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The 100 Group

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Dear Sir

Security and Sustainability in Defined Benefit Pension Schemes

I am writing on behalf of the Pensions Committee of the 100 Group of Finance Directors with regard to the above-named consultation.

The 100 Group

The 100 Group of Finance Directors represents the views of the finance directors of FTSE 100 and several large UK private companies. Our member companies represent around 90% of the market capitalisation of the UK FTSE 100 Index, and in 2015 paid, or generated, taxes equivalent to 14% of total UK Government receipts. Our aim is to contribute positively to the development of UK and international policy and practice on matters that affect our businesses, including pensions, taxation, financial reporting, corporate governance and capital market regulation. The 100 Group represents companies sponsoring defined benefit (DB) pension schemes with assets of approximately £500bn and membership of 3.6m.

Whilst this letter expresses the views of The 100 Group of Finance Directors as a whole, those views are not necessarily those of our individual members or their respective employers.

General comments

We welcome the Government's decision to undertake this wide-ranging overview of DB pension schemes. Whilst we share the view expressed in the consultation that 'there is not a significant structural problem with the regulatory and legislative framework', we believe that legacy DB pension schemes do place a considerable burden on the sponsors who provide them, sometimes at the expense of employer contributions to or employer focus on defined contribution (DC) provision for current employees, and that there are a number of improvements that could be made to minimise the impact that DB schemes can have on UK business.

We have chosen not to respond to all the questions set out in the consultation, but rather to make a small number of key points in response to specific areas of the Green Paper.

Question 1: Funding methodology

The focus on gilts-based valuation methodology has not been helpful to sponsors with DB pension schemes and may have led to excessively high contribution levels and sub-optimal investment strategies. Whilst we realise that there are some flexibilities within the system and that approaches other than gilts-based measures are permitted within the legislation, this is not always well understood by trustees of pension schemes, or indeed by the Pensions Regulator, so that it is often difficult in practice to move away from such methodologies. It would be helpful for the Pensions Regulator to give clearer guidance on the range of acceptable valuation methodologies, drawing greater attention to the flexibilities in the system and the alternatives to gilts-based valuation methods.

Question 1: Frequency of valuations

We note the suggestion in the Green Paper of increasing the frequency of valuations for certain categories of scheme and reducing it for others. Large schemes and the employers who sponsor them already review their funding position far more frequently than required by legislation, often on a daily basis, so we do not see that there is any need to change the prescribed frequency of formal valuations. However, there would be merit in more emphasis on risk-based monitoring from the Pensions Regulator with there being a lighter regulatory touch where the scheme is clearly 'on track' or where the pension scheme does not pose undue risk given the strength of the underlying sponsor covenant. Schemes sponsored by 100 Group sponsors will already have the integrated systems in place to ensure that they are monitoring the risks within their scheme.

Question 1: Trapped surplus

An issue that is not raised by the consultation paper, but which is very relevant to the funding of pension schemes is that of trapped surplus. Given concerns that the current valuation methodology requires higher contributions to be paid now than would otherwise be needed, some companies think it likely that in the long run the schemes they sponsor will become overfunded, leaving a surplus trapped within the scheme. Employers are understandably reluctant to make contributions they consider excessive to meet the promised benefits if this means that cash that could otherwise be used to invest in the business (and thereby strengthen the employer covenant) or to make contributions to the pensions of current employees ends up trapped in a legacy DB scheme. The alternatives which exist such as contributions to an escrow account are expensive and tax-inefficient.

We would therefore encourage the Government to review whether any easements can be made to circumstances in which surplus can be refunded to employers, in particular to the requirement that 'the trustees are satisfied that it is in the interests of the members that the power is exercised in the manner proposed'. The 'interests of the members' formula was discredited by the High Court last year in the *MNRPF* case as an accurate representation of the legal responsibilities of pension trustees. It is therefore unhelpful, and – since trustees will be governed by their general duties at law in deciding questions of surplus refunds - unnecessary to set it out as a specific requirement in the surplus refund legislation.

Question 4: Affordability

Question 4(a) asks whether there is any evidence that deficit reduction contributions are currently unaffordable. Whilst we do not believe that deficit reduction contributions are unaffordable for corporate sponsors as a whole, there are undoubtedly some sponsors who struggle to pay their contributions or who can only do so at the expense of investment in their own business. Even where sponsors can 'afford' their contributions, this does not necessarily mean that this can be achieved without constraints elsewhere in their business, nor that this is the optimal use of corporate cash taking all circumstances into account.

It is important for Government to recognise that profits, dividends and investment are all normal features of a successful business and contribute to economic growth, and businesses should not be required to make good their pension scheme deficit as quickly as possible to the detriment of their underlying business. Any failure to invest in the business now could lead to diminished investment returns in the future, and hence ultimately to a weakening in the strength of the sponsor backing the pension scheme. In addition, failure to invest properly in business could inhibit growth in the economy as a whole.

We also think that an important issue is intergenerational fairness – a feature which could become part of the legal framework governing pension scheme trustees if the IORP II Directive is enacted into UK law ahead of our exit from the EU taking effect. The pace of funding the deficit in DB schemes means that sponsors are directing a large part of their pension spend to people who left the employer some time ago at the expense of the pension provision of current employees. The focus on headline DB disclosures in company accounts also means that the attention of senior executives is more focused on DB provision for former employees rather than DC provision for current employees.

