Response to security and sustainability in defined benefit pension schemes consultation

About Hymans Robertson LLP

We are a leading independent pensions and risk consultancy and are experts in UK private and public sector pensions.

Executive summary

DB schemes are broadly 'affordable', but there is still significant and unnecessary risk of benefit loss

While we would agree with the DWP's summary that DB schemes are affordable to most sponsors, we must not overlook the fact that there is still £423bn p.a. risk in the system. For a significant minority of schemes the security of the benefits promised is at risk. It is clearer now more than ever that DB benefits no longer come with a cast iron guarantee. Indeed, the Pension Protection Fund's (PPF's) modelling suggests that in the worst 10% of outcomes around 1,000 sponsors could be insolvent by 2030.

The pensions burden on companies has increased markedly. Looking to companies to make 'higher contributions' in isolation is not a sustainable strategy

On average, companies 'can' afford these benefits, but the cost of providing them has increased significantly. While it is important to debate how much cash should flow into schemes in current market conditions, a balance needs to be struck. Throwing more cash at deficits could make schemes less affordable and redirect funds from valuable business investment. A strong business means a strong covenant. As a strategy, simply pouring more money into schemes has not worked for the last 15 years. On that basis, it is fair to assume it won't over the next 15. Risks need to be clear, consciously taken and well managed.

A focus on deficit figures has distracted from what really matters: improving the security of pensions

For too long schemes have viewed an increasingly complex web of investment, funding and strategy decisions through the narrow filter of deficits and discount rates and they have tried to fix deficits in a fast and furious way. Not only can this lead to significant cash calls on sponsors, it can hinder a scheme's ability to accurately measure what really matters: the chance of successfully paying members' benefits balanced against the risks if things do not go to plan. This can be improved by £250bn without increasing cash contributions if schemes are patient and take a truly integrated approach to risk management.

A balance needs to be struck, and deficits are part of the picture. But, to maintain a healthy business, pension contributions need to be kept affordable both now and in future. If we do that, schemes are less likely to fall into the Pension Protection Fund (PPF), where members lose £50,000 of benefits on average, employees lose jobs, and businesses are broken.

An integrated approach to risk management is key to tackling the £423bn risks of DB in drawdown

The affordability of DB pensions can be improved if schemes take a fully integrated approach to risk management. By this we mean genuinely integrating funding, investment and covenant and taking an appropriately long term and risk-based view. Schemes need to look across all the levers that impact funding and find the optimum balance to deliver members' benefits with greater certainty and reduced costs.

We see strong evidence of a lack of evolving or balanced risk management across UK DB. As schemes mature, investment strategies should evolve so that they are resilient to increasing levels of drawdown. We see little evidence that this is happening, even amongst the largest pension schemes and sponsors. This cashflow risk myopia likely reflects decades of cashflow stability up to now. But with schemes facing a mountain of pension payments ahead, which peaks at £100bn p.a. change is needed. In addition, we see a landscape where the greatest risk being run collectively by schemes remains rates and inflation (£277bn out of total annual deficit risk of £423bn). Yet we struggle to believe that this is aligned with trustees' and sponsors' conviction that they will be rewarded proportionately for taking yield risks. Most would feel that they will earn a higher premium from other risks such as well diversified growth, credit or illiquidity for example.

Overall, schemes need to take informed, risk-based action to become more resilient to risk and improve member outcomes. Otherwise a quarter could see no improvement in their deficit in 20 years' time. By this point a further £100bn or more in contributions will have been paid into schemes and more pensioners risk losing £50k of their lifetime savings on average from falling into the PPF.

Beware a return to the false comfort of shorter recovery plans

The green paper raises the prospect of measures to encourage sponsors with significant resources but substantial deficits in their schemes to make faster progress in repairing those deficits.

While there are some cases where companies could pay off their deficits sooner, this is not the greatest concern. A bigger issue is that in many cases short time horizons are forcing greater and unnecessary risk taking. For the majority of schemes where the benefits are expected to be paid, allowing more time for recovery plan payments and asset returns means a scheme can take less asset risk and measurably improve the security of benefits. Our recent research showed that this can improve members' benefit security by £250bn[1] without increasing deficit contributions.

It is too simplistic, not least a step backwards, to say 'long recovery plans are bad'. If used to manage risk, longer is typically better. If used to reduce cost, longer is worse. Blanket discouragement of using the lever of recovery plan duration could be a mortal blow to scheme-specific risk management.

Where affordability is strained, better use should be made of flexibility already in the system

Before looking at alternative ways to create more flexibility for schemes, we need to review and make better use of the flexibility that is already there. Taking advantage of what is already available is likely to be far more palatable for the vast majority than a move to conditional indexation or a wholesale move from RPI to CPI.

For example, where short term affordability is constrained whilst longer term affordability is not in serious question, a reduction or pause in deficit contributions can make sense and is possible under the current funding regime. In fact, the first, most obvious route is to explore adopting longer recovery plans (as outlined above). This is a simple way to help schemes give their sponsors more time to improve their commercial circumstances.

Where paying benefit in full is in question, it should be easier to reach a fair benefit compromise

For some schemes the long term credibility of the sponsor underwriting long term funding risk and cost is in question. In these cases we believe it should be made easier for compromise agreements between trustees and employers to take place. As a general principle, we are not in favour of any measures that change scheme rules. A DB pension is a form of deferred pay and should be treated with due respect. But we are supportive of the notion that a sponsor could come to a trustee board with a proposal that is genuinely in members' best interests.

[1] **Hymans Robertson 'A Better Future for DB' report, November 2016: https://www.hymans.co.uk/media/uploads/Whats_next_for_DB.pdf**

The system should allow agreements of this nature to be reached in a cost effective way alongside appropriate member protections.

Changing benefits without members' consent should not be the norm nor an override. But it should be easier to do in individual cases when demonstrably in all parties' interests. Often the risks can be clear before you are at the point of imminent insolvency. If we allow sponsors and trustees to head off the potential for cumulative risks in good time, not only do we have a stronger chance of protecting members' benefits, this will also lessen the burden on the PPF.

Asset pooling is a better way to achieve scale benefits than the creation of a private sector 'superfund'

There is a compelling case for consolidation among some smaller schemes where governance can be constrained, risk management can be lacking and total running costs as a proportion of assets can be high and unsustainable. However, there are also many small schemes that are run cost effectively whilst managing risk effectively too.

Given many schemes are well run and affordable irrespective of size, making consolidation mandatory would be wrong. There is also no clear suggestion on how to cut the Gordian knot tying a scheme to the covenant of its sponsor. Forcing well run schemes to 'level down' will not only be met with strong resistance, it is unnecessary and counterproductive. If schemes are affordable, achieving value for money, managing their risks appropriately and getting good advice, the only guaranteed winner from the upheaval would be today's advisors, who would be paid, effectively, to windup schemes early. Compulsory consolidation would face stiff opposition from UK businesses unless it comes with significant cost and risk savings, which if delivered would not obviously be fair to other stakeholders such as taxpayers. Someone has to bear the cost and risk of the DB promise, and consolidation does not by itself take that problem away however much we might wish it were so.

When we conducted research into this issue in the context of the Local Government Pension Scheme back in 2013, we found that the same cost savings that come from full merger of assets and liabilities could be delivered in broadly the same magnitude, though more quickly and easily, through asset pooling. This argument is even stronger when looking at this through a practical lens - in the private sector there is significant benefit diversity which would make liability pooling complex. There are 60 times as many schemes, there is governance diversity and there is far less alignment of interest between the sponsoring employers of the funds. The only guaranteed winners of massive scheme mergers would be pension consultants.

Overall, affordability is not a systemic issue across UK DB. Therefore we do not believe cost-reduction to be the number one priority for those managing DB schemes. Rather, some schemes are simply exposing themselves to too much risk and as a result unnecessarily putting members' benefits at risk.

Question 1

Are the current valuation measures the right ones for the purposes for which they are used?

