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Securing the future of pensions

NAPF SUBMISSION TO THE DWP DEREGULATORY REVIEW OF PRIVATE PENSIONS: A CONSULTATION DOCUMENT BY CHRIS LEWIN AND ED SWEENEY

SECTION 1 - INTRODUCTION

1. The National Association of Pension Funds welcomes the opportunity to respond to the consultation paper - *Deregulatory review of private pensions* issued by Chris Lewin and Ed Sweeney. We fully support the review and its objectives of simplifying and reducing the burden of legislation on private pensions, and seeking consensus on the balance between member protection and encouraging employer provision.

2. This paper restates the NAPF's key priorities, as outlined to the DWP and the DWP appointed external reviewers in meetings and written submissions.

3. The NAPF is the leading voice of workplace pensions in the UK. Our 1300 members provide pensions on behalf of more than 15 million people and have combined assets of around £800 billion.

SECTION 2 – NAPF PRIORITIES

4. The current regulatory regime for private pensions is no longer fit for purpose. The present system has grown and grown over the past twenty to thirty years. What we have now is a system of regulation that is complex and difficult to understand. The system needs to be simpler and offer greater flexibility to employers regarding scheme benefit design. Only by adopting substantive reform can we hope to maintain a long-term future for DB in the UK.

5. The proposals put forward by the NAPF aim to ensure that all scheme members, both current and deferreds, play their part in helping secure the sustainability of DB pension schemes.

6. Of the proposals outlined in the consultation paper, we think the external reviewers should give priority to recommending reform in the following key areas;

   - **Normal Pension Age (NPA), allowing schemes to change NPA to reflect increasing longevity;**
   - **Revaluation of deferred pensions, for future leavers only set the revaluation cap at 2.5%; and**
   - **Mandatory increases to pensions in payment, removing the requirement for future accruals.**

7. We are eager to work with the Government in identifying ways in which our proposals would be acceptable to all concerned – employers, today's members, deferred members and future members.

SECTION 3 – NAPF COMMENTS TO SPECIFIC QUESTIONS

8. This section provides the NAPF's response to the specific areas raised in the consultation document, some of the comments repeat those already made in Section 2. We address the areas as they occur in the consultation document. The NAPF's priority order for these is set out in Annex A.

9. Finally, while we are fully committed to achieving as much as possible from the current reform process, we think there is also scope for more wide-ranging deregulatory reform, one that is not restricted to a tight timeframe and that allows for the whole of the pensions regulatory landscape to be re-examined.

Risk sharing

10. The NAPF supports the idea of greater risk-sharing because it avoids placing the full risk of pensions on employees, as is the case in DC provision, while allowing the employer to sharer some of the risks associated with DB schemes with those that will benefit the most. However, although we are supportive of measures to promote risk sharing, we do not think a new regulatory regime is required. Instead we think that this can be achieved by adopting he NAPF's priorities for reform; by allowing schemes to make changes to LPI; revaluation; and changes to NPA.

Limited price indexation of pensions in payment

11. As highlighted in the NAPF response (September 2006) to the Pensions White Paper, unlike DC schemes, DB schemes are required to provide LPI at the lower of price inflation or 2.5% for each year the pension is in payment. This adds significantly to scheme sponsors' costs (and therefore risks). The NAPF would like the law to be changed so that, for future accruals only, LPI is granted on a discretionary basis – though with the proviso that, if a surplus were to be achieved the first call on it would be to provide indexation of pensions in payment up to LPI 2.5%.

12. This would allow schemes greater leeway to reduce costs going forward and bring risk-sharing more in line with those offered by DC arrangements. The Netherlands provides an example of a system where schemes are only required to provide pension increases where scheme funding permits. This is a relatively straightforward way to deregulate, it will offer employers a genuine cost saving and should not require detailed or major changes in the administration processes. We believe that many schemes will welcome this reform.

13. The additional costs and associated scheme funding pressures that arise from LPI are already recognised by the Government. To reduce the possibility of the Government acting as the guarantor of last resort to the PPF, the Government has given the PPF powers to approach the Secretary of State for Work and Pensions for permission to reduce benefit levels it can pay to failed schemes if its own funds are under pressure of insufficient.

14. Many employers have chosen to maintain their DB arrangements. The NAPF annual survey shows that one third of private sector defined benefit schemes are still open to new employees, with many employers wanting to retain DB schemes for as long as they possibly can.

15. The NAPF believes that by removing the requirement on schemes to provide LPI going forward will help those employers maintain DB further into the future and provide more certainly to shareholders of the future costings of DB arrangements.

16. The NAPF has prepared some costings, including the impact on schemes and the impact on scheme members. These are shown in the tables below.

17. The cost savings to schemes of awarding indexation to pensions in payment on a discretionary basis would reduce annual funding cost by at least 16%.

18. Table 1 shows the reduction in cost for a typical DB scheme of future accruals of benefits for members of different ages and earnings on the basis that the scheme would not fund in advance for any future post-retirement pension.

