Unite submission to the DWP Options for Defined Benefit schemes call for evidence – 5th September 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.

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Question 1 - Do you agree with the assessment of the position? Is there evidence to the contrary?

Unite has facilitated and negotiated pension 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.

Question 2 - What changes might incentivise more trustees and sponsors of DB schemes to consider investing in productive assets while maintaining appropriate security of the benefits promised and meeting their other duties?

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 - 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.

Current climate

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.

Question 3 - How many DB schemes' rules permit a return of surplus other than at wind up?

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 discretionary 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 or an insurer is the only one to potentially benefit. Members have contributed too and trustees should be given the power where needed to improve member benefits where it is appropriate to do so.

Question 4 - What should be the conditions, including level of surplus that a scheme should have, be before extended criteria for extracting surplus might apply?

As stated above, any surplus in a 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 discretionary increases.

There are great dangers in trying to change legislation in order to access pension surplus, whilst completing factoring out and undermining the scheme funding regime. The Government is barking up the wrong tree and needs to focus on:

- 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.

Question 5 - Would enabling trustees and employers to extract surplus at a point before wind-up encourage more risk to be taken in DB investment strategies and enable greater investment in UK assets, including productive finance assets? What would the risks be?

Again, there are great dangers in trying to change legislation in order to access pension surplus, whilst completing factoring out and undermining the scheme funding regime. The Government is barking up the wrong tree and needs to focus on:

- 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.

Question 6 - Would having greater PPF guarantees of benefits result in greater investment in productive finance? What would the risks be?

No, not against the current scheme funding regime.

The Government needs to be extremely careful and should not politically dictate what investment decisions trustees should take and should not create a separate legal framework that threatens to contradict and undermine the tried and well established current regulatory framework of fiduciary duty that trustees are bound by.

The real debate about use of PPF surplus should be about member benefit improvements.

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.

Changes should be made to the Pension Protection Fund (PPF), Financial Assistance Scheme (FAS) and Fraud Compensation Fund (FCF) to 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.

Question 7 - What tax changes might be needed to make paying a surplus to the sponsoring employer attractive to employers and scheme trustees, whilst ensuring returned surpluses are taxed appropriately?

Totally inappropriate suggestion by the Government to try and bring pension scheme surpluses within the taxation system.

Any surplus in a 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 discretionary increases.

For a closed scheme, this is currently determined by the rules in each individual 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 or an insurer is the only one to potentially benefit. Members have contributed too, and trustees should be given the power where needed to improve member benefits where it is appropriate to do so.

Question 8 - In cases where an employer sponsors a DB scheme and contributes to a DC pensions scheme, would it be appropriate for additional surplus generated by the DB scheme to be used to provide additional contributions over and above statutory minimum contributions for auto enrolment for DC members?

No, totally inappropriate.

Any surplus in a 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 discretionary increases.

For a closed scheme, this is currently determined by the rules in each individual 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 or an insurer is the only one to potentially benefit. Members have contributed too, and trustees should be given the power where needed to improve member benefits where it is appropriate to do so.

Question 9 - Could options to allow easier access to scheme surpluses lead to misuse of scheme funds?

Yes.

It wouldn't be right to allow easier access to scheme surpluses. There are laws preventing this, for good reason since Maxwell.

Again, there are great dangers in trying to change legislation in order to access pension surplus, whilst completing factoring out and undermining the scheme funding regime. The Government is barking up the wrong tree and needs to focus on:

- 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.

Question 10 - What impact would higher levels of consolidation in the DB market have on scheme's asset allocations? What forms of consolidation should Government consider?

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 ins and buy outs.

Ultimately the choice of consildation should remain a trustee and sponsoring employer joint decision and should not be mandatory.

Again, the Government needs to be extremely careful and should not politically dictate what investment decisions trustees should take and should not create a separate legal framework that threatens to contradict and undermine the tried and well established current regulatory framework of fiduciary duty that trustees are bound by.

Question 11- To what extent are existing private sector buy-out/consolidator markets providing sufficient access to schemes that are below scale but fully funded?

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't 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.

Question 12 - What are the potential risks and benefits of establishing a public consolidator to operate alongside commercial consolidators?

Obviously within the pension landscape there is NEST which is a workplace pension scheme set up by the Government. NEST is increasingly playing the role of offering a home to smaller savers and employers that bigger DC Master Trusts don't want to home because of the servicing required and the lack of profit that come with that.

You could argue that a public consolidator could play a similar role, but that is not really addressing the problem, which is that scheme funding requirements are too prudent and the level of profit margins that insurance companies are able to make from buy ins and buy outs is unchallenged.

Question 13 - Would the inception of a public consolidator adversely affect the existing bulk purchase annuity market to the overall detriment of the pension provision landscape?

It would depend on what part of the market a public sector consolidator was aiming to operate in. If it was like a NEST model, then it probably wouldn't disrupt the market that much but ultimately what additional benefits would it offer members?

More security is debatable depending on the covenant of the employer and if it only led to greater surpluses being returned to sponsoring employers then Unite fails to see what the upside is for members.

Question 14 - Could a public consolidator result in wider investment in "UK productive finance" and benefit the UK economy?