We have restricted our comments to measures within the scheme specific funding regime. We consider comments on corporate accounting measures and Pension Protection Fund (section 179) measures to be outside of the scope of our response.

Broadly, we feel that the flexibility of the scheme specific funding regime allows appropriate valuation measures to be set, used and monitored. We do not think the funding regime needs to be changed in this regard. However, we do have some comments on its use.

Firstly, we feel across the industry too much focus is given to 'balance sheet deficits' at a point in time. By their nature, however set, pension scheme deficits will be volatile, and pensions are a long-term promise. Too much focus on a single 'number', and how this moves over time, is not helpful, either for an individual pension scheme or across the industry. The focus should be more on member outcomes and in understanding what can affect them – especially in adverse circumstances. To do this, trustees and sponsors need clarity on their risks, in order to manage them and mitigate the risks associated with members not receiving their promised benefits in full.

While it is important to debate how much cash should flow into schemes in current market conditions, throwing more cash at deficits could make schemes less affordable and redirect funds from valuable business investment. A strong business means a strong covenant. As a strategy, simply pouring more money into schemes has not worked for the last 15 years so it is fair to assume it won't work over the next 15. Arguably the focus on deficit headline figures leads to significant cash calls on sponsors and distracts from what is important: meeting the interdependent objectives of ensuring there is a good chance of paying benefits to pensioners in full and that there is a healthy business sponsoring the scheme. A balance needs to be struck, and deficits are part of the picture. But to maintain a healthy business pension contributions need to be kept affordable both now and in future. If we do that, schemes are less likely to fall into the Pension Protection Fund (PPF), where members lose £50,000 of benefits on average, employees lose jobs, and businesses are broken.

Yet, when we conducted research for our annual Trustee Barometer report[2], only 1% of trustees told us they focus on the long-term probability of paying their members' pensions. This highlights that when it comes to strategy, the industry still relies on volatile balance sheet deficits and discount rates. Focusing on these in isolation is clouding the issue of how best to secure members' pensions.

The Pensions Regulator has been actively advocating a more holistic, joined up approach – with trustees acting as risk managers for their schemes. This is an approach we have favoured and adopted for over ten years. We are wholeheartedly behind the Regulator's push to see integrated risk management become standard industry practice.

[2] **Hymans Robertson Trustee Barometer 2016:**
https://www.hymans.co.uk/media/uploads/Trustee_Barometer_-_January_2017.pdf

Our Trustee Barometer research also showed that 53% of trustees believe their schemes could benefit from a slower and steadier approach. But a short term balance sheet focus has led to strategies that increase the cost and uncertainty of delivering members' pensions, unnecessarily putting benefits at risk. Research that we undertook in 2016[3] explored the merits of a 'lower for longer' approach. Our modelling showed that, on aggregate across the UK DB universe, if sponsors paid lower annual cash amounts for a longer time period, coupled with a lower-risk investment strategy, it would improve members' benefit security, reduce risk and volatility, and increase the probability of successfully paying members' benefits. We estimate that the increased benefit security of such an approach could increase the value of members' benefits by £250bn.

a) Are the flexibilities in setting the Statutory Funding Objective discount rate being used appropriately?

- **If not, why, and in which way are they not being used appropriately?**
- **What evidence is there to support this view?**
- **How could sponsors and trustees be better encouraged to use them?**

As explained above, we think the necessary flexibilities already exist within the funding regime. If the regime changes materially across the board there is potential to undermine the majority of well-run schemes, or for many pensioners to lose out, to deal with the challenges of the few at the edges.

The Pensions Regulator's increasing focus on trustees and sponsors engaging in holistic risk management of funding, investment and covenant risks is helpful and should, over time, allow more schemes to improve their risk management to improve member outcomes, benefiting members and sponsors alike. This will only happen if the wider pensions industry follows suit.

There may be some regulatory or legislative amendments which could make this easier for trustees and sponsors by linking up regulation and best practice. For example, secondary funding targets. Many trustees and employers do set long term funding targets which look 'beyond' the period of the statutory technical provisions and recovery plan, seeking to obtain full funding alongside a lower-risk investment strategy that looks further into the future. This can then become the more 'helpful' measure to monitor and use to set strategy. However, the legislation still requires a technical provisions measure to be calculated and reported, and as such trustees and their advisers then 'back-fill' their work as a 'tick box' exercise to produce a technical provisions figure and recovery plan, while in reality focusing (correctly) on their longer term measure. It would be helpful for legislation and guidance to link the two approaches.

b) Should we consider shorter valuation cycles for high risk schemes, and longer cycles for those that present a lower risk?

- **What should constitute a high or low risk?**
- **Or should a risk based reporting and monitoring regime be considered?**

We do not have a strong view, instead advocating shorter times to perform a valuation (see c below). We note that trustees already have the power to call an earlier valuation, where circumstances warrant it. Annual actuarial reports ensure that funding is monitored between valuations (and well managed schemes monitor funding levels much more frequently than annually, allowing any necessary discussions or steps to take place in good time in the event of significant deterioration).

[3] **Hymans Robertson 'A Better Future for DB' report, November 2016: https://www.hymans.co.uk/media/uploads/Whats_next_for_DB.pdf**

Finally, our understanding is that the triennial valuation cycle for technical provisions (with annual actuarial reports between valuations) is a requirement of the IORP and IORP II Directives. For so long as the UK is wedded to the EU legislation, we understand governments could feasibly require shorter (i.e. annual) cycles for high-risk schemes, but could not extend the intervals beyond 3 years for those at low risk.

c) Should the time available to complete valuations be reduced from 15 months?

- **What would be an appropriate length of time to allow?**

We are supportive of reducing the timescale. The 15 month period was set over 10 years ago, and technological advances now mean an actuarial valuation can be carried out much faster. We think 9 months is a reasonable period to target, subject to two practical considerations:

1. Administrators would need to provide data to actuaries swiftly after the valuation date. This can be a challenge where data is poor or systems are inefficient. Trustees should be supported to focus on cleaning their data, for risk management purposes. More efficient systems should enable administrators to provide the data in good time.
2. Actuarial valuations must include asset values based on the scheme's audited report and accounts. A 9 month period may be a challenge given that up to 7 months are allotted for the production of the pension scheme's annual report and accounts, and much of that time may be spent obtaining the auditor's sign off. Whilst not insurmountable, this practicality needs to be considered.

Where schemes do currently go beyond the 15 month deadline, in our experience this is usually not because the valuation calculations themselves take too long to complete, but because the trustees and companies are unable to agree the funding outcomes in time.

d) Should other measures or valuation approaches, for example stochastic modelling, be mandated or encouraged?

- **If so, which ones and for what purpose?**
- **How would the information provided to the Regulator to explain the agreed recovery plan differ from that at present?**
- **What would the costs be, and would they outweigh the benefits?**

We believe that such techniques should be encouraged, but not mandated. Our view is that the best outcomes can be obtained by trustees and sponsors using risk-based approaches to consider funding, investment and covenant risks in a joined up manner. There are many ways to do this effectively – with stochastic modelling being a helpful tool. Over recent years, such techniques have become accessible, cost effectively, to more and more schemes. There is little reason for larger schemes not to use techniques like these to holistically manage their risks in an integrated way, as per the Regulator's guidance which we fully support. For very small schemes, while some complex techniques may be disproportionately expensive, the costs of undertaking some form of simple risk-based or modelling work has become much more affordable, and we would strongly encourage this.

Question 2

Do members need to understand the funding position of their scheme, and if so what information would be helpful?

a) Should schemes do more to keep their members informed about the funding position of their schemes?

Schemes already communicate with members through annual summary funding statements. However, we suspect many members do not fully understand, engage with or (in some cases) even read these. Part of the problem is, again, the focus on a single deficit figure at a point in time. We think it would be helpful for trustees to more clearly demonstrate the risks and 'probability of success' to members. Ideally, this would include 'pence in the pound' measures, for example, explaining that their scheme can currently afford 90 pence in the pound of each member's promised pension – but that through a combination of recovery plan contributions, investment returns and the sponsor covenant underwriting the remaining 10 pence, the intention remains to pay members' pensions in full. This would make clear that private sector DB pensions cannot ever be 100% guaranteed, explaining the risks in an accessible way.

