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Gabrielle Park
Deregulatory Review
Department for Work and Pensions
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5 April 2007

Dear Ms Park

Consultation document: Deregulatory Review of Private Pensions

I am writing on behalf of the Hundred Group of Finance Directors in response to your invitation to comment on the consultation document named above. The Hundred Group represents the Finance Directors of the UK's largest companies.

I regret that we have not been able to respond to all the issues raised by this consultation in the very short period permitted for responses. Had we had longer to respond, we would have responded in more detail on some of these issues. If the DWP would like us to consider any specific matter when all responses are in, we would be pleased to do so.

The format of our response is to consider first the two issues that are of most importance to the Hundred Group – namely the asymmetry in the ownership of surplus and the balance of powers in investment decisions. The latter of these two issues is not mentioned in the consultation paper, but is a very important one for the Hundred Group.

The rest of our response considers the other issues raised by the consultation document. We have addressed the issues in general terms rather than answering each of your 66 questions in turn.

Please contact me if you would like any further information on any of the matters discussed in our response.

Yours sincerely

Eddie Weiss
Chairman
Hundred Group Pensions Working Party

Response of the Hundred Group to the Deregulatory Review Consultation

Key Issues for the Hundred Group

1. Return of surplus to the employer

Recommendations

- Legislation should be introduced to make it clear that surplus belongs to the employer.
- There should be a level of funding above which employers have an automatic right to a refund of surplus.
- There should be a lower level of funding above which it is possible for a surplus to be refunded following discussions between the trustees and the employer.

Answers to questions raised in consultation document

1. Do you believe that the current legislation discourages employers from agreeing to appropriate contribution levels due to concerns that any funding surplus would not be returned, should it arise?

   Yes

2. If the answer to 1 is "yes", is it your concern that the threshold at which a payment to the employer may be considered by the trustees is inappropriate? Is there a threshold that would better balance interests of employers and members?

   Yes, we believe that the threshold at which the trustees may consider a refund should be set at FRS 17 and that there should be a higher threshold (buy-out) at which employers should be given an automatic right to a refund of surplus.

3. If the answer to 1 is "yes", is your concern the ability of the trustees to block return of surplus?

   Yes – employers should have an automatic right to a refund of surplus above a certain threshold.

4. Do you agree that a refund should be payable on request to an employer once a scheme's funding level reaches a certain threshold? If so, should that threshold be a premium over the buyout level of funding, or some other level of funding?

   We believe that a refund to the employer should be payable as of right once a scheme's funding level has reached full buy-out funding. We also believe that a refund should be possible with the agreement of the trustees for levels of funding above a lower threshold (possibly FRS 17).

Response of the Hundred Group to the Deregulatory Review Consultation

Surplus belongs to the employer

Recent legislation (particularly the June 2003 changes) has established clearly that any shortfall of funding below the level needed to secure the pension promise is the responsibility of the employer. To balance the economic risk that they face through deficits, employers need to have full economic ownership of pension surpluses. To address the issue of ownership of surplus, it is necessary for new legislation to provide clarity regarding the employer's ownership of surplus.

Current rules on surplus discourage employer contributions

In the absence of any change, there will be an uneconomic and unhealthy situation. Employers and trustees will be at odds in respect of the level of conservatism used for assumptions. Trustees are guided to establish conservative funding targets, using "prudent" assumptions which do not adequately reflect expected investment performance. This increases the likelihood of funding overshoot and surpluses. Companies are therefore reluctant to contribute towards funding deficits, preparing to repair deficits over the longest period possible in order to avoid a trapped funding surplus.

We believe that in many cases contingent assets do not represent an effective or tax efficient solution to scheme deficits (although they may be of use for example for asset-rich cash-poor charitable organisations). We believe that emphasis on contingent assets detracts attention from the reason why companies are reluctant to provide immediate assets to pension schemes (namely, the difficulty of recovering over-funding).

Allowing employers the ability to recover surplus would therefore encourage quicker recovery of deficits and would be in the interests of all parties involved in pension schemes.

Automatic right to a refund of surplus

In principle, employers require certainty. It is not acceptable to leave the situation open for negotiation and discussion with trustees in all cases. Trustees may well find it difficult to convey to members the reasons for any repayment. In addition, they are likely to find it reasonable to agree to a refund of surplus in principle when there is a deficit, but may change opinions and assumptions when surplus funding arises.

We believe that an appropriate level for an automatic right to surplus would be the buy-out funding level. The employer owns the full deficit up to buy-out level, so it is symmetrical to allow the employer an automatic right to any surplus in excess of the full buy-out level.

