Security and Sustainability in Defined Benefit Schemes

RESPONSE FROM ICAS TO
THE DEPARTMENT OF WORK AND PENSIONS

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Background

ICAS is a professional body for more than 21,000 world class business men and women who work in the UK and in more than 100 countries around the world. Our members have all achieved the internationally recognised and respected CA qualification (Chartered Accountant). We are an educator, examiner, regulator, and thought leader.

Almost two thirds of our working membership work in business; many leading some of the UK's and the world's great companies. The others work in accountancy practices ranging from the Big Four in the City to the small practitioner in rural areas of the country.

We currently have around 3,000 students striving to become the next generation of CAs under the tutelage of our expert staff and members. We regulate our members and their firms. We represent our members on a wide range of issues in accountancy, finance and business and seek to influence policy in the UK and globally, always acting in the public interest.

ICAS was created by Royal Charter in 1854.

General comments

The ICAS Pensions Panel welcomes the opportunity to respond to the DWP's Green Paper 'Security and Sustainability in Defined Benefit Pensions'.

In broad terms, we believe that the regulatory regime for defined benefit (DB) pension schemes is appropriate and is working satisfactorily. Similarly, we believe that the funding regime strikes an appropriate balance between the needs of sponsoring employers and scheme members.

We are aware of the on-going debate about whether the funding regime is driving sub-optimal investment decisions by scheme trustees and consequently increasing the level of risk borne by employers. However, the scheme funding regulations do provide a high degree of flexibility, which makes a definitive conclusion to this debate difficult to reach without further research.

Without being able to reach a definitive conclusion and with evidence that, on the whole, sponsoring employers are continuing to pay dividends and support their pension schemes, there is no evidence of systemic weakness in the regulatory system and therefore it is challenging to develop proposals for wide-ranging reform of DB pensions.

We believe that there is scope to improve the effectiveness of trustee boards and that the regulator has a role to play in this. However, we are not convinced that those schemes which could benefit most from consolidation, for example, through cost savings from economies of scale, will necessarily find this achievable.

We are open to the idea of compulsory notification of corporate transactions and to clearance being required from TPR in very limited circumstances and for fines to be levied for non-notification. However, we agree that any extension of TPR's powers in this area needs to be made with caution and that any reforms must not damage the competitiveness of UK business.

We believe that urgent reform of the employer debt rules under Section 75 of the Pensions Act 2005 is needed to enable employers participating in multi-employer schemes to cease future accrual without triggering a cessation debt. We, therefore, welcome the consultation on Section 75 reform which has been launched recently by the DWP and we will respond to this separately.

Any enquiries should be addressed to Christine Scott, Head of Charities and Pensions, at cscott@icas.com

Detailed comments

Funding and investment (Questions 1 to 3)

We support the approach to scheme funding introduced by the Pensions Act 2004 and believe that the law is sufficiently flexible for the purpose intended.

We are not convinced that most of the suggested changes, set out on page 49 of the Green Paper, would address the concerns expressed by some commentators, which have been set out in the introduction to the section on ‘funding and investment’.

We do not believe there is a systemic weakness in the DB sector which needs addressing. However, we do recognise that smaller schemes are less likely to have a professional trustee on the board or to be able afford the level of advice needed to follow an optimal investment strategy and may therefore seek to comply with regulatory requirements and no more.

Of the changes which have been suggested, we believe the following have some merit and would be worthy of further consideration with proposals being brought forward in a White Paper, as appropriate.

- Improve decision-making skills through better training and guidance.

We support the priority given in TPR’s Corporate Plan (2017 to 2020) “to drive up standards of trusteeship across all schemes, with a particular focus on chairs and professional trustees.”

However, smaller schemes with lay trustees should not be forgotten in any plans to drive up standards of stewardship, governance and decision-making.

Improved standards cannot be achieved solely by focusing on technical skills and we believe that other skills such as leadership skills and negotiating skills are essential.

- Mandate the use of professional trustees.

We believe that having a professional trustee is likely to add value to a scheme. It may not be desirable to mandate the use of professional trustees, although we believe that wherever possible schemes should engage a professional trustee.

Professional trustee appointments are generally positive for schemes but compulsion would not guarantee the quality of appointees. Professional trustees who are in the early stage of their development will take time to reach their potential and not all those who are new to the trustee role have previous pension experience.

If the Government choses to mandate the engagement of a professional trustee or introduces incentives to engage one, this would need to be supported by the development and introduction of quality standards for professional trustees or even a formal professional trustee qualification.