There is a balance to be struck between ensuring members understand the risks, but without causing undue alarm. An advantage to including such information is that members can allow for this within retirement planning. If they appreciate that their DB benefits are not 100% guaranteed, they may for example look to bolster retirement income through additional DC pension, or other savings. Or it may prompt them to seek advice on exploring the new flexibilities offered post Freedom & Choice.

Another issue is that information reported in summary funding statements (and other communications) is often very out of date. The SFS requirement is triggered by the production of an actuarial valuation or report, and the timing and contents of the statement are largely determined by that valuation or report; however, by the time when it falls due, more recent information is typically available. Changes to deadlines for valuations (as per question 1) should consider associated deadlines for summary funding statements to improve this.

b) Do we need Government communications to provide information to the wider public and media about the degree of certainty and risk in the regime?

- **What difference could this make?**

Yes, and we think the messages from all parties should be consistent. There is often a misconception that DB pensions are 'risk free', with cast-iron guarantees. This can therefore cause consternation when DB schemes fall into the PPF, or are wound up, and members' benefits are reduced. It is important that pension scheme trustees, sponsors, government, press and bodies such as the FCA make clear that, while the funding regime and other protections in place are designed to give members a great deal of protection, risks can never be wholly eliminated. As mentioned above, this allows members to consider these risks when planning for their retirement.

Question 3

Is there any evidence to support the view that current investment choices may be sub-optimal? If yes, what are the main drivers of these behaviours and how could they be changed?

Before addressing each specific sub question, we believe it is useful to set out a wider context.

It is difficult to be definitive as to what suboptimal 'means' in this context as the characteristics, maturity and sponsors of each DB pension scheme in the UK can vary markedly.

We believe it is more helpful to identify 'constraints' to good decision making and see how these might be removed.

Potential constraints are:

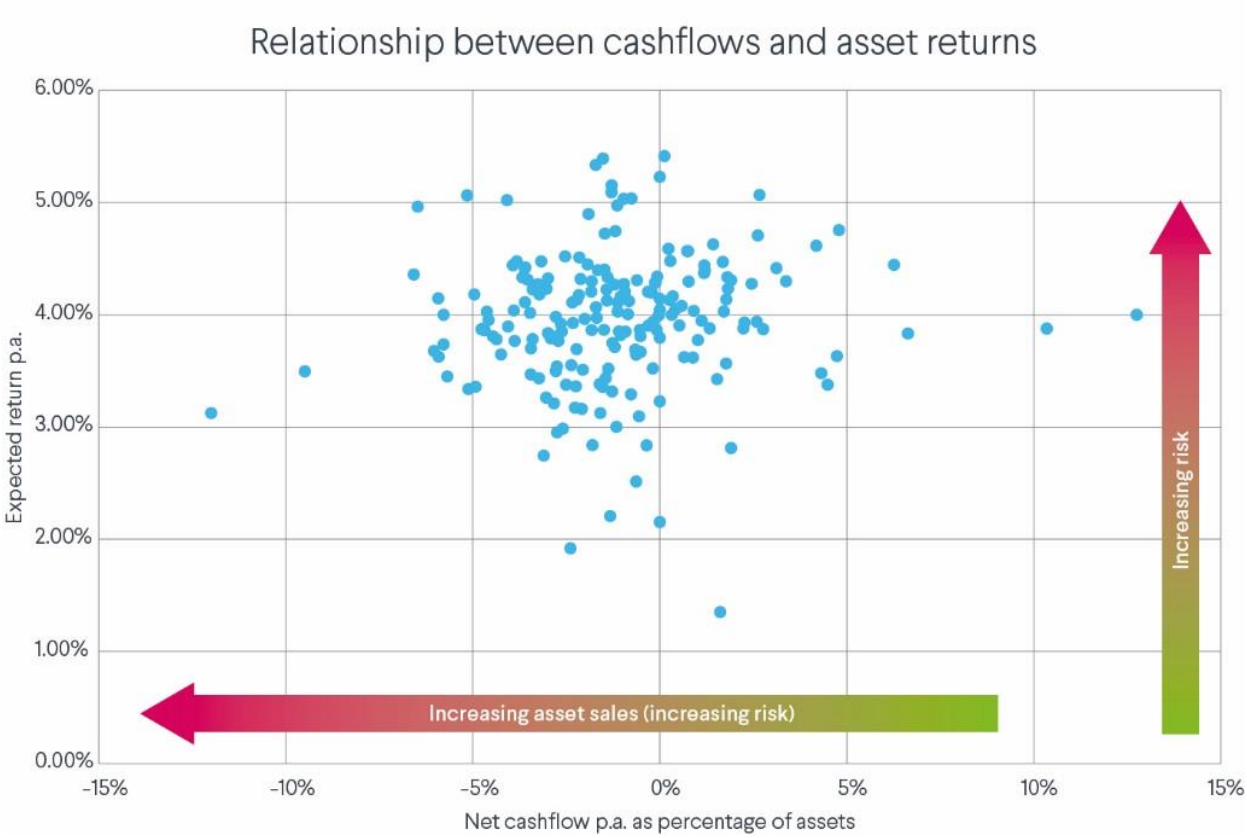
- Within Trustee/sponsor/investment manager influence:
  - understanding of choices;
  - fees levied;
  - access to assets;
  - liquidity requirements to pay benefits; and
  - operational support to implement decisions.
- Government control:
  - Regulation;
  - PPF; and
  - taxation (SDRT for example).

Evidence that supports a contention that these have led to wide spread sub-optimal decision making is difficult to source directly, but we highlight below a couple of characteristics of UK schemes that we find unusual:

Accounting for maturity

DB pension schemes are maturing and are increasingly having to sell assets to meet benefit payments. This exposes schemes to the risk that volatile assets may need to be realised at depressed levels after a market fall, therefore crystallising losses and permanently compromising capital.

The following chart plots the net cashflow position of the majority of FTSE 100 companies with a DB pension scheme against projection of future asset growth from their current investment strategy. This data is taken from our 2016 FTSE350 pensions analysis.



Expected return is our central growth estimation based on reported asset allocation. In general a higher return expectation reflects a higher risk strategy.

The chart suggests that there is little evidence of a relationship between maturity and level of risk taken. This exposes more mature schemes to a greater risk of asset sales at depressed prices and permanent impairment of capital.

An optimal choice may therefore be expected to reduce this crystallisation risk as schemes mature.

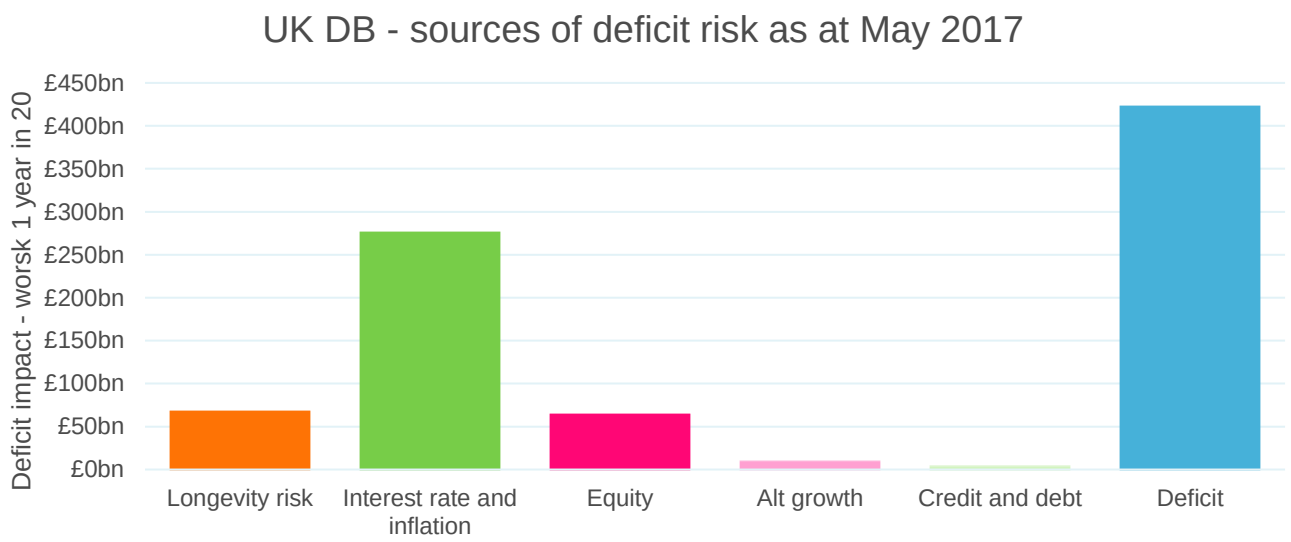
Managing risk exposures

The largest investment risks that DB pension schemes are generally exposed to within the investment strategy are equity volatility (due to large equity allocations) and interest rate volatility which impact the valuation of liabilities and cost of transferring risks to the insurance market.