We would therefore argue that employers should have an automatic right to the refund of surplus above this level without any need for trustee agreement and also irrespective of the rules on surplus set out in the scheme rules. A legislative override to scheme rules would be required as well as a change in the surplus legislation to confirm employers' automatic right to a surplus in these cases.

Possibility of a refund of surplus at a lower funding level

In addition to this automatic right, we believe that employers should be able to negotiate with trustees for a refund of surplus in other circumstances, for example where schemes are fully funded on a minimum FRS17 basis. This would also require changes in legislation and a legislative override of scheme rules.

In these cases, the employer would not have an automatic right to surplus, but a possible refund of surplus would be one of the issues on the table when trustees and employers were negotiating a funding strategy. For example, an employer might agree to make payments more quickly into a pension scheme in return for an agreement to allow surplus to be refunded when a funding level agreed between the parties has been achieved.

Taxation

We believe that it is reasonable for any surplus repayments to be chargeable to tax in such a manner as to result in an equivalent tax cost for the repayments compared with the tax advantages received from contributions and investments.

Timing of the change

The time to make this change is now when there are few surpluses and when employers need encouragement to make the contributions needed to make good the deficits in their pension schemes.

2.

Response of the Hundred Group to the Deregulatory Review Consultation

Balance of Powers in Investment Decisions

Recommendation

- Trustees should be required to seek the agreement of the employer on investment principles rather than just to consult them.

Background

The trustees of a DB pension scheme have the legal power to decide its investment strategy. Section 35 (5) of the Pensions Act 1995 (revised by the Pensions Act 2004) states:

"Neither a trust scheme nor a statement of investment principles may impose restrictions (however expressed) on any power to make investments by reference to the consent of the employer."

However, the trustees cannot exercise this power in isolation. They also have a duty to consult with the sponsoring employer regarding its proposed investment strategy (The Occupational Pension Schemes (Investment) Regulations 2005 Reg 2(2)(b)). There is no penalty for failing to consult, and unlike scheme funding there is no provision for the Regulator to intervene. However, as with much consultation, a proper process needs to be followed if trustees are to be properly exercising their duty to the trust.

The Statement of Funding Principles

The Statement of Funding Principles (SFP) sets out the scheme's funding strategy and has to be agreed by both the employer and trustees for the vast majority of pension schemes.

Although the SFP must use prudent assumptions, the calculation of the recovery plan and/or the liabilities can take into account the expected outperformance from riskier assets i.e. contributions can be limited by assuming that part of the deficit may be removed if equities outperform gilts as the trustees (and the sponsoring employer) hope. The trustees can only agree to a recovery plan that allows for the degree of exposure to equity that the scheme has and importantly they need to be confident that any shortfall in returns would be met by the employer.

This means that the decisions taken by the trustees regarding their investment strategy may have direct implications for the range of options that are available when they discuss their funding strategy. However, the employer has no say in the underlying investment strategy itself under current legislation.

Investment knowledge

The Pensions Act 2004 requires trustees to have:

"The degree of knowledge and understanding that is appropriate for the purposes of enabling the individual properly to exercise his functions as trustee of any relevant scheme."

For many trustees, this is a challenging requirement. Requiring employer agreement to the investment strategy would bring additional expertise to the investment decision.

The current role of the employer

The Pensions Regulator's guidance indicates that trustees must take the employer's position into account as follows:

- Trustees should consider the ability of the employer to cope with the financial consequences of investment returns being lower than expected.
- A healthy ongoing sponsor's business will be in the best position to ensure that its pension obligations are met in the long term.
- Trustees should take into account the employer's business plans and 'maintaining an environment that supports the employer's business'.

The importance of employer agreement to investment strategy

There are effectively two ways for a DB scheme to recover from a deficit:

- Investment returns on Scheme assets which generally occur through equity outperformance (ie a higher investment risk strategy)
- Increased contributions by the employer

Clearly the employer will always prefer deficits to be reduced by investment returns, whilst recognising that it will have to make good any deficit not covered by these returns.

Every risk the pension scheme runs, save the risk of employer insolvency, is a risk to the employer as it is the employer who has to make good any deficit. Clearly employers wish to minimise the risk of investments not providing sufficient returns, whilst ensuring that the investment strategy is appropriate to the employers' circumstances

Advisors are, as a result of the regulator's stance, encouraging the trustees to be some would say excessively prudent, in some cases seeking to set a funding level of buy-out as the first step in scheme funding negotiations.

- View of covenant
  If trustees and employer do not agree on the strength of employers' covenant, trustees will take a more prudent view to assumptions, including return on investment, and will often pursue a bonds based investment strategy. This means the employer has to provide more cash to fund the scheme.