An incentive could be in the form of a ‘regulatory dividend’ in respect of TPR’s risk assessment.

Any steps taken to mandate or increase the engagement of professional trustees would increase demand for them. Therefore, before taking a decision to mandate the engagement of professional trustees, the Government should assess whether there would be a sufficient supply.

In addition, there would need to be some consideration of how to manage conflicts of interest in order to address the perception that can arise that a professional trustee is really being appointed to serve the employer’s interests and are often paid by the employer. This is especially an issue where trustee/employer relations are difficult.

- Further research into trustee decision-making, the factors affecting investment strategies and choices of asset classes.

Further research could provide evidence to support recommendations for change, although the research may highlight, for example, that trustee decision-making could be improved through an innovative approach to training rather than provide evidence to support changes to regulations or to regulatory guidance.

We discussed the question of whether the period for completing actuarial valuations should be reduced from 15 months to 12 months or to 9 months. However, we were unable to reach a consensus on this issue.

Several Pensions Panel members support the 15-month timescale, this reflects concerns that for some schemes discussions with the sponsoring employer(s) are sufficiently challenging and complex to require 15 months, for example, in a multi-employer or group situation more the one valuation may be prepared in relation to the scheme. Several members supported a shorter timescale, with some support for 12 months and some for 9 months.

The rationale behind a shorter period is that the valuations would be more meaningful and a shorter timescale would create an impetus for identifying and resolving issues more quickly. A shorter period would also reflect advances in technology which mean that the numbers can be produced more quickly than was the case when the 15-month period for sign off was first set.

While we cannot make a specific recommendation on reducing the timescale for actuarial valuations, this is clearly an issue which the Government will need to consider further. However, should the Government by minded to shorten the timescale, we would recommend that this be done incrementally and that extensions be allowed by appeal to TPR if circumstance justify it.

Employer contributions and affordability (Question 4)

It is our experience that finance directors are taking an even greater interest in managing pension liabilities than before with a view to de-risking: there are some benefits in this regard from DB to defined contribution (DC) transfers taking place under the freedom and choice reforms. A desire to de-risk, and reduce balance sheet volatility, is understandable given the impact on liabilities of low interest rates and the visibility of pension deficits in financial statements.

If a corporate is making returns above the discount rate being applied to scheme liabilities, this outperformance indicates that it can meet its pension scheme commitments. The evidence in the Green Paper on the ability of companies to pay dividends, suggests that there may be scope for employers to do more to reach self-sufficient or even buy-out levels of funding.

We do believe that classifying employers as ‘stressed’ for the purposes of amending member benefits would create moral hazard and therefore believe there is no scope for major reforms in this area of pensions policy.

It is possible for employers to negotiate with employees to amend benefits under existing regulations. However, ‘informed consent’ would be needed if regulations were to be loosened but this would raise several additional issues which would then need to be addressed, for example, what happens when consent is not forthcoming or if scheme members, including deferred members, are not fully engaged in the process. It is possible that not all deferred members will be readily contactable.

Another consequence could be that more members seek early retirement to gain the protection of the Pension Protection Fund by being in receipt of their benefits. Therefore, potential unintended consequences must be thought through before the ability of ‘stressed’ employers to reduce benefits is increased.

Any steps taken to make it easier to reduce member benefits would need to be accompanied by a requirement for employers to treat any separate pension scheme for executives in the same way to avoid creating a specific moral hazard in this regard.

We believe that introducing a statutory override to enable schemes to increase benefits based on the Consumer Price Index rather than the Retail Price Index would be politically difficult. This would constitute a change to the employment contract and, if not agreed by employees, could lead to employers firing and re-hiring which would not be desirable.

Member protection (Question 5)

While we do not believe that there is systemic risk within the UK’s arrangements for DB regulation, there is risk and where risk exists it should be managed both in relation to smaller and larger schemes.

For example, insurance companies provide smaller employers sponsoring smaller schemes with bundled services for administration and advice. This means that schemes comply with regulations which is important. However, it is our experience that trustee engagement with scheme advisers may occur in times of crisis rather than as a matter of routine and that there is very little, if any, challenge of actuarial assumptions used in scheme funding valuations. Sponsoring employers of bundled schemes tend to be less engaged than other employers and advisers find it a challenge to persuade them of the merits of taking a greater interest in the affairs of the scheme.