In many cases, due to large deficits in DB schemes and low hedging levels, the exposure to interest rate volatility risk will be the largest and most concentrated risk as shown in the following chart. This chart shows the short term break down in the 'tail risk' i.e. adverse outcomes – in this case looking at the worst 1 year in 20 – for UK DB. It shows that the deficit could grow by over £400bn in 1 year (the blue bar) or around 20% of our UK GDP. This is based on the sum of the component risks – where clearly interest rate and inflation risk (the green bar) is dominant.

Of course the UK DB aggregate risk outlook does not tell the whole story and each scheme's strategy and risk profile will be unique. What is clear though, is that on average the risk exposure in UK DB schemes is concentrated on interest rate and inflation risk, as opposed to being well balanced and diversified. It also shows that longevity risk is increasingly material and yet it is a risk for which we suspect many UK DB schemes do not have an active or well-articulated plan to tackle it. In our view, this needs to change.

The chart below is based on analysis from Hymans Robertson's UK DB index which captures the broad asset and contribution strategy and liability characteristics of all UK Private sector DB pensions schemes.



Although low levels of interest rates need to be considered, a more optimal investment choice would be expected to diversify these risk concentrations.

Moving to specific questions:

a) Do trustees/funds have adequate and sufficient investment options on offer in the market?

- **Is there anything Government could do to address any issues?**

Broadly we would agree there are sufficient options in the market. Generally all DB schemes require assets that provide:

- **Growth** to close deficits;
- **Income** to meet pension payments without being a forced seller; and
- **Protection** from market setbacks for members and sponsors.

Demand tends to lead product development and we have seen significant innovation by the market in areas including LDI, cashflow generation and alternative assets. We believe there are therefore adequate asset 'options'.

The issue is therefore not investment options, but:

1 Understanding; potentially addressed by wider use of professional trustees rather than further onerous requirements on well-meaning lay trustees. A solution could incorporate the use of both professional and lay trustees.

2 Engagement; disintermediation of decision making between trustees/sponsors and the investment of assets through solutions that package both strategic advice and investment management.

3 Supply/demand imbalance and therefore pricing of assets (for example the availability of appropriate types of infrastructure investment). We see a role for government in addressing such imbalance for the benefit of taxpayers and pensioners, though this is outside the scope of this response.

4 Governance; this is partly the understanding of decisions required, but also sufficient executive resource for advice and to ensure effective execution.

5 Minimum investment sizes in some asset classes that might be addressed by joint procurement.

6 Transaction costs (including taxation) that may discourage implementation of change.

It is these areas that we believe are fundamental to addressing the issue and we expand on these in our responses below.

b) Do members need to understand the investment decisions that are being made?

- **- If yes, are there any specific decisions that need articulating?**

Members are promised a benefit, not the success or otherwise of a funding/investment strategy. Under current legislation, the risk of underfunding sits with the sponsor. However, the exception to this is the risk of insolvency of the sponsor when the pension scheme has insufficient assets.

Our view is that an articulation of what a particular asset does is less valuable to a member than an understanding of how the overall funding strategy impacts the likelihood of their benefits being paid. We comment on the latter in our response to question 2.

c) Would it be appropriate for the Regulator to take a lead in influencing or determining an acceptable overall level of risk for a scheme in a more open and transparent way?

Our view is that it is difficult to apply general rules given the wide range of scheme characteristics, sponsor profiles and funding approaches taken (some that will include some form of contingent asset security).

We therefore favour a more holistic approach in line with the current Integrated Risk Management approach with oversight from professional, regulated advisers. The publication of statistics on pension schemes' approach to funding (asset allocations, funding assumptions and recovery periods, etc.) with commentary from the Regulator on overall expectations is valuable in terms of nudging trustees and sponsors towards appropriate solutions.

Further, we believe it is important to avoid the temptation of setting clear but artificial rules (such as set recovery plan lengths) that may drive behaviours inconsistent with prudent risk management (i.e. drive high risk strategies to reduce 'calculated' recovery periods – which in turn would reduce members' benefit security).

The exception to this would be more definitive views in cases where trustees and sponsors cannot agree or in outlier cases where the Regulator does become involved and guidance and potentially direction around acceptable solutions is of value.

d) Would asset pooling or scheme consolidation help schemes to access better investment opportunities?

For context, we do not see liability pooling as necessary to achieve the cost and opportunity benefits of asset pooling. There are a variety of asset pooling solutions available for standalone schemes, including platforms, fiduciary and asset pools such as those that are emerging in the Local Government Pensions Scheme environment.

In addition, asset pooling already exists through manager unit trusts, and large passive managers generally offer scope for even small schemes to access a wide range of asset classes. However, these existing asset pools do have a number of issues:

- Tiered fee scales that allow larger schemes to achieve lower costs;
- Access to less common 'alternative' assets can be constrained for smaller schemes due to minimum investment levels; and
- Liquidity requirements can make it difficult for smaller/more mature schemes to 'lock-up' assets for longer periods to access higher yields.

Joint procurement of managers that allowed schemes to pool to access lower fee tiers and asset classes with higher minimum investments, whilst still continuing to allow schemes transparency and control of strategy, would be valuable in addressing all of these issues. It would also continue to separate the conflict of interest arising by separation of the strategic funding decisions and management of assets.

Such pools may also allow clients with differing liquidity requirements to 'cross' assets to increase liquidity for those who require it.

This would be most likely of value to smaller schemes (<£100m) and might be achieved by a form of grouping of schemes with similar requirements at the strategic advice level and then offering them the option to jointly procure management services with their peers to reduce costs (selection, appointment, advice and ongoing management fees).

Evidence supporting this is set out in our own analysis for the Department of Communities and Local Government (DCLG) on the structure of the Local Government Pension Scheme[4] which highlighted the significant scale of savings that can be made through the use of asset pooling scale. This is particularly true in respect of alternative asset classes which tend both to have higher fees and to require large minimum investments, especially in the case of Fund-of-Fund approaches.

[4] **Hymans Robertson LGPS Structure Analysis, December 2013**

For context, the table below shows that increasing AUM has a larger impact on fees for private equity than for traditional listed equity funds. We have shown average fee levels across various sizes of mandates for both asset classes received from several managers as part of a 2016 manager search process.

Fees for various AUM levels (Bps)				
	£25m	£50m	£100m	>£100m
UK Active Listed Equity	63	60	55	53
Private Equity	75	66	59	53

Source: Hymans Robertson

Please note, in the table above we have not allowed for the performance and commitment fees charged by private equity managers, as the charging structures vary greatly across managers. Private equity fees would be higher across the board than shown above, but the management fee component captures the fee element that varies with mandate size.

We have also shown how increasing AUM affects the average fees returned from respondents for absolute return bond funds and syndicated loans mandates below.

