**Unite response to the Work & Pension Committee Defined Benefit Pension Schemes Call for Evidence – 26th April 2023**

**Introduction**

**This response is submitted by Unite the Union, the UK and Ireland'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.

From its inception the perspective of The Pensions Regulator (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 Defined Benefit (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 Pension Protection Fund (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.

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.

1. **Is the right regulatory framework in place to enable open DB schemes to thrive?**

No.

**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 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.

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.

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.

Unite believes 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. 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 by TPR. 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.

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).

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.

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

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.

2. **Is there sufficient capacity in the buy-out market to meet demand from DB schemes? If not, what are the alternatives?**

No.

The overall UK insurance market is worth over £1.7 trillion by assets. The market value of DB schemes is worth around £1.28 trillion. The actual amount of insurance companies that can actually deal with large buy out deals, can probably be counted on one hand. With the current more favourable buy out pricing the capacity simply isn there.

From a members' perspective what we wouldn't want to see is insurers selling on their books of written annuities to less reputuable insurance companies that are potentially registered in areas where members cannot access the Financial Services Compensation Scheme (FSCS) and pensioners are left massively less secure.

3. **What should the Pensions Regulator (TPR) do to improve the quality of trustee boards?**

Unite sees no justification for more onerous requirements for trustee knowledge and understanding than are currently required.

It would be worrying if additional requirements, for instance on knowledge and understanding, disenfranchised lay members from becoming trustees. Unite believes that member-nominated trustees bring important and varied perspectives from outside the pensions industry, as well as contributing a knowledge of scheme members. This latter aspect is very important when schemes have to consider the communication of scheme aims and decisions.

Unite would like to see half of the trustee board made up of member-nominated trustees.

If there are concerns that lay trustees lack sufficient knowledge, this should be addressed in post-appointment training, not by installing a cadre of professional trustees with similar backgrounds and assumptions.

4. **What, if any, further steps should be taken to encourage DB scheme consolidation?**

From a members' perspective Unite is obviously wary of anything which could compromise security of benefits or involved any alteration of them not subject to member consent.

It has some theoretical advantages in terms of scale efficiencies but how does it affect the employer covenant? How does it affect access to the PPF?

It has also been linked to notions of standardisation or even reduction of member benefits on transfer of schemes in - which would not be acceptable.

The simple message is superfund consolidators need to be regulated whether that is via the same system that insurance companies have or something slightly different to guard against some of this.

The Pensions Regulator has put some gateway tests in place but it isn't regulation.

However there is also a point here that doesn't really get discussed, which is the excessive profit margins that insurance companies are making with pension scheme buy outs.

5. **Are there any circumstances in which consolidation should be mandatory?**

No, it should remain a trustee and sponsoring employer joint decision.

6. **Do the recent improvements in funding levels change the future role of DB schemes in UK pension provision?**

It should do.

Funding levels improving is obviously welcome but if schemes had taken a long term approach to the amount of investment risk they take, then overly pessimistic funding positions wouldn't have been an issue in the first place in the majority of situations that we encounter.

The real game changer should be the fact that future service contrbution rates have become more affrodable for employers and members alike, at levels not seen in a decade or more.

However, the sad reality is that the majority of employers have already closed their DB schemes to future accrual and the ones that remain are not changing course and are falling over themselves in a rush to the door to make proposals to close their DB schemes to future accrual.

7. **How should scheme surpluses be treated? For example, should they remain in the scheme or be shared between employers and scheme members? Are the issues different for open and closed schemes?**

This is currently determined by the rules in each indivdiual scheme and will be the decision of the trustees.

Any surplus in an open scheme should remain in the scheme and if the trustees deem that it is appropriate to enhance members' benefits or more likely reinstate members' benefits that have been detrimentally changed in the years previous then this is a valid option, as is making improvements to pensioner increases and giving greater consideration to discreationary increases.

It wouldn't be right for employers to be given access to a surplus in an open scheme. There are laws preventing this, for good reason since Maxwell.

For a closed scheme again this is currently determined by the rules in each indivdiual scheme but it wouldn't be right if over-prudent funding in previous years means that due to the rules of a certain scheme that the employer is the only one to potentially benefit. Mebers have contributed too and Trustees should be given the power where needed to improve member benefits where it is appropriate to do so.

8. **What are the implications of improved funding levels for the Pension Protection Fund?**

The PPF is financially strong. Its reserves are close to what are needed to meet its funding objectives. It has proposed reducing the levy charged to scheme sponsors by nearly 50% (a reduction of £190 million). So, levy payers are benefiting from the PPF's strong financial position, but members are not.

It's time for members to benefit also.

9. **Should changes be made to the Pension Protection Fund (PPF), Financial Assistance Scheme (FAS) or Fraud Compensation Fund (FCF) to improve outcomes for members?**

Yes the PPF, FAS and FCF should improve outcomes for members.

The PPF is paying compensation to about 180,000 members (with about 108,000 further members waiting to receive compensation in the future). The average amount of compensation is a little under £5,000 a year.

There are about 79,000 people receiving compensation under the FAS (with about 67,000 waiting to receive compensation). Average FAS compensation is around £1,500 a year.

PPF / FAS compensation is less than the benefits members originally accrued. A number of reductions are applied. One is to the way that compensation increases while in payment.

The relevant legislation provides for different increases for compensation relating to pension accrued before April 1997 and pension accrued after 1997.

Generally, compensation in relation to pension accrued before April 1997 is not increased at all and compensation in relation to pension accrued after April 1997 is increased in line with inflation (as measured by CPI) up to a maximum of 2.5%.

Where there is an increase, this is applied on 1 January based on the increase in CPI in the 12 months to the previous May (9.1% this year). So real incomes will fall for PPF / FAS members next year (by up to 9.1%).

The argument for not having any increase for pre-'97 accruals is that there was no statutory requirement for schemes to increase pensions in payment before then. But, in practice, the vast majority of members were in schemes that gave increases for pre-'97 accruals (some gave full inflation with no cap). It seems perverse to take away all indexation rights from everyone when a more targeted approach is obviously possible.
Over 80,000 PPF members (and a higher proportion of FAS members) will get no increase on their compensation at all in January.

The legislation governing increases for post-'97 accruals in the PPF (but not FAS) gives the Board of the PPF discretion to apply another rate of increase instead of CPI (capped at 2.5%). Many members who get some increase on their compensation will still get less than the 2.5% cap due to having some accruals pre-'97.

This level of reduction in the real compensation paid to PPF / FAS members will cause great hardship. The PPF has sufficient funds to pay its members more. The Government could choose to improve FAS benefits.

Changes to legislation are required to give increases to pre-'97 accruals or more than 2.5% to post-97 benefits paid by FAS. The Board of the PPF has the discretion (but does not appear to be using it) to pay higher increases in relation to post-'97 benefits to its members.

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