This is a worrying question.

The Government needs to be extremely careful and should not politically dictate what investment decisions trustees should take and should not create a separate legal framework that threatens to contradict and undermine the tried and well established current regulatory framework of fiduciary duty that trustees are bound by.

The Government should leave investment decisions to trustees.

If we look at ESG (Environmental, Social and Governance) as an example. We have recently seen UK pension schemes raise concerns over the Governments climate rhetoric. UK asset owners, including a number of pension schemes, have written to Prime Minister, Rishi Sunak, to warn that the Government's recent rhetoric could risk stopping the finance sector from making the investments needed to reach net zero and grow the economy.

The open letter, which received backing from financial organisations representing £1.5trn in assets under management, argued that, without long-term clarity from government, the £50-60bn per year of investment needed to reach net zero won't happen.

The letter raised particular concerns that the Government's recent public statements and policy signals could be undermining the UK's climate commitments, 'blurring' regulatory visibility for investors and risking the finance sector's ability to make the large-scale investments required to accelerate net-zero delivery.

"Recent public debates have cast doubt on the UK's 2030 phase-out of new petrol and diesel cars and 2035 phase-out of gas boilers, while the reforms to the UK's carbon markets, energy efficiency standards for the private rented sector, and plans to issue new oil and gas licences in the North Sea all cast uncertainty on government's commitment to the UK's near and longer-term climate targets," it stated.

"As investors and financial institutions, we need confidence in the government's long-term commitment to this agenda to allow us and our investee companies to make multi-billion-pound investments in the UK's sustainable economy of the future."

In particular, the group urged the Government to provide long-term policy certainty to ensure the UK is a world leader in sustainable finance, by making clear that important policy pillars driving investment, like predictable carbon pricing mechanisms, the transition to EVs, and improved energy efficiency standards for housing, will not be changed abruptly.

This, according to the group, would then enable investors to follow suit and channel private capital into new technologies and projects that will decarbonise the country.

Commenting on the open letter, UK Sustainable Investment and Finance Association (UKSIF) chief executive, James Alexander, stated: “The global competition to capture billions of pounds of private investment in the clean industries of the future is intense. Ministers’ recent remarks are undermining investor confidence and putting the UK’s net-zero head start at risk.

“The major financial players are deciding where to invest, and the UK needs to look both attractive and consistent as a leading destination for sustainable investment.”

Adding to this, BT Pension Scheme Chair, Otto Thoresen, stated: “We call on the UK government to uphold its net-zero ambition and take meaningful action over the coming years to demonstrate its commitment. Long-term and consistent policy will help drive real investment into the UK economy.

“Holding sustainability considerations at the core of this will lead to a more prosperous economy, increased growth and job creation which in turn will help secure our members’ pensions.”

Signatories to the letter included Aegon, Brunel Pension Partnership, BT Pension Scheme, Camden Council Pension Scheme, Royal London, Railpen, People’s Partnership, Scottish Widows, TPT Retirement Solutions and Universities Superannuation Scheme.

Question 15 - What are the options for underwriting the risk of a public consolidator?

It would need to be underwritten by the Government, with a Crown guarantee.

Question 16 - To what extent can we learn from international experience of consolidation and how risk is underwritten?

Nothing to add.

Question 17 - What are the potential risks and benefits of the PPF acting as a consolidator for some schemes?

The PPF levy is paid for by DB schemes from member and sponsoring employer contributions. It- is not funded by the UK taxpayer. So, any notion of a public sector consolidator must be funded by the taxpayer and separate from the PPF.

Question 18 - Would the Board of the PPF be an appropriate choice to operate a public consolidator?

It would be a matter for their consideration but in Unite’s opinion the current Board lacks member and trade union representation.

Question 19 - How could a PPF consolidator be designed so as to complement and not compete with other consolidation models, including the existing bulk purchase annuity market?

Again, it would depend on what part of the market a public sector consolidator was aiming to operate in. If it was like a NEST model, then it probably wouldn’t disrupt the market that much but ultimately what additional benefits would it offer members?

More security is debatable depending on the covenant of the employer and if it only led to greater surpluses being returned to sponsoring employers then Unite fails to see what the upside is for members.

Question 20 - What options might be considered for the structure and entry requirements of a PPF-run public consolidator, for example: are there options that could allow schemes in deficit to join the consolidator? what principles should there be to govern the relationship between the consolidator and the Pension Protection Fund? should entry be limited to schemes of particular size and / or should the overall size of the consolidator be capped? how could the fund be structured and run to ensure wider investment in UK productive finance? how to support continued effective functioning of the gilt market?

Again, the PPF levy is paid for by DB schemes from member and sponsoring employer contributions. It is not funded by the UK taxpayer. So, any notion of a public sector consolidator must be funded by the taxpayer and separate from the PPF.

Again, the Government needs to be extremely careful and should not politically dictate what investment decisions trustees should take and should not create a separate legal framework that threatens to contradict and undermine the tried and well established current regulatory framework of fiduciary duty that trustees are bound by.

The Government should leave investment decisions to trustees.

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John Neal – National Pensions Officer, Unite the Union 5th September 2023