Fees for various AUM levels (Bps)				
	£100m	£200m	£350m	>£350m
Absolute Return Bonds	47	44	42	41
Syndicated Loans	51	47	44	43

Source: Hymans Robertson

e) Is regulation (including liability measurement requirements) incentivising overly risk-averse behaviours/decisions that result in sub-optimal investment strategies?

Liability measurement requirements do not in our view directly incentivise risk-averse behaviour. However, as an industry there has been a herding around ‘gilts plus’ discount rate approaches which can, if relied on in isolation (i.e. absent a broader Integrated Risk Management approach), lead to risk-averse investment behaviours. It can also lead to managing assets to reduce the volatility of the gilts-plus balance sheet measure, rather than selecting an asset strategy to increase the chances of paying pensions whilst reducing risk. However, none of this is a regulatory requirement and good risk management, which looks at both balance sheets and cashflows and relies only on a liability measure to summarise (rather than select) a given strategy should avoid overly risk-averse behaviour. We see Integrated Risk Management as an opportunity for the industry to improve outcomes for members.

We do not, however, believe regulation is the only driver of lower risk strategies, or indeed that lower risk strategies are risk-averse. Trustees need to be cognisant of the need to secure member benefits should a sponsor insolvency occur. Both the PPF and insurance companies use a form of lower risk 'gilts' valuation measures in their calculations for the cost of securing member benefits, and therefore trustees do need to be aware of these when determining appropriate risk levels for investment/funding strategies. This use by the PPF and insurance companies is due to the layers of regulation added by successive governments that have 'hardened' liabilities by removing various discretions and pressure release valves. For schemes there is a balance between assets that deliver growth, income and protection, and the right mix will vary between schemes and sponsors.

In summary, our view is that regulation is flexible enough to allow scope to implement optimal investment strategies.

f) Are you aware of evidence of herding or poor advice from the intermediaries and advisors?

No.

g) Are measures needed to improve trustee decision making: skills such as enhanced training, more Regulator guidance, or the professionalization of trustees?

This is a theme which has also been the subject of other consultations and discussion papers in recent months. Following its discussion paper on 21st century Trusteeship and Governance, the Pensions Regulator has committed to undertaking a targeted education drive to raise the standards of trusteeship in 2017. Alongside this, the FCA has published its interim report on its asset management market study which highlights some limitations of the current structure for trustee boards making investment decisions. We responded in full to the consultation on 21st century trusteeship[5], and therefore have not repeated our response here.

[5] **Hymans Robertson 21st Century trusteeship:**
https://www.hymans.co.uk/media/uploads/1609_Twenty-first_Century_Trusteeship_60SNS.pdf

Question 4

Is there a case for making special arrangements for schemes and sponsors in certain circumstances such as a different regime for employers who can afford to pay more, and/or new or enhanced flexibilities for stressed sponsors and schemes?

We do not think there should be any over-arching changes to allow sponsors to reduce benefits, switch from RPI to CPI through a statutory override, or introduce conditional indexation. However, as the consultation acknowledges, there have been instances where trustees and employers have agreed to 'compromise agreements', which have been agreed by the parties involved to be in the best interests of the members.

We are in favour of ensuring that such agreements can be made, on a case by case basis, with appropriate safeguards in place and with the involvement of the Pensions Regulator. At present, it can be very difficult for such agreements to be carried out, and they can be extremely costly for trustees and sponsors, including in terms of professional fees. We would be supportive of making it easier for such agreements to be made (including, but not limited to, the potential broadening of circumstances in which a regulated apportionment arrangement could be carried out).

a) Do you have any evidence that Deficit Repair Contributions are currently unaffordable?

In aggregate, no. For example, our FTSE350 pensions analysis report in late 2016[6] showed that 80% of FTSE350 companies with DB pension schemes could pay off their pensions accounting (IAS19) deficits with less than 6 months of earnings. However, we would stress two points:

1. The amount of cash which companies are committing to DB pensions has risen steadily over several decades for a number of reasons – arising from the UK economy, rising life expectancy and widespread legislative and regulatory changes. Many companies have paid very significant deficit reduction contributions over the last decade, to find that deficits remain as high as ever. Even if strictly 'affordable', the amounts paid by most companies is far higher than ever envisaged when the DB schemes were established.
2. While in aggregate we do not consider DRCs to be unaffordable, they are for a significant minority of companies.

b) Should we consider measures to encourage employers who have significant resources as well as significant DB deficits to repair those deficits more quickly?

- **If so, in what circumstances, and what might those measures be?**

We feel it is right that trustees and employers agree appropriate recovery plan lengths and structures collaboratively on a scheme–by-scheme basis, taking into account other factors like sponsor covenant and investment risk. Trustees have significant powers where they believe their sponsor should pay deficits more quickly. While some companies could afford to pay deficits more quickly, there is a balance to be struck between the needs of members and the sponsor's legitimate business needs and aims. For instance, companies try to manage their overall debt profile so it remains affordable; it would not be typical business practice to pay off other forms of debt as quickly as the company possibly could. As stated above, many companies have been paying considerable amounts of money to clear pension scheme deficits for many years already.

[6] **Hymans Robertson FTSE350 Pensions Analysis 2016:**
https://www.hymans.co.uk/media/uploads/FTSE350_Pensions_Analysis_Report_2016.pdf

While we would agree that there are some cases where companies could pay off their deficits sooner, this is not the greatest concern. A bigger issue is that in many cases short time horizons are forcing greater and unnecessary asset risk taking. For the majority of schemes where the benefits are expected to be paid (and are manageable for the sponsor), having a longer recovery plan, and giving assets more time to grow, means a scheme can take less asset risk and measurably improve the security of benefits. As set out in response to question 1, our analysis showed that a 'lower for longer' approach across the universe of DB schemes in the UK could actually increase the value of members' benefits by £250bn[7], due to this improved benefit security.

It is too simplistic, not least a step backwards, to say 'long recovery plans are bad'. If used to manage risk, 'long' is typically better. If used to reduce cost, longer is worse. Blanket discouragement of using the lever of recovery plan duration could be a blow to scheme specific risk management.

c) If measures are needed for stressed sponsors and schemes, how could 'stressed' be defined?

- **Should a general metric be used, or should this be decided on a case by case basis?**

See below.

d) Are there any circumstances where stressed employers should be able to separate from their schemes without having to demonstrate that they are likely to become insolvent in the near future?

See below.

e) How would it be possible to avoid the moral hazard of employers manipulating such a system in order to off load their DB liabilities?

- **Would some sort of 'quid pro quo' be appropriate to ensure the scheme is not disadvantaged relative to other creditors of the employer/stakeholders?**
- **What could this look like?**

At present, stressed employers can generally only separate from schemes via regulated apportionment arrangements, and then only in very specific circumstances, including that insolvency is likely within the next 12 months. There will be, however, many schemes where there is a relatively large deficit, coupled with a sponsoring employer that is either weak or small in comparison. In these cases there may be little realistic chance of full funding being achieved in any reasonable timescale. However, without facing imminent insolvency options are currently very limited.

As the consultation says, there have been instances of scheme sponsors and trustees agreeing to compromise agreements. These can potentially benefit scheme members, employees and sponsoring employers alike.

In our view the regulatory framework should support trustees and sponsors when both parties believe that continuing to run the scheme on is untenable. The Pensions Regulator should have an involvement, and the legal structure should mean that a disproportionate cost is not incurred in advisory fees.

Solutions might involve an ongoing link between the sponsor and the scheme, the link being permanently severed with the scheme running on, members' benefits being bought out below 100% with an insurer, or the scheme entering the PPF. The regulations should be accommodative subject to the safeguards set out below.

[7] **Hymans Robertson 'A Better Future for DB' report, November 2016: https://www.hymans.co.uk/media/uploads/Whats_next_for_DB.pdf**

There would be a number of safeguards needed to avoid misuse. It is vital that members' interests are treated as paramount, with trustees acting as a 'first line of defence', and tPR and PPF providing additional safeguards. Specific safeguards could include:

- A requirement for the Pensions Regulator to be involved early in the process;
- A requirement for a trustee board involved in such discussions to have a professional trustee on the board (potentially a requirement for them to act as chair); and
- Requirements for any such arrangements to provide suitable upside arrangements, e.g. where pension increases are reduced, a requirement to provide discretionary pension increases in future if the scheme or sponsor's fortunes were to improve.

