Unite response to the Department for Work & Pensions Draft Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2023 Consultation – 17th October 2022

Introduction

This response is submitted by Unite the Union, the UK's largest trade union representing over one million members across all sectors of the economy including transport, manufacturing, financial services, food and agriculture, construction, energy and utilities, information technology, service industries, health, local government and the not for profit sector. Unite also organises in the community, enabling those who are not in employment to be part of our Union.

Unite has facilitated benefit changes, agreed between members and employer, for many schemes. It is a key part of our role to balance the benefits provided, cost of that benefit provision and the risk that the scheme can afford to take, recognising the impact that this has on the funding level, investment strategy and affordability.

Unite does not support the proposed direction for the revised code of practice for defined benefit (DB) funding. Unite believes this will ultimately lead to greater conservatism and control of schemes' investment strategies, which is not merited for all schemes.

From its inception the perspective of TPR has been focused on seeking to ensure members get the benefits they have been promised, effectively their past service benefits. It has never been given or had the objective of seeking to maintain and promote the continuation of pension accrual in DB pension schemes. As a result of this the way it has operated has added to the problems, which have led to employer flight from providing DB schemes to their employees.

A central objective it has had has been to protect the PPF. This translated into a general pressure to improve funding levels of all schemes so that where, as is inevitable, employers become insolvent the impact on the PPF is limited. While to an extent this has, of late, been balanced off by a responsibility to consider the interests of employers ('minimise any adverse impact on the sustainable growth of an employer') it has not been balanced by an objective of seeking to maintain and promote quality DB schemes.

It could be argued that TPR preference is for DB schemes to be closed to further accrual in order to channel the maximum company contributions into making deficit payments to schemes, which would be invested so cautiously that they can buy out all their liabilities with an insurance company.

A general perspective from those involved with schemes is that the intervention of TPR is something to be avoided. As a result the pressures to adopt cautious funding strategies have intensified. This perspective goes against the limited encouragement that the TPR had given for schemes to adopt flexibilities. The leopard is not believed to have changed its spots.

Rather than just intensifying pressure on schemes to de-risk all the time TPR should be making much greater efforts to promote responsible approaches to managing risk as will allow schemes to continue on a basis which benefits their members and does not put employers under too much pressure.

A key part of this is that pension schemes need to be allowed to focus again on the long term, both in relation to their funding and investment policy, so as to ride out short term fluctuations in markets and to invest more in return-seeking assets to keep benefits affordable.

Unite believes that TPR is failing to strike the right balance between conducting enforcement where it is genuinely needed and not encouraging trustees and employers to be over prudent, de-risk and ultimately close DB schemes where a DB scheme is sustainable.

There are four key matters we wish to highlight in particular, and further comments are set out below:

- A Fast Track system should be viewed as a short-cut for schemes that are closed to future accrual only. Bespoke should mean bespoke, recognising the specific circumstances of the scheme.
- Covenant support is scheme-specific, and many structures are capable of supporting integrated funding solutions well beyond 3-5 years.
- Schemes that are open to new entrants are very different but equally schemes that are open to future accrual only and are not mature in nature should not be treated with a one size fits all approach.
- Shared cost schemes, whilst rare, need the flexibility to continue to function within the regulatory regime.

A Fast Track system should be viewed as a short-cut for schemes that are closed to future accrual only. Bespoke should mean bespoke, recognising the specific circumstances of the scheme

The settled position after more than a decade of the scheme specific funding regime is that:

- the scheme-specific funding system deliberately does not require solvency based funding;
- trustees need to consider what employers can reasonably afford to pay to meet funding deficits, balanced against the sustainable growth of sponsors;
- the PPF is there to provide a safety net in the event of employer insolvency, and recognising its existence, in conjunction with prudent ongoing funding, is exactly what pension schemes should be doing.

The proposed direction for the revised code of practice for defined benefit funding risks enshrining what is currently the TPR preference – requiring schemes and sponsors to de-risk and plan for buy-out (or perhaps consolidation), which will increase the costs for sponsors and will unnecessarily shorten the life of sustainable DB schemes for members.

Unite believes that, in general, the discount rates used in DB scheme valuations are overly pessimistic. The approach being taken both reflects and encourages overly cautious investment strategies focussed on the short-term rather than the long term. Excessive prudence in funding and investment has compounded the impact of the factors increasing the cost of pensions and contributed greatly to the downgrading and demise of DB schemes.