Table 1: Impact on members of a discretionary LPI

Member	Age	Earnings (£pa)	Cost of one year's accrual (LPI) (£)	Reduction in cost of one year's accrual (£)
A1	25	12,500	1,875	283
A2	25	25,000	3,750	565
A3	25	50,000	7,500	1,131
B1	35	12,500	2,187	1,137
B2	35	25,000	4,375	2,274
B3	35	50,000	8,750	4,548
C1	45	12,500	2,875	1,160
C2	45	25,000	5,750	2,320
C3	45	50,000	11,500	4,640

D1	55	12,500	3,625	794
D2	55	25,000	7,250	1,588
D3	55	50,000	14,500	3,175

19. In terms of the cost saving to schemes versus the reduction in members benefits, we feel that in order to help employers to keep schemes open there will be an inevitable trade-off between savings to the scheme and cost to the individual. The key is getting the balance right, ensuring that schemes continue in to the future is the best outcome for scheme members.

Revaluation of deferred pensions

20. The NAPF believes that DB schemes should be given greater flexibility to adjust or reduce the revaluation of deferred pensions. We think legislation should be changed so that, *for future leavers only*, the ceiling on revaluation on pensions in deferment should be reduced from 5% LPI over the whole period of deferment to 2.5% LPI.

21. One reason why we believe this reform is important is that it allows DB schemes to share the increasing costs between current and deferred members. Another reason for suggesting this change is that we can see no justification for continuing with 5% for revaluation purposes when the ceiling for indexing pensions in payment was reduced from 5% to 2.5% in 2005. Our calculations show that reducing the increases in deferment to a 1.5% ceiling could reduce a scheme's liabilities by around 11%. Entirely removing the requirement to increase pensions in deferment reduces liabilities by 19%.

22. Many schemes would welcome the opportunity to have the ability implement a reduction in revaluation for future accruals. We do not think that a reduced cap would have a significant impact on labour mobility.

23. Employers and schemes want to be able to demonstrate a commitment to their existing workforce by offering them high quality pensions, this is being undermined, in some cases, by the increasing costs associated with deferred members. With labour mobility increasing we can only see these costs escalating unless a reduction in the level of revaluation for future accruals is allowed.

Normal pension age

24. Allowing schemes greater flexibility over NPA should be a priority for the external reviewers. We believe that schemes should be able to make changes to NPA in

line with increases in life-expectancy. According to a survey by PWC[1], published in January 2007, life expectancy in retirement is now assumed on average to be one year higher than last year. This adds roughly 7% to the calculated costs of pensions and as much as £40 billion to the accounting deficits of UK private pension schemes".

25. Government has set a precedent by changing the age at which the BSP is paid. Firstly, to equalise men and women's state pension age at age 65, then for everyone SPA will gradually rise to 68 to reflect increases in longevity.

26. Changes to regulation would be required if schemes were to be given the flexibility to amend NPA for all accrued service. Schemes may require a legislative override to be able to apply such a rule.

27. The NAPF provided costings in our response to the May 2006 Pensions White Paper, these are shown in the tables below.

28. As Table 2 shows, making changes to the scheme's NPA on the basis set out above would have the effect of reducing the scheme's past service liabilities by £10m a year (to £490m) and would represent a saving in terms of lower contributions of 6% a year.

Table 2: Impact on scheme costs of changes to NPA

	Scheme	After NPA changes
Liabilities (£m)	500	490
Assets (£m)	425	425
Deficit (£m)	75	75
Future service cont. rate	20%	19.5%
Contributions payable		
Future service (£m)	20	19.5
Deficit (£m)	8.8	7.6
Annual saving (£m)		1.7
Annual saving (%)		6

29. The following table shows the estimated additional liabilities falling on a typical DB scheme with NPA of 65 from anticipated future improvements in post-retirement mortality. The examples given are for scheme members at different ages and on different incomes (average earnings, half average earnings and twice average earnings) and with different periods of service at the time the change is

[1] PWC 2006 Survey of Actuarial Assumptions – UK Pension Scheme Funding January 2007

implemented (2, 10 and 15 years). The amount shown represents the release of liability that the scheme would enjoy if pension ages were increased in line with a longevity index. It shows, for example, that for a 25 year old earning £25,000 with two years' service, the scheme's liabilities would reduce by £565. For a 35 year old on the same earnings, the reduction in liability would be £2,274. It can be judged, therefore, that the impact on an individual member's accrued benefits would be modest.

Table 3: Effect of changes to NPA

Member	Age	Service (years)	Earnings (£pa)	Accrued liability (£pa)	Reduction in liability (£pa)
A1	25	2	12,500	3,750	283
A2	25	2	25,000	7,500	565
A3	25	2	50,000	15,000	1,131
B1	35	10	12,500	21,875	1,137
B2	35	10	25,000	43,750	2,274
B3	35	10	50,000	87,500	4,548
C1	45	15	12,500	43,125	1,160
C2	45	15	25,000	86,250	2,320
C3	45	15	50,000	172,500	4,640

Legislative override

30. We think it would be useful to have a limited statutory override to provisions in trust deeds and rules that prevent changes to rights attributable to future service. We do not think it should be a general override. It may be appropriate for the Government to prescribe in which areas an override is allowable.