Care would be needed when designing such processes to ensure that members would remain eligible for PPF protection. The safeguards above should prevent employers from being able to 'walk away' from the scheme, transferring their risks to the PPF, unless demonstrably in all parties' interests).

f) Are there any circumstances where employers should be able to renegotiate DB pensions and reduce accrued benefits?

- **If so, in what circumstances?**

Under normal circumstances, no. We feel that employers should generally respect the defined benefit 'promise' to members. However, the exception to this would be the form of 'compromise agreement' detailed in parts d) and e).

g) Is there any evidence to suggest that there is an affordability crisis that would warrant permitting schemes to reduce indexation to the statutory minimum?

For reasons expressed earlier, we do not feel that there is an 'affordability crisis', though we are conscious that many employers have paid vastly more cash into DB pensions than was ever initially envisaged. Nonetheless, in our opinion, schemes should not be able to reduce indexation to the statutory minimum, except for in very particular circumstances for stressed schemes (as set out in e). Otherwise, we believe accrued benefits constitute a promise to members, corresponding to deferred pay, and should be treated as such.

h) Should the Government consider a statutory over-ride to allow schemes to move to a different index, provided that protection against inflation is maintained?

- **Should this also be for revaluation as well as indexation?**

We think there is a very difficult balance to consider here. On the one hand, we believe that accrued benefits are a promise and should not be worsened, except for in the very particular circumstances that we set out for stressed schemes in e). On the other hand, we appreciate that schemes are currently subject to a 'Rules lottery' from trust deeds drafted long before CPI was ever envisaged. This has led to some schemes being able to change their indexation basis while others have not. There is also the argument that CPI is, generally, considered to be a better index for measurement of rises in the cost of living, which is the purpose for which index-linked pensions were initially introduced.

On balance, and given other comments regarding affordability, and re-building confidence in outcomes from the pension system, we **do not** support a statutory override (for either indexation in payment or for revaluation). We acknowledge that this is a subjective and difficult decision.

i) Should the Government consider allowing schemes to suspend indexation in some circumstances?

- **If so, in what circumstances?**

We are generally not supportive of this, consistent with our responses to earlier questions. It is unclear to us that a temporary break from the requirement to pay pension increases would materially help a sponsoring employer that is struggling to survive.

Again, our exception would be where an indexation freeze is included within a compromise agreement between the trustees and sponsor in particular stressed circumstances, as set out in question e, although we expect that in these stressed cases suspension may often be permanent rather than temporary.

j) How would you prevent a sponsoring employer from only funding a scheme to a lower level in order to take advantage of such an easement?

The valuation protections and trustees will be the first line of defence. In combination with the fact that these easements are only available to stressed employers, we expect this would make the incentive to game the system in this way suitably small.

k) Should Government consider allowing or requiring longer, deferred or back loaded recovery plans?

- **If so, in what circumstances?**
- **Should other changes be considered, such as the valuation method of Technical Provisions?**

This flexibility already exists within the current funding regime and we believe this should be retained. Individual trustees and sponsors, taking advice as appropriate, are best placed to balance the needs of cash, investment risk, recovery plan length and structure (including any back loading or deferral period), and covenant risk.

We do not believe that the government should consider requiring longer, deferred or back-loaded recovery plans. However, there can certainly be occasions where (as referred to in question 1) a lower and longer recovery plan, coupled with a lower level of investment risk, can be more likely to lead to members' benefits being paid in full, as well as a better outcome for the sponsor, and we are supportive of this flexibility.

l) Should it be easier to take small pots as a lump sum through trivial commutation?

Yes, we believe so. Currently, there are different requirements for 'trivial commutation' and 'small pots'. In some cases extensive tests are required to test eligibility (for example, checking the amounts of pensions in payment prior to April 2006), which can be a barrier for smaller schemes carrying out an exercise or offering this option.

This can lead to costs for schemes of all sizes which we feel are disproportionate.

We believe it would be appropriate for all members with less than a set amount of pension in any scheme to be able to take the full amount as cash, which is also more consistent with the principles of Freedom & Choice, from which members of DC schemes have benefited. We believe it is unlikely many individuals would seek to 'game' the tax system by keeping large numbers of small pensions in different DB pension arrangements, so the risk to the government is minimal.

Question 5

Do members need further protection, and should this be delivered by a stronger and more proactive Regulator, and/or trustees with enhanced powers?

There is a delicate balance between providing protection to members, enabling employers to focus on their business without overly burdening them, and having an effective regulator. We think the balance is currently about right. In particular:

- Trustees already have significant powers and we do not feel these need to be enhanced. Our concern is more that trustees do not always feel empowered to use such powers, because, for example, of lack of knowledge or support.
- The Pensions Regulator already has significant power, and already operates as both policeman and judge in the current regime. We do not believe its powers generally need to be enhanced, though there may be scope for allowing powers to be used more cost effectively.

We agree the whole pensions industry can do better in protecting members and aiming to optimise member outcomes. We feel this should be via good risk management, tools and clear and effective legislation, rather than more onerous regulation or increased trustee powers.

a) Would greater clarity over the requirements for scheme funding be helpful to members and to sponsors?

- **If so, would this be better set out in detail in legislation or through increased guidance and standards from the Regulator?**

In general, we feel the relevant legislation, guidance and regulation already exist and are clear.

We are also generally supportive of 'principles based' rather than 'rules based' regulation. However, there may be merit in introducing more 'rules based' guidance for smaller schemes, where resources are limited (and tPR's involvement is also likely to be limited). This could act as a 'regulatory underpin': for example there could be a specific requirement that for schemes under a certain asset size (e.g. £20m), sponsors and trustees must fund schemes on a basis at least as strong as (for example) an accounting basis, with the scheme-specific funding regime as a further layer of regulatory protection.

b) Is it possible to design a system of compulsory proactive clearance by the Regulator of certain corporate transactions, without significant detriment to legitimate business activity?

- **If so how?**
- **What are the risks of giving the Regulator the power to do this?**

This is a difficult balance, both for ensuring effective time and use of the Pensions Regulator, and not causing overly onerous strains on businesses.

At present, there are several different pieces of regulatory policy and guidance for employers to consider, including the notifiable events framework, guidance on corporate transactions, and the material detriment test. It may be possible to simplify, combine and/or streamline these to reduce the regulatory burden on employers (and trustees) for the more 'routine' issues which may occur. This would free up regulatory time and attention for tackling more material issues.

Given that many schemes already face funding risks (see for example the PPF's analysis of the likely number of insolvencies by 2030) it will be difficult to draw a neat line between cases that require compulsory clearance and those that do not. Draw the net too wide and you layer unnecessary and unwelcome costs on UK plc. Draw it too narrow and no doubt important cases will be missed. Either way, we will face further insolvencies of DB sponsors irrespective of transaction activity.

c) Should the Regulator be able to impose punitive fines for corporate transactions that are detrimental to schemes?

- **If so, in what circumstances?**

We think this might be appropriate, if the transaction itself was materially detrimental to the scheme. However, this would only be appropriate if guidance and regulation were very clear about what transactions needed to be reported to the Regulator/clearance or the avoidance of the DB liabilities was clear and deliberate. Fines would then only be possible where a corporate transaction has been entered into which is materially detrimental, the required process has not been followed and tPR had not been consulted at the appropriate time.

d) What safeguards could ensure that any additional powers given to the Regulator do not impact on the competitiveness of the UK business or the attractiveness of the UK market?

We would suggest an annual audit of tPR's effectiveness. A 'good' result would be that it shows tPR is actively involved in only a small amount of cases, but for those where it is, its involvement is material and proportionate.

e) Should the Regulator have new information gathering powers?