Rising life expectancy, volatile financial markets and previous low interest rates have presented a big challenge to DB schemes but we do believe that those challenges can and should have been managed in a better way as would have allowed more schemes to continue on a sustainable basis, and those continuing to provide better benefits than are often now provided.

Actuarial and accounting practices compounded by misguided regulation have compounded the economic and demographic challenges rather than helping schemes and employers to manage them. In particular the drive to de-risk investments has inflated pension deficits and hugely increased the cost of future service benefits.

This situation has been developing over many years with notable factors being the change to mark to market accounting and valuation of pension schemes on current market values, denying the opportunity to take a long term view, through to the current approach of gilts-plus methodology to determine investment returns, regardless of that market being grossly distorted.

If decent levels of pensions are to be provided then schemes necessarily must invest contributions in return-seeking investments over the long term. Without taking some risk there will be little reward and pension saving ceases to be viable. Yet all the pressure on DB schemes has been to reduce risk. Too great an orientation towards bond-based investment strategies results in excessive prudence and guarantees that the cost of benefits will be high. It represents a 'solution' which crystallises a problem rather than solving it.

The whole point of DB schemes is that they are collective schemes which can and should be able to take more risk than an individually invested pension and so deliver better value. This, just as much as the employer underwriting them, is what makes schemes viable. The effect of de-risking makes the employer the first resort for additional pension funding rather than the last resort.

What is needed is a greater emphasis on the long term funding position as will allow greater investment in return-seeking assets. Discount rates should be based on the expected returns which schemes actually hold, with a margin for prudence, rather than a gilts-plus methodology. This has been particularly important during a sustained period when the margin between expected returns on gilts and on other assets has widened markedly.

There is scope for greater flexibility in terms of funding and investment than schemes are currently minded to adopt but trustees are conditioned to press a prudent approach on employers. Advisers and TPR are geared up to reinforce that perspective rather than to critically evaluate it. It will require a strong intervention by government and by TPR to overcome the herd instincts in this area which are driving DB schemes over a cliff.

The funding regime is meant to be scheme-specific, and that is a key factor which must always be borne in mind. Whilst a Fast Track system may be helpful to both TPR and certain schemes that are closed to future accrual, its formulation should not influence the way the scheme-specific regime operates for schemes in general.

Therefore its Unite believe that a Fast Track system should be viewed as a short-cut for schemes that are closed to future accrual only. It may be attractive to schemes that are closed to future accrual, if it enables them to operate with lower advisor costs and less management time. It may also be attractive to TPR, if it enables TPR to streamline its process and focus its resources on other schemes.

However it is inappropriate to use these Fast Track parameters as a starting point against which to compare open schemes approaches to scheme-specific funding, i.e. the approach envisaged as Bespoke in the consultation document. The Bespoke option should genuinely be bespoke, and should not be measured against the Fast Track approach in this way.

Covenant support is scheme-specific and many structures are capable of supporting integrated funding solutions well beyond 3-5 years

There are many different forms of covenant support which do not lend themselves to the approach set out in the consultation document. Sometimes the strength of covenant derives from the legislative and structural support from a sponsoring employer, industry or Government. All Trustees and schemes have a dedicated team of professionals with in-depth knowledge of a sponsoring employer or industry, who advise the Trustee on covenant matters. This analysis and advice enables the Trustee to take a holistic view of all aspects of covenant, and settle funding plans.

However there are other schemes, and other sectors, that have more complex covenant support than envisaged within the consultation document. The approach needs the flexibility to acknowledge that

covenant does not readily fit into four neat boxes, and formal explicit guarantees are not the only way to become comfortable to rely on covenant for the long term.

Schemes that are open to new entrants are very different but equally schemes that are open to future accrual only and are not maturing should not be treated with a one size fits all approach

For schemes that are not maturing, but reach a steady state with an indefinite time horizon. They can use this, and the fact that this usually produces a cash flow neutral position, to withstand investment volatility. When you do not need to sell assets to make pension payments, it is reasonable for such schemes to adopt an investment strategy with that seeks greater return, being able to tolerate more risk, which leads to lower Technical Provisions.