31. Some schemes will be prohibited from adopting changes if there trust deeds and rules are written in such a way that they require members consent, even for future changes. A legislative override may be necessary in such circumstances.

Principles based regulation

32. We support the idea of principles based regulation. We think this should form part of the longer-term rolling deregulatory review. However, such an exercise should

only be undertaken, if the new regime is markedly simpler than current arrangements. If this is not the case the cost of the new approach may well outweigh the benefits delivered.

Disclosure

33. The NAPF supports a principles based approach to disclosure. We think the current arrangements are overly prescriptive and would benefit from reform. However, many schemes have invested substantially in recent years in adopting the systems and processes to meet the current rules, so ideally they should be able to continue with existing processes where they meet the requirements of any new principles based regulations.

Trustees

34. There is some anecdotal evidence which suggests it has become more difficult to find and retain suitable volunteers for trustee positions, even though, in some cases the number of volunteers has remained constant. However, the calibre of those volunteers has, in some cases, declined. We believe some of this can be attributed to the higher profile of pensions, the risk of conflicts of interests and the new TKU requirements.

35. The NAPF believes further consideration should be given to the issue of personal liability and whether there are steps that could be taken that would protect both the trustees and the members' interests. This should include the use of statutory exemption of trustees from all or most liabilities incurred in the course of their functions.

36. The current requirement that 1/3rd of trustees be member nominated is, we believe, the right balance. We do not see any gain in increasing the number of Member Nominated Trustees (MNTs). Some employers fear that increasing the number of member nominated trustees may result in them losing some control over the decision making process around the design and benefit structure of their pension. This is particularly important for those employers operating in a competitive labour market.

Return of surplus to employer

37. We believe that the current legislation discourages employers from agreeing to target high funding levels as any funding surplus would not be returnable to the employer.

38. We think there may be scope to include in scheme recovery plans the mechanism and circumstances under which a surplus can be returned to an

employer. We believe there are two good reasons for adopting this approach. Firstly, this allows for a principles based approach to be adopted. Secondly, schemes will be able to negotiate an arrangement which suits their needs.

39. One final point that has been brought to our attention is that it would be useful to clarify who owns the surplus. (In many cases the employer and trustee can achieve agreement on it as it is explicit in scheme rules, however this is not the case of all schemes.)

Section 67 Pensions Act 1995

40. There are circumstances under which Section 67 makes it difficult for schemes to make small changes to trust deeds and rules, despite the changes in the 2004 Pensions Act.

41. We believe that it would be useful to allow some leeway for changes in actuarial value. To ensure that members have appropriate protection schemes should only be able to amend accrued rights provided that the effect would not be to reduce the actuarial value of any member's benefits by more than 5% and that total scheme liabilities do not fall in value.

Employer Debt

42. The NAPF believes that the operation of section 75 and its regulations create unnecessary problems. Of particular concern is the effect of section 75 on legitimate corporate transactions where the requirement for a company involved in a takeover or merger to meet full buy-out costs is acting as a barrier to transactions.

43. We have one example of where section 75 causes problems; this is outlined briefly below, however we are able to provide further details on a confidential basis.

44. *XYZ Trustee Co Ltd (XYZTCL) is trustee of XY schemes. Z is the investment adviser subsidiary to the trustees and YZ is the administration subsidiary. Both have the same covenant which comes from XYZTCL and therefore the £17bn assets. They want to merge both into one company. However, This would lead to s75 debt but would not change covenant. So now the Trustee Company have to contort the organisation to avoid debt.*

45. We think the existing legislation should be amended. We believe that section 179 is a more appropriate measure of the debt on the employer and should be used in all cases, including corporate transactions, except where the scheme of a solvent employer is being wound up, in which case s75 should be used.

FRS 17

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46. FRS 17 has a number of short-comings that the NAPF feel should be addressed. We think the reviewers are right to high-light the impact of FRS 17. Whilst we agree that there should be transparency, we feel the time is rights to review the manner in which FRS 17 is calculated. In particular, we believe every effort should be made to achieve a less volatile measure of funding.

47. Arguments have been made that employers are using FRS 17 as an excuse to close DB schemes. We do not accept this argument. However we do accept that FRS 17 has focused the attention of CFOs and company boards on the size of their pension liabilities. This is to be expected as they are under constant pressure to present an accurate picture of their company's financial position to shareholders and analysts. It is therefore essential that FRS17 does not overstate the liability presented by the pension scheme to the company.

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Annex A

The external reviewers are asking respondents to indicate areas where they would most like to see reform. We believe they should give the following order of priority to the reforms under consideration. Our priority order is based on the potential to encourage employers to maintain DB provision.

High priority

- revaluation of deferred pensions
- mandatory increases to pensions in payment
- changes to NPA
- modification of debt on employer (S.75)
- Section 67

Other priority

- FRS 17
- Surpluses
- Trustees
- Disclosure
- Legislative override

We think principles based regulation should be an overarching policy, one which is considered when making any recommendations on future legislative reform