Unite response to The Pensions Regulator (TPR) Defined Benefit Funding Code of Practice Consultation – 2nd September 2020

Introduction

This response is submitted by Unite the Union, the UK's largest trade union representing over 1.4 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 low interest rates do present 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 is particularly important now as the margin between expected returns on gilts and on other assets has widened markedly.

A clear illustration of the impact of a more enlightened approach to funding and investment can be found by comparing the PPF's assessment of the general level of scheme funding (of FTSE350 companies DB Schemes) on a bond-based investment approach, which shows a large aggregate deficit, and the First Actuarial FAB Index, which adjusts to allow for best estimate investment returns and shows an aggregate picture of a large surplus.

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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