Whilst we do not question the obligation of sponsors to pay benefits to former employees in full in normal circumstances, we would challenge any requirements to privilege deficit reduction contributions to DB pension schemes over investing in the sustainable growth of a business or ensuring that the current workforce has appropriate retirement provision. Contributions should therefore not be 'affordable' if affordability comes only at the expense of the business or current employees.

In addition, many 100 Group companies operate on a global basis and provide pension benefits across a range of different international jurisdictions. For such companies, the affordability of pension contributions has to be considered on a global basis and UK pensions obligations cannot be unduly privileged over those arising in the rest of the world.

Question 4: Statutory override

In general, we agree with the Green Paper's view that accrued DB pensions constitute 'hard promises', although we think it is important to remember that successive waves of Government legislation have hardened those promises, for example by introducing a requirement to index members' DB pensions accruing from 1997, when previously schemes and/or employers were able to choose whether and how to index benefits.

We believe, however, that there are arguments for a statutory override to enable employers with schemes with RPI indexation hard-coded in their rules to switch to CPI. As things stand, as the Green Paper notes, there is a lottery under which some schemes were enabled to switch from RPI to CPI automatically (as also happened for public sector schemes), whereas other schemes have remained stuck with RPI simply as a result of the way their rules were drafted many years ago.. We would urge the Government to introduce a statutory override power to level the playing field between schemes.

Allowing schemes to switch to CPI indexation makes particular sense, given that there is now increased evidence-based understanding of the flaws in RPI and a widespread consensus that successive changes to RPI have rendered it an inadequate measure of inflation. This led to its de-designation as a National Statistic in 2013, something which could not have been predicted by those drafting scheme rules decades earlier. Given that the Government is largely responsible for the fact that RPI is now a dysfunctional measure of inflation, it should provide employers with the legal tools necessary to rectify the situation.

Case law, including the recent Court of Appeal decision in *Barnado's,* has made it clear that there is no section 67 issue in switching from RPI to CPI in respect of accrued benefits, and we would suggest that this gives some comfort to the Government that it is appropriate to enable all schemes to make the switch.

We believe that the statutory override power should be exercisable by the employer on their own, since in practice it may well be difficult for trustees to agree to the exercise of such a power, and should be available to all employers, irrespective of their funding position, since its introduction is not primarily intended as a measure to help stressed schemes (for whom other measures are likely also to be necessary), but rather as a way of creating a level legal playing field between schemes (and their sponsoring employers) by allowing them to increase benefits in line with an inflation measure which has not been discredited. We are clear that this does not go against the general principle that accrued pensions constitute 'hard promises', but rather would represent a correct statement of what that promise was actually intended to be, namely a promise to index benefits in line with a properly constituted measure of inflation.

Question 5: Clearance

We do not believe that a mandatory clearance requirement would be workable, and think that it could have serious repercussions for legitimate business activity, with transactions or restructurings that would profit a business (and provide additional covenant support to a pension scheme) being abandoned because of the need to go through a laborious clearance process. This would be even more likely if the Pensions Regulator were to introduce 'hard charging' for processing clearance applications as proposed in the Green Paper.

Question 5: Punitive fines

Likewise, we do not agree that punitive fines of the kind proposed by the Work and Pensions Select Committee would have any meaningful effect on employers sponsoring DB schemes. It is more likely that they would act as a deterrent to legitimate transactions than prevent rare cases of actual detrimental activity.

Question 5: Dividends

We also think it is inappropriate for employers to be required to consult trustees on the payment of dividends in certain circumstances. Plainly, dividend policy, and in particular a significant change to dividend policy, is likely to be a matter of interest to the trustees in ongoing funding and other negotiations with the employer. Some companies may provide advance notification of dividend payments to the trustees as a matter of courtesy, or have dividend-sharing or matching arrangements in place with the scheme. But that should not mean that trustees have a say in that dividend policy, or an opportunity to hold up the legitimate distribution of dividends. Responsible dividend policies play an important role in business growth and in the overall investment returns seen in the economy.

Furthermore, as noted above, many 100 Group companies operate on a global basis. As a result, their dividend policies will be linked to global performance and profitability, and it would be both difficult in practice and unfair in principle for companies to have to think about the size of a global dividend payment solely in the context of UK DB pension contributions or deficits.

Question 6: Consolidation

In general, consolidation is likely to be an issue mainly for small schemes who can benefit from economies of scale rather than for companies of the 100 Group's scale. We believe that any such consolidation would have to be on a voluntary basis. Although we are aware of the Australian 'improve or move' initiative, we think it would be difficult for the trustees of a scheme to take a decision to consolidate without the agreement of the sponsoring employer. Despite the work of the PLSA's DB Taskforce in this area, we also find it hard to see how such consolidation could work unless the consolidator scheme were to remain sectionalised.

We hope that you find these comments useful. Please do not hesitate to contact me if you would like to discuss any of the points raised.

Yours faithfully,

Alan Stewart
Chairman
The 100 Group Pensions Committee