We are supportive of the proposal set out in the consultation document, regarding creating an overall duty for parties to co-operate with the Regulator.

f) Should civil penalties be available for non-compliance?

We have not answered this question. Other responders may be better placed to comment on legal mechanisms for non-compliance.

g) Should levy payers be asked to fund additional resources for the Regulator?

Some expenses of more complex cases (e.g. regulated apportionment) are already met by the sponsors that instigate the processes, we believe this is reasonable and should continue.

How to fund more general tPR resources is a delicate and potentially political issue. In our view, if our proposals under a) and b) are adopted, this should not lead to large additional resources being needed, as there should be savings offsetting additional costs. However, we feel that any additional costs should be balanced between levy payers and the specific parties involved in a case.

h) Should trustees be given extra powers such as powers to demand timely information from sponsors, to strengthen their position?

- **If so, what extra powers might be helpful?**

We have not answered this question. Other responders may be better placed to comment.

i) Should trustees be consulted when the employer plans to pay dividends if the scheme is underfunded – and if so, at what level of funding?

Yes, if the impact on the scheme could be materially detrimental. Current guidance makes clear that sponsors should not be prevented from paying ordinary dividends if the scheme's deficit is being appropriately managed via a suitable recovery plan and we agree that is appropriate. Whether or not the impact could be viewed as materially detrimental will depend on the relative sizes of the scheme and sponsor, the investment strategy, the covenant as well as the level of dividend payments and scheme funding level. In other words, as the Pension Regulator recognises, effective risk management decisions are multi-faceted and are best taken in an integrated way.

j) Is action needed to ensure that members are aware of the value of and risks to their DB pensions.

Yes, and this is covered in our responses to questions 2a and 2b.

Question 6

Should Government act to encourage, incentivise, or in some circumstances mandate the consolidation of smaller schemes into vehicles with greater scale and better governance in order to reduce the risk to members in future from the running down of closed, especially smaller, DB schemes?

We believe some consolidation of schemes at an **asset level** could be of very significant help where schemes struggle to follow best practice risk, cost and opportunity management. Their struggle could be due to governance, knowledge or cost per member of accessing asset opportunities. This is consistent with our research into the Local Government Pensions Scheme in 2013[8] which showed that the cost saving benefits of asset pooling were broadly similar to asset and liability merger, albeit the benefits are faster and cheaper to realise.

However, we do not believe mandating asset pooling is the appropriate approach as:

- There may be a levelling down of some schemes with great governance and best practice risk management;
- There would be significant costs involved with any merger (advice and transaction costs). These may expect to have a payback period through better advice and lower fees, but may exacerbate the situation for schemes already in difficulty and in fact, we expect similar savings can be achieved faster through asset pooling; and
- Sponsors, trustees and members continue to bare the ultimate risk. Pooling may disassociate the underwriter of the risk from decision making about that risk, further exacerbating any engagement issues and potentially leading to risks to the pools (a sponsor that sues an underperforming pool that it was forced to go into) potentially to the detriment of other pool participants.

We would therefore favour encouragement and incentivisation through the attractions that asset pools could offer in terms of lower fees and better governance.

Such an approach is likely to be very attractive for smaller schemes where the cost per member is relatively high, assuming the costs can be materially reduced.

An approach could include some form of joint procurement of a separate professional trustee, adviser and asset managers to gain fee, scale and potential liquidity advantages, whilst maintaining individual trustee boards at a scheme level, transparency of fees and managing conflicts of interest. The implementation of this should be done carefully so as to manage the size of pools (ability to influence markets) and should continue to ensure a healthy market operation of competition between professional trustees, consultants and managers to drive efficiency and advice development. Pools with mandated solutions or pools with too much asset scale would reduce both competition and innovation, and we understand one of government's key goals is to maintain competition to achieve the healthy market for advice and management.

a) Is there anything in the existing legislative or regulatory system preventing schemes for consolidating?

- **How might such barriers be overcome?**

See b) below

[8] **Hymans Robertson LGPS Structure analysis, December 2013**

b) What other barriers are there which are preventing schemes from consolidating?

- **How might they be overcome?**

There are significantly fewer barriers to asset pooling than there are to 'fuller' (asset, liability, governance and service) consolidation. We believe that it can sustainably achieve the vast majority of attainable cost savings whilst improving outcomes for schemes that are governance or cost constrained. As we note above, this is therefore likely to be more desirable and easily achievable for many schemes.

There are more substantial 'hard' and 'soft' barriers to 'fuller' consolidation.

'Hard' barriers are likely to include:

- Differences in different schemes' trust deed and rules, particularly the 'balance of powers';
- Technical difficulties in consolidating (e.g. merging) schemes with different benefit structures, funding levels / funding plans, investment strategies, sponsor covenants;
- Poor data held by many schemes (including guaranteed minimum pension data and the difficulties arising from GMP reconciliation);
- GMP equalisation requirements (though we note work is currently underway in this area, aimed at helping schemes both equalise GMPs and convert them to a simpler benefit form);
- Schemes needing to fund to full buy-out level if consolidating via cutting the link to the existing sponsoring employer;
- High adviser fees involved in any form of consolidation exercise, as a result of the above.

Some possible methods of overcoming these barriers are included in c) and d) below.

'Soft' barriers are likely to include:

- Conflicts of interest for trustees, sponsors and advisers;
- Fear from trustees or sponsors of legal or other challenge from members, where benefits or security are altered following a consolidation;
- Concerns about the multi-employer regime for sponsors, including 'section 75' debt issues;
- Trustees and sponsors not wishing to abdicate responsibility for their scheme members, or lose control. This will often be for paternalistic or altruistic reasons, so there must be a good reason for trustees and sponsors to believe that their members' interests would be 'in better hands' following any consolidation.

Having some form of officially endorsed consolidation vehicles might deal with multiple issues above, and some further comments are set out in c) and d) below. However, as set out above, we believe there should be no compulsion for schemes to consolidate and that the industry already offers and continues to work on cost-efficient, more streamlined solutions for smaller schemes.

c) Should Government define a simplified benefit model to encourage consolidation?

Yes, we support this in principle. In practice, there would be individual winners and losers from such an approach, and therefore we envisage this being an **option** for schemes rather than compulsory. The overall administrative and other savings, such as wind-up costs, could be substantial and could therefore increase benefit security.

d) Should rules be changed to allow the reshaping of benefits without member consent?

- **In what circumstances?**
- **Should there be prescribed restrictions to the types or limits of such reshaping?**

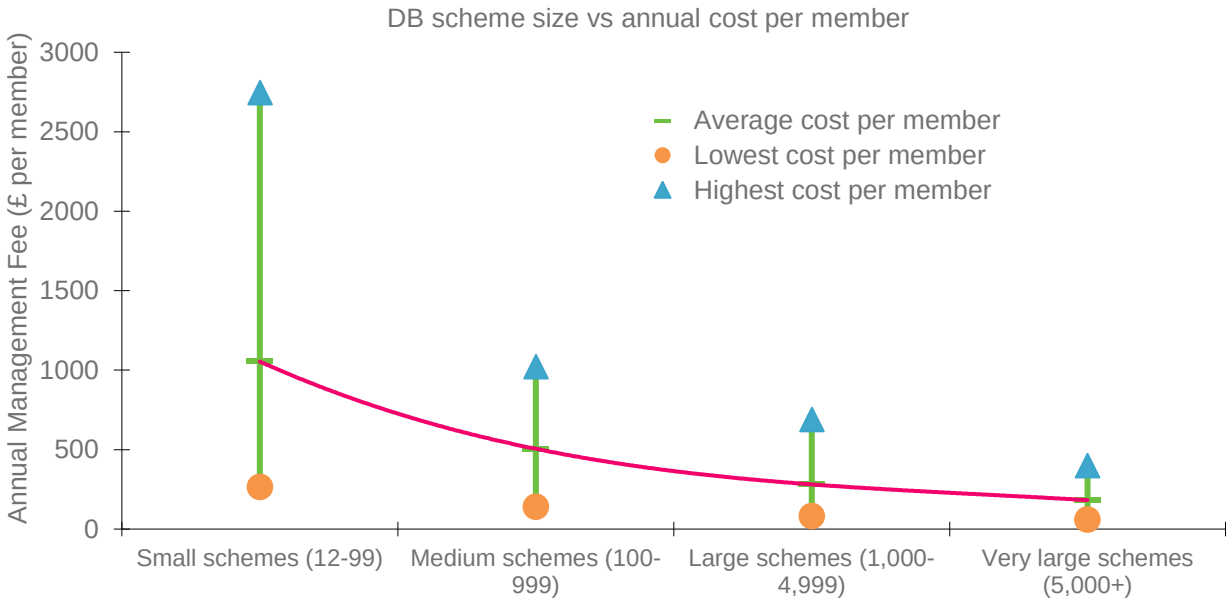
We do not see a strong case for changing the current rules, which already allow this via the 'actuarial equivalence' route.