With regulatory resources focusing on larger schemes and with the skills and experience being a challenge for smaller schemes, it is questionable whether members of these schemes are receiving added value.

We believe that it is possible to address the ‘skills gap’ in the trustee boards of smaller schemes through a greater focus by TPR on trustee education and, in our response to questions 1 to 3, we have welcomed the focus on standards of trusteeship in TPR’s latest corporate plan. Behavioural change is possible and trustees should be able to both understand and challenge the advice they receive.

There is scope for TPR to enhance the level of engagement it has with trustees more generally, for example, through following up on information gathered via the scheme annual return. The scheme return could be used to identify trustee boards with trustees who have not completed the trustee toolkit within a certain number of months of appointment.

From a good governance perspective, we believe that TPR could use annual return data to assess improvements, or otherwise, in standards of governance over time. This may involve making and recording qualitative judgements, for example, the extent and timeliness of recording trustee decisions, the quality of member communications, the quality of the Chairman’s Governance statement and the quality of the annual report and accounts. The findings could enable TPR to better target engagement with schemes and to develop key messages for the sector based on broader trends. If trustees were more likely to feel that they were being ‘regulated’, this could have a positive impact in itself.

TPR has the power to appoint a professional trustee to a trustee board, if it has concerns relating to Section 179 levels of funding: this power is designed in part to protect the Pension Protection Fund. We believe that extending the circumstances where TPR can appoint a professional trustee to a trustee board should be considered, for example, where the board is not considered to be providing added value i.e. doing no more than ensuring compliance with regulatory requirements.

We would welcome developments which would provide members with evidence of how a scheme is being governed which could perhaps act as a catalyst for improving scheme governance. Paragraph 331 of the Green Paper suggests the publication of a joint statement by the sponsoring employer and the trustees on the objectives of the scheme. We believe that there could be some merit in bringing forward more detailed proposals on a joint statement in a White Paper.

Paragraphs 333 and 340 raise the issue of member communication and the potential to improve communication so that members better understand the level and the nature of risks their scheme runs. We agree that there is further scope for improvement in this regard.

The theme of member protection in the context of corporate transactions has been to the fore recently with the high-profile examples of the BHS and Tata Steel pension schemes.

We agree with TPR’s assessment that existing arrangements, whereby clearance can be sought before a corporate transaction is complete is not working well. Trustees and sponsoring employers tend to seek clearance too close to completion of the transaction or opt not to seek clearance at all. However, the DWP is rightly cautious about increasing TPR’s powers over corporate transactions in case this damages the competitiveness of UK business.

We are sympathetic to this dilemma and are open to the idea of compulsory notification to and clearance from TPR in limited circumstances and for fines being levied for non-notification. There is also scope for further monitoring of corporate activity by TPR more generally to identify trustee boards and employers who should be seeking clearance.

Consolidation (Question 6)

We support scheme consolidation in principle but only on a voluntary basis. In practice, we are not confident that there will be sufficient impetus for many non-associated employers to actively seek to participate in one of the consolidation models available. We do recognise that there are several options available for consolidation and acknowledge the work undertaken by the Pensions and Lifetime Savings Association's DB Taskforce on evaluating these options.

In summary, schemes which may benefit most from consolidation because of a weaker employer covenant may be those where cost is too high a barrier to entry, for example, the sponsoring employer may not be able to borrow sufficient funds to join a Superfund. Schemes which may find consolidation more affordable, i.e. those with a stronger employer covenant, may be moving towards self-sufficiency and buy out, meaning that there is no incentive for the trustees to consider consolidation.

The main thrust of the Green Paper is that smaller schemes which, due to their size, are unable to achieve the benefits of economies of scale enjoyed by larger schemes. While efficiencies may well be available from, say, joining a non-sectionalised defined benefit master-trust scheme, the initial costs involved and the practical difficulties which may be encountered, for example, in harmonising benefit structures, could be significant barriers. On the other hand, joining a sectionalised defined benefit master-trust and retaining existing benefits structures would mean less opportunity to make savings and the cost of retaining separate advisers may outweigh the benefits.

We would support steps by Government to remove regulatory barriers to consolidation. We are particularly keen to see reform of the application of the employer debt rules to employers participating in multi-employer schemes under Section 75 of the Pensions Act 1995. Therefore, we welcome the consultation on Section 75 which was launched recently and will respond to this separately. We believe that reform of the employer debt rules could be beneficial to the financial health of employers who must currently keep an active member in a scheme to avoid triggering a cessation debt.