- Increasing the deficit
  Adopting a more conservative investment strategy for example increasing exposure to gilts (e.g. to reduce the volatility of the funding position of the scheme) impacts on funding targets and often results in employers having to increase contributions to the scheme potentially restricting the core business of the employer. This threat is often used by trustees in deal situations as the investment strategy is purely in their domain.

- Increasing the risk of surplus
  Employers that are required to fund higher targets over shorter periods of time are concerned that this runs the risk of surplus being trapped in the scheme.

Conclusion

The Pensions Act 2004 boosted trustees' powers, allowing them to work in partnership with employers to set scheme funding objectives and recovery plans. The Regulator is able to intervene if agreement is not reached.

However the Government missed the opportunity to include investment strategy within the new partnership framework. This resulted in employers being asked to run risks over which they have little or no control (i.e. that the investment strategy may lead to increased employer contributions), making DB schemes even less attractive.

We propose that trustees, rather than just consulting employers on investment principles, should have to seek their agreement. This can easily be done under the existing primary legislation by amending the regulations. Failure to reach agreement could be dealt with in a number of ways without any need for additional legislation. For example the Regulator could issue an Improvement Notice, or obtain a Skilled Persons Report.

Response of the Hundred Group to the Deregulatory Review Consultation

Issues Raised in Consultation Paper

1. Risk-Sharing Schemes

Recommendation

- Increased flexibility of scheme design for employers should be encouraged, where necessary by changes in legislation.

Possible risk-sharing arrangements

The consultation asks for examples of innovative arrangements which are not possible under the present framework. The following are examples currently operating outside the UK:

- A defined benefit scheme is provided with no pension increases. A defined contribution arrangement is set up alongside to provide inflationary increases.
- Pension increases are provided on a defined benefit scheme up to age 75. From that date, the pension becomes flat rate.

2. Limited Price Indexation of Pensions In Payment

Recommendation

- Increased flexibility in granting increases to pensions in payment would be welcome.

Likely take-up if indexation requirement reduced

A number of companies have offered to purchase non-statutory pension increases back from their scheme members in return for a cash payment. This suggests that employers would be interested in removing statutory increases in future.

One of the key arguments against having to provide LPI indexation is the difficulty of matching the benefit with an appropriate investment. Making future increases discretionary would allow investment in more risk-seeking assets.

3. Revaluation of Deferred Pensions

We have no comments to make on this topic in the limited timescale available to us.

4. Normal Pension Age

Recommendations

- A legislative override is needed where normal pension age is set out in contracts rather than in scheme rules.

- Increases of normal pension age in line with a longevity index (e.g. linked to State Pension Age) should be allowed.

Need for legislative override

Many companies have stated normal pension age in contracts of employment rather than or in addition to scheme rules. A legislative override is needed to ensure that such companies are not prevented from raising normal pension age for future service to reflect increasing longevity.

5. Legislative override

Recommendations

- The need for legislative overrides should be considered whenever new legislation is introduced with the aim of improving flexibility in scheme design.
- Examples discussed in this response to the consultation paper include surplus, indexation of pensions in payment and normal pension age (although this should not be taken as a comprehensive list).

6. Principles based regulation

Recommendations

- Principles based regulation may be appropriate in certain areas.
- A full scale change to principles-based regulation would be unnecessarily disruptive at the present time.

7. Disclosure

We have no comments to make on this topic in the limited timescale available to us.

8. Trustees

Recommendations

- The Pensions Regulator should produce more guidance on how trustees should deal with conflicts of interest.
- A move to 50% member-nominated trustees would exacerbate the difficulty in finding member-nominated trustees at present.

9. Return of surplus to the employer

Please see our detailed comments on pages 1-3 of this response.

10. Section 67 Pensions Act 1995

We have no comments to make on this topic in the limited timescale available to us.

11. Employer Debt

Recommendations

- The requirement for it to be more likely for a debt to be met for a withdrawal arrangement to be considered should be dropped.
- Section 75 should not be the only measure of debt for an employer ceasing to participate in a pension scheme.

Cessation of participation

We are aware of businesses restructuring in order to avoid a debt arising on cessation of a participating employer. It is inappropriate for a pension scheme to drive business decisions in this way.

Section 75 debt should not apply where an employer ceases to participate except where the cessation leads to a significant weakening of the employer covenant.

In particular, ceasing to employ people should not necessarily count as cessation of participation and trigger a Section 75 debt.

12. FRS 17

Whilst we accept that pension scheme debt should be disclosed on the balance sheet, we note the volatility implicit in FRS 17. Measures to reduce this volatility would be welcome.