There can be reluctance to using this approach in some cases, due to a fear of creating individual 'winners and losers' (e.g. if a member's benefits are changed to a higher pension with lower future increases, but they live longer in retirement than assumed). Clear guidance and legislation setting out how trustees and advisers can consider such issues may help remove some barriers, giving comfort and protection to trustees where they have taken appropriate steps, especially if coupled with a standard set of benefits (per c above), such that many schemes would feel comfortable reshaping benefits to this same standard. However, we feel strongly that actuarial and / or legal adviser sign-off would still be required, certifying that members could expect benefits of at least equal value on average.

e) Are costs and charges too high in DB schemes?

Overall costs are a poor indicator of value. Cost per member is be a better indicator. Anecdotally the average running cost of a large pension scheme is of the order of 0.5% to 0.75% p.a. (including asset management, consultancy and administration).

The following analysis is taken from the Pensions Regulator DB scheme costs comparison tool. The tool is based on the Pensions Regulator's defined benefit (DB) scheme running costs research report 2014. The research reveals that overall scheme costs per member do fall as scheme size increases.



Source: http://www.thepensionsregulator.gov.uk/trustees/your-db-scheme-costs.aspx

To put this into context, the average annual volatility of a pension scheme's funding level is around 10% to 15% p.a. A £1bn scheme is therefore subject to administration and risk management costs of £5m to £7.5m per year in comparison to risk exposure of £100m to £150m.

Ensuring appropriate levels of competition in provider markets, transparency of fees, management of conflicts of interest and low barriers to change will ensure high level costs are set at appropriate levels for larger schemes.

However, this does not address the issue of cost per member for smaller schemes that struggle to spread the costs over a wide enough membership and are therefore more reluctant to take appropriate advice.

Asset pooling approaches and joint procurement of services for schemes with similar characteristics could therefore be of high value, especially for smaller schemes that are not taking enough advice to manage the high level of risks to which they are exposed.

f) Should schemes be required to be more transparent about their costs or justify why they do not consolidate?

- **In what circumstances?**

We agree that there should be more transparency of costs, especially to sponsors who are ultimately responsible for funding the schemes.

One option may be for government to introduce a fee threshold based on a multiple of the average scheme's fees (as a proportion of assets). Schemes should be able to go above that limit but be required to explain why they had done so (this will create further support for some form of pooling approach, given costs per member are inversely correlated with scheme size).

The threshold would allow trustees to have a sense of what is 'normal', and how their scheme compares.

g) Is there a case for mandatory consolidation?

- **In what circumstances?**

No. For the reasons set out above, we do not believe consolidation should be mandatory.

However, we see a strong case for encouraging asset pooling through approaches that offer reasonable costs per member and better levels of advice and risk management that will encourage sponsors/trustees to voluntarily consolidate for the benefit of all stakeholders.

We do not believe there should be any mandatory consolidation of smaller schemes into larger vehicles. It should be possible for a small DB scheme to be well governed, well advised and well run. Solutions for smaller schemes already exist and there is considerable work being undertaken in the pensions industry to create streamlined, efficient solutions for small schemes.

However, we are supportive of schemes being able to consolidate where trustees and sponsors believe that it is in their interests (to benefit from scale, for example), and we agree that government should remove any barriers to them doing so.

Ultimately, many schemes will be seeking to buy-out their benefits with an insurer in the medium to long term and the buy-out market, backed by its stringent capital requirements for insurers, is ultimately the ideal consolidation vehicle for employers who want to remove their DB pension risk.

h) Should the Government encourage the use of consolidation vehicles, including DB master trusts?

- **If so how might it do so?**

As discussed, the industry is actively engaged in ensuring smaller schemes have options available to ensure they can be run well, efficiently and in a cost-effective and streamlined way. Consolidation vehicles should absolutely be an option, but only one option. Consolidation vehicles should be predicated on the premise of improving member outcomes which is done by better managing risk (rather than just reducing costs). An independent quality assurance programme and related mark (like the Kitemark for DC schemes) could encourage use of consolidation vehicles that demonstrably improve member outcomes.

i) Are further changes needed to the employer debt regime in multi-employer schemes to encourage further consolidation?

See n) below.

j) Is there a case for consolidation as a cheaper, but more efficient form of buy-out, with the employer and trustees discharged?

- **If so, (a) what should be the requirements for a scheme to enter such a consolidator, especially the level of funding; and**
- **(b), should the residual risk be borne by the member, or by the PPF?**

The rationale for this proposal would be that the buy-out market is inefficient for smaller schemes. Our own experience suggests that schemes with assets of less than c £30m may find it difficult to obtain buy-out terms as attractive as those available to larger schemes.

However, the answer to this challenge would be 'end of life' consolidation so that schemes can buy annuities in bulk, when they need to, whilst keeping the sponsor relationship and risk protection in place until then. For many schemes this will be a decade away by the time they are close to buy-out funded, and therefore running minimal risks. We would naturally see this as a form of asset and liability pooling, rather than full-scale merging between schemes. However, we also believe that by this point technology developments will likely have rendered much of the fixed cost of buy-out obsolete (man-hours on data and calculations). So this is something to monitor rather than being a near-term priority on which lots of time and effort should be invested.

In the meantime, the market is of course always evolving. If buy-out were to become equally affordable for small schemes as larger ones, we'd not be in favour of consolidation purely as a form of buy-out. This would needlessly transfer risk away from particular scheme sponsors to PPF levy payers or the taxpayer (or both). It does not seem fair for PPF levy payers or taxpayers to take on these risks and costs. We also feel that if smaller schemes were able to reshape benefits to a 'standard' (as per c and d), as well as ensure that their data is in good shape, then this would likely help them attain a good price in the buy-out market, by reducing transaction costs.

k) Should Government encourage creation of consolidation vehicles for stressed schemes?

We do not think there should be a specific vehicle for such schemes as cost savings (if there are any net of transition costs and given a short life expectancy) will likely not be their key concern. The focus would be on achieving the best secure benefit outcome for members in the near-term. The broader options being considered in this consultation and response should of course be open to them.

l) Should employer debt legislation for multi-employer schemes require full buy-out and for the actuary to assess liabilities for an employer debt by estimating the cost of purchasing annuities?

See below.

m) How else could historic orphan liabilities be met if they were not shared between employers?

See below.

n) Are new measures needed to help those trustees of an association or employers who could be held individually liable for an employer debt?

We think there is a clear distinction between associated multi-employer schemes (where the various employers are in the same group) and non-associated multi-employer schemes, where the employers are generally entirely separate. Different solutions may be needed for each and we are in favour of a separate full review of this area.

We responded to the Department for Work and Pensions' March 2015 call for evidence on employer debt in non-associated multi-employer defined benefit pension schemes, and note the publication in April 2017 of a separate consultation paper: 'The Draft Occupational Pension Schemes (Employer Debt) (Amendment) Regulations 2017'. We welcome the opportunity to respond on this topic, and will do so separately.

For and on behalf of Hymans Robertson LLP

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