect in respect of the inquiry into the Pension Protection Fund and Pensions Regulator.
2. It follows previous submissions from Prospect into earlier iterations of this inquiry which covered our views in some shortcomings related to the PPF and the level of benefit offered. This submission focusses on current problems associated with funding defined benefit pension promises.
3. Prospect welcomes the ongoing detailed work of the committee in this hugely important area. Prospect has been campaigning and negotiating for years for decent pensions provision for our trade union members, and have seen many employers abandon decent levels of pension provision.
4. We have also seen many employers whose ongoing sustainability has been threatened by the funding requirements of a defined benefit scheme. At the current time there are two notable examples:

- i. ADAS – a provider of agricultural, environmental and rural services consultancy services; this company was previously part of the Ministry for Fisheries and Food (now DEFRA). It was privatised in 1997, and in keeping with government policy, established its own defined benefit scheme for staff who left civil service employment. Many staff also transferred their civil service pensions. ADAS kept the scheme open to ongoing service accrual until 2003. The liabilities associated with pensions built up in that six year period, alongside those of pensions which were voluntarily transferred from the civil service pension scheme, are deemed unaffordable by the company, and they are seeking an agreement with tPR/PPF as placing this legacy pension fund into the PPF is viewed as the only means by which the business can continue trading. As well as the cost of funding the historic pension liability, the company also cite increasing costs associated with PPF levy and technical advice as being significant contributors to their financial difficulties.

Members, who now face the prospect of 10% reductions in initial pensions, accentuated by a reduction in pensions indexation, are significantly aggrieved that, at the time of transfer, they were given assurances about security of pensions in the ADAS fund, including those that were voluntarily transferred from the Principal Civil Service Pension Scheme. These assurances were not realistic and pension has been lost in a way that members were not forewarned about. Indeed members feel they were assured that the impending loss was not possible.

ii. An employer in the utility sector – who has a small number of employees who retain the right to a defined benefit pension scheme, including some who have Protected Person status. These employees are members of a multi-employer post-nationalised utility scheme. The burden of the deficit as well as meeting future benefit accrual costs, has been crippling for the business and without the support provided to the Protected Persons in the Scheme (based on the historic post-nationalised industry protections), the company would have gone into administration over a decade ago. This support has helped to avoid insolvency, but resulted in the severe restriction of the company's operation including the proposed diminution of some staff pension rights. It has, severely reduced the opportunity to attract investment and removed any hope of shareholder return, and thus only narrowly avoided administration in recent times.

5. The point is that pension liabilities are already having knock on effects. This has long been the case, with the most extreme impacts resulting in transfer to the Pension Protection Fund. Transfers into the PPF may have seen their peak – we note that from information posted on the PPF website that of the 800+ schemes that are reported to have transferred to date¹, these have occurred in:

2006	3
2007	12
2008	53
2009	41
2010	93
2011	173
2012	153
2013	112
2014	126
2015	39
2016 (to June)	31

6. All of the crises arise from the valuation attached to pension liabilities. The regulatory system correctly requires DB schemes to be funded, and this attaches significant importance to the mechanism by which pension promises are valued. In the long term, the cost will mainly be a function of pay level, longevity and

¹ <http://www.pensionprotectionfund.org.uk/TransferredSchemes/pages/Transferred-Schemes.aspx>

inflation. We accept that longevity increases have been experienced, but believe that the DB funding crisis is largely caused by the common choice of mechanism for discounting future payment streams into a present value.

7. In the light of BHS and pensions matters arising with Tata Steel, Prospect is aware that the issue of pension regulation is an extremely high profile matter and we welcome a diligent approach from the Select Committee in this respect. However we are mindful that the current landscape is herding toward a position that is seeing assumptions of the present cost of pension promises increasing at a rate that is inconsistent with the growth in pension provision. Ahead of any serious review into pension regulation, Prospect believes that a meaningful discussion needs to be had about current funding requirements and the mechanism for discounting future payment streams. It would be inappropriate to regulate to permit any weakening of pensions benefits protections whilst detailed consideration of funding requirements is warranted.

8. The Regulations prescribing this mechanism² indicate that discount rates should take into account either or both:

- i. the yield on assets held by the scheme to fund future benefits and the anticipated future investment returns, and
- ii. the market redemption yields on government or other high-quality bonds.

9. The significant growth in scheme liabilities in recent years is primarily due to reducing discount rates – there has been no equivalent growth in longevity, pay or inflation (individually or cumulatively) that has caused such a growth in pension level.

10. The impact of the discount rate on DB funding is huge. There is however no right or wrong approach to how it should be formulated, there is only the mechanism prescribed by Regulations and by the Pensions Regulator. If a scheme is underfunded, it prejudices the ability for promises to be met in the long term, whereas if a scheme is overfunded it runs the risk of tying up excess resources in a pension scheme that could be diverted elsewhere. Either outcome can result in snap decisions being taken. An excessive funding target risks future benefit accruals being terminated unnecessarily, and it risks contributions to a replacement DC scheme being unnecessarily low because the most of the employer's available money is being spent on DB contributions.

11. Variations in the discount rate will result in significant deviations in funding level, with trends over the last two decades seeing reductions in the discount rate being accompanied by increases in the valuation of liabilities and deficits.