As TPR will be aware, an amendment was made to clause 123 of the Pension Schemes Bill in the House of Lords, for schemes that are expected to remain open to new members. This amendment is consistent with the White Paper ("Protecting Defined Benefit Pension Schemes"), from which the Pension Schemes Bill originated, which stated that a suitable Long-Term Objective could be for a scheme to run-on with employer support (for open schemes). This consultation was issued before the amendment was made, it is important that TPR response to the consultation takes account of it.

Any open scheme can, of course, close in the future. Consequently, it is reasonable for open schemes to need to have appropriate contingency planning, setting out how such a change would then be reflected in the integrated funding strategy. However, assuming that open schemes inevitably become closed, as suggested by the consultation document, is a significant step too far.

One of the reasons given in the consultation for treating open schemes in the same way as closed schemes is to avoid a step change on closure. However, this approach does not eliminate this, but simply accelerates it. Through artificially creating that step change immediately, instead of at the point it would become justifiable, it becomes a self-fulfilling prophesy. Perversely, the likely outcome of this unnecessary increase in cost would be closure to future accrual, which goes against one of TPR stated views (within paragraph 467 and elsewhere) of "making sure the funding framework does not unduly increase the cost of future accruals, which could lead to scheme closures".

Shared cost schemes, whilst rare, need the flexibility to continue to function within the regulatory regime

In a shared cost environment, the impact of the suggested approach is heightened. Any step change in funding, or unnecessary increase in cost, is shared with the members. This would create unfairness between different cohorts of members, and could put very onerous burdens on an otherwise affordable and sustainable pension provision.

There is a real sense of collaboration in a shared cost arrangement, which encourages employers and members to find integrated funding solutions, which reflect both their interests. This can include benefit changes, which allow continued accrual, and can deliver better outcomes than simply demanding ever increasing contributions from employers, who then close the scheme.

Unite has facilitated benefit changes, agreed between members and employer, for many schemes. It is a key part of our role to balance the benefits provided, cost of that benefit provision and the risk that the scheme can afford to take, recognising the impact that this has on the funding level, investment strategy and affordability.

Shared cost schemes have characteristics that are not typical in the universe of schemes TPR regulate. These schemes are important, not simply to our members, but also to employers and wider industry, and it is essential that the regulatory approach can accommodate these features. Unite would welcome the opportunity to meet with TPR to discuss any of the points raised.

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Question 1: Draft regulation 4(1)(b) provides that a scheme reaches significant maturity on the date it reaches the duration of liabilities in years specified by the Pensions Regulator's revised Defined Benefit Funding Code of Practice.

i) Do you think that it would be better for the duration of liabilities at which the scheme reaches significant maturity to be set out in the Regulations rather than the Code of Practice?

ii) If you think that the point of significant maturity should be specified in Regulations, do you agree that a duration of 12 years is an appropriate duration at which schemes reach significant maturity?

Given the consequences under the draft Regulations of a scheme attaining "significant maturity", it is not appropriate to specify a single fixed period as the measure of significant maturity. The period can change markedly, over relatively short time periods, in response to factors that have no bearing on the scheme's maturity. For example, the recent sharp rises in gilt yields have seen scheme maturities as measured by actuarial duration fall significantly (by several years) over a period of months even though the demographic make-up of the schemes hasn't changed.

Consistent with your stated intention "…not to move away from the strengths of a flexible scheme-specific approach", we suggest that the question as to whether a scheme has reached significant maturity is something that remains scheme-specific, subject to appropriate guidance from TPR. Whilst duration of liabilities is a useful indicator of a scheme's maturity and, for many schemes a duration of 12 years may be an appropriate time to adopt a low-dependency investment and funding strategy, it should still be open to individual schemes to reach a different conclusion, provided that they can justify that conclusion.

Question 5: Does it work in practice to set a minimum requirement for the relevant date to be no later than the end of the scheme year that the scheme is estimated to reach significant maturity?

Such a requirement does not work for schemes which, remain open to new members and where the employer has committed to ongoing provision of final salary benefits.