² The Occupational Pension Schemes (Scheme Funding) Regulations 2005

12. Prospect is concerned that despite the flexibility outlined by the Regulations (in 8 above), most trustees in conjunction with their professional advisers are formulating discount rates with prime consideration given to movements in the yields in Government Gilts. There is strong evidence for this in the Pension Regulator's publication Scheme Funding Statistics Appendix, June 2016³, Tables 4.1 and 4.2. The difference between the average Single Effective Discount Rate used by schemes and gilt yields has been remarkably constant for 9 years.
13. The depression of this measure through quantitative easing has had a corresponding impact on discount rates and on the present value attached to pension fund liabilities.
14. To demonstrate this, it might be helpful to look at some excerpts of the BHS Pension Scheme 2012 valuation report⁴ which is the most recent publicly available such document. This shows:
- a. (page 21) between 2009 and 2012, the number of scheme members reduced by some 1,700
 - b. (page 21) the total value of annual pensions (either actually in payment or deferred to pension age) due to members had fallen between 2009 and 2012 from £30.4m to £30.1m
 - c. (page 23) the fund had grown £278.5m in 2009 to £344.0m in 2012; with some £114m growth in the fund due to investment returns and growth in the interim.
 - d. (page 8) the deficit reported in 2009 of £148m had grown to £211m by 2012. Amongst the factors for this change, it is interesting to note that £15m in company contributions were paid against this, that the pension fund grew by more than anticipated (saving £68m) and that lower pension increases were adopted (saving £26m). However changes to financial assumptions (primarily the discount rate) contributed £128m to the growth of the deficit.
 - e. (page 6) the discount rates used reduced by some 1.2%pa between 2009 and 2012.
 - f. (page 13) analysis shows an impact of changing the discount rate on the fund's deficit. It shows that if the discount rate was to
 - i. further decrease by 0.5%pa over the period up to retirement, then the deficit and overall scheme liability would increase by £16.7m

³ See <http://www.thepensionsregulator.gov.uk/docs/scheme-funding-appendix-2016.pdf>

⁴ <https://www.bhspensions.com/wp-content/uploads/2015/09/Bhs-Actuarial-Valuation-Report-31-March-2012.pdf>

- ii. Decrease by 0.25%pa for the period after retirement, then the deficit (and overall scheme liability) would increase by £18.5m
 - g. By extension of these figures an overall decrease of 1% to both discount rates would increase the liability by £107.4m; from £554.5m to £661.9m – an increase of roughly 20%.
 - h. If one thought that an increase of 1% to both discount rates would result in a corresponding liability decrease of 16%, this would see the overall liability figure reduce from £554.5m to £465.8m. Compared with assets of £344m, this would mean that a deficit of some £120m would have been in place, rather than £211m.
15. This illustrates the huge impact of modest changes to outcomes of an actuarial valuation caused by adjustments to assumptions, and the detrimental impact of low discount rates.
16. The numbers quoted in sub-paras (g) and (h) above are a result of some basic arithmetic, it may be appropriate to ask the BHS scheme actuary for their view on the impact low discount rates have had, the likelihood of such low discount rates prevailing, the circumstances under which they would increase and the impact an increase would have.
17. In any event it may be beneficial for the Committee to invite a representative of the actuarial profession to address these points and give a view on their experience of actuarial valuations of DB pension funds in recent years. In Prospect's mind it would seem appropriate to ask some questions:
- a. Why are gilt yields viewed as the most appropriate mechanism for formulating discount rates?
 - b. Does the profession believe that any other appropriate mechanisms are possible? Would, say, a rate based solely on a prudent assumption of expected return on assets be workable?
 - c. Is there anything theoretically wrong with smoothing liabilities over a period of time?
 - d. If gilt yields suddenly returned back to levels of, say, 4.0%⁵ would a lot of the current deficit issues disappear?
 - e. How can an actuary measure whether a discount rate that was assumed in the past has been proven to be "right" or "wrong"? Given that discount rates are an assumption, what are the long term impacts of them being mis-representative (either too high or too low), and found, with the benefit of hindsight, to be significantly wrong?

⁵ Bank of England 20 year nominal spot rate over period 2005 – 2010

- f. Does the actuarial profession have any concerns that the current depressed gilt yield market represents a new "normal" for the long term?
 - g. Why is the actuarial profession persisting in using a gilt yield based method when it is known that gilt yields are depressed, that gilt yields do not indicate the return on non-gilts, and an alternative method of setting a discount rate is available in regulations to use?
18. We are alert to the detrimental effect of over-estimating a discount rate, which could result in longer term under-funding and threaten the security of future pension payments, if a sponsor is unable to meet their commitment. However we are equally mindful of the excessive onus that is being placed on sponsors now as a result of low discount rates, with pension schemes being closed (with contributions to replacement DC schemes being very poor) and some employers' own security being threatened. This is a very fine tightrope to walk, but we feel that some application of the flexibility in the current regime is warranted, which would allow a re-think of how discount rates are calculated.
19. In conclusion, Prospect is keenly aware of the repercussions arising from large defined benefit pension deficits. We do support the prudent funding of these pension schemes but feel that the degree of prudence has been stretched too far through the use of artificial discount rates which have needlessly become wedded to short term movements in gilt yields. We are keen to participate in any debate on defined benefit regulation but believe that the issue of funding needs to be addressed first.