For an open scheme, the current position maybe that it does not expect to reach significant maturity at any point in time. It may be reasonable to expect that new members will continue to join a scheme, to enjoy final salary benefits and for the profile of the membership to remain relatively stable over time (as it has done in the past). Should that change, for example if fewer new members joined than expected or if benefits were significantly reduced or, if a scheme were too close to new members, it would be possible to estimate the date at which the scheme would become significantly mature.

In its 2020 consultation on the defined benefit funding code, TPR proposed that schemes, which are open to new members, should have to assume that they would immediately cease admitting new members – effectively treating it as a scheme that had closed to new members.

Should TPR, in its revised funding code of practice, require schemes that are open to new members to assume in calculating the relevant date that they would cease to admit new members (whether immediately or at some point in the future) that would lead to funding and investment strategies that did not reflect the schemes' characteristics. The result would be unnecessary additional costs and some such schemes would be forced to close unnecessarily. That outcome would be contrary to the aims expressed in paragraph 1.4 of the consultation.

Question 10: Do you think that the provisions of paragraph 4 of Schedule 1 will allow appropriate open schemes to continue to invest in growth assets as long as that risk is appropriately supported?

It is important that the ability of open schemes to invest in growth assets is not unduly constrained. A significant risk for members' benefits in such schemes is the risk of not earning the level of returns required for the scheme to be viable.

Consultation para 3.33 does not seem to understand that the relevant date of an open scheme is often "never". Para 4 of Schedule 1 describes a pathway which open schemes might never take. Therefore it is not so much whether para 4 "allows" open schemes to invest in growth assets, but that para 4 is never triggered.

The notion that an employer must support investment risk is ill conceived. Defined benefit scheme rules do not promise an investment return, they promise a benefit. Trustees have two resources with which to pay benefits: assets and the returns thereon, and contributions. The key task is to support the payment of benefits, and investment returns may have an important role in accomplishing that task, even if seeking a good return comes with an investment volatility.

In Schedule 1, the principles described in 4(2)(a) and (b) are unsound and should be removed.

Considering 4(2)(a), it is not the case that less investment risk should be taken where the employer covenant is weaker. In cases of weakly funded schemes with an employer with low financial resources, this will put benefits at greater risk. The lower investment return from lower risk investments will give the trustees less resource with which to pay benefits. There is no merit in making the investments more certain to be insufficient to pay the benefits in full

The key task for the trustees is not to make the investment return more certain, but to make the benefit payments more certain. Focussing on minimising investment risk is not a substitute for focussing on minimising the risk of being unable to pay the benefits.

Considering 4(2)(b), schemes which are better funded could be on a virtuous spiral of escalating funding level as they shrink in size. They could reasonably remain invested in return seeking assets with the prudent funding margin covering investment return uncertainty. Which returns us to our previous point, that there is not really any such thing as a low dependency investment strategy, but given any particular investment strategy, there is a high enough funding level which results in a low likelihood of needing to call on the employer for further contributions.

Question 13: Will the matters and principles set out in Schedule 1 enable the scheme specific funding regime to continue to apply flexibly to the circumstances of different schemes and employers, including those schemes that remain open to new members?

The draft regulations provide that, once a scheme reaches significant maturity, it must not only be invested in accordance with a low dependency investment allocation but it must also be funded 100% on a low dependency actuarial basis, consistent with the investment allocation. Such a provision is inherently inflexible and generic and, as such, goes against the stated intention which is "*…not to move away from the strengths of a flexible scheme specific approach*."

It seems to us that the kinds of actions envisaged in the new draft funding and investment regulations are already being undertaken voluntarily by many schemes under the scheme specific funding regime, and therefore we doubt the value of the new regulations.

The scheme specific funding regime has important and useful flexibilities which the new draft funding and investment regulations do not have. In the scheme specific funding regime, there is the concept of funding prudently by reference to the expected return on the assets and future contributions, which the new draft regulations do not have. We think the new regulations will impede the flexibility of the scheme specific funding regime.

Question 14: Is the level of detail required for the funding and investment strategy by draft regulation 12 reasonable and proportionate?

For a scheme that remains open to new members it is neither reasonable nor proportionate to require it to set out details of a hypothetical asset allocation when they are not on a "journey plan" towards significant maturity and, given that they expect the membership profile to remain stable over time, they are not able at present to estimate the time at which such an allocation might become relevant. The regulations and funding code should together be sympathetic to this.

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