Occupational Pensioners' Alliance

Written Response to

Deregulatory Review of Private Pensions

The Occupational Pensioners Alliance (http://www.opalliance.org.uk/) has its origins in the Maxwell affair. It is comprised of forty member associations nationally. Each member association focuses the views of the members of schemes for their company. An elected Council focuses the views from the associations. In aggregate, more than 2 million scheme members are represented in this way.

March 2007

General

This consultation document suffers from reflecting the views of the majority of those who were consulted. (Annex A). It is sympathetic to the continuation of degraded schemes when the need is for good pension schemes.

Actuaries, administrators, and legal advisers are provided with jobs and profits by pension schemes, whether the pension schemes are good ones or not. It is not surprising that these people have a primary concern that final salary schemes should be kept going, and only a secondary concern about the benefits provided.

This attitude will be shared by businesses taking a short term view of what would improve the appearance of their accounts.

There is an alternative viewpoint, which the DWP would have heard if it had chosen to take input from the Occupational Pensioners' Alliance:

Provision of occupational pensions is mostly voluntary. Businesses will provide them only if they make business sense. They will make sense if they are sufficiently valued by staff. Hence good pensions promote their continued existence, while degrading pensions is a downward spiral of disillusion amongst scheme members and employers.

Your Questions

1) Do you consider that the interests of employees will be served by the presence of more risk sharing schemes? What risks do you believe are most appropriately shared?

Other things being equal, more risk sharing schemes would be a gain for employees. However, this consultation document integrates "more risk sharing schemes " with "degraded schemes". Employees are not well served by having more degraded schemes.

There are some risks that employees (who will eventually be retirees if they don't die first) should not be required to adopt :

- longevity. The whole point about an annuity/pension is that it is a measure of insurance against poverty arising from living "too long". There is no sense in re-introducing the risk that the consumer was insuring against. Nothing can assure against eventual poverty but the key characteristic of annuities and pensions is that they reduce the financial risk of not dieing, for the consumer.

- inflation. A pay increase at less than inflation is effectively a pay cut. Occupational pensions are deferred pay. Pensions in payment increases of less than inflation cut the rate of pay for work that has already been delivered. Government Actuary figures show that for the period that statistics are available, the typical company inflation proofed pensions even where the regulations did not require it. There is no ethical basis for suggesting that DB pensions should lose value, measured in the pounds that were current when the pension was earned.

2) Do you believe that employers are interested in supporting schemes in which the risks taken by employers and employees are balanced differently than under traditional money purchase or defined benefit schemes?

Some are and some are not. A company which is looking for staff reductions by attrition, with those jobs going to India, will not be looking to provide good schemes.

3) Are you aware of situations in which the present framework has prevented the implementation of an arrangement under which risks were shared between the employer and the member in a novel way? Can you describe what specifically prevented implementation?

Novelty in itself is not desirable, if the novel scheme is not a good one. Sponsors have great flexibility in controlling their risks – they can decide when to increase employee contributions, prohibit accruals, change the definition of what is pensionable pay, etc. There is no <u>need</u> for sponsors to have more "flexibility", there is only a desire amongst some sponsors to have more freedom to oversell their scheme to employees without facing the consequences.

4) What do you believe to be the main obstructions to creativity in scheme design? Do you believe that they should be removed?

The main obstruction to creativity is the fuzziness and complication about what such schemes will actually deliver. This cannot be removed. (If it could be this question would not be talking vaguely about creativity, but would be talking about specific alternatives.)

5) Would you favour an approach under which specific forms of shared risk schemes are recognised, along with appropriate safeguards, or would you prefer that current regulations be loosened to allow a variety of approaches?

The former, which is what we have now. Sponsors can and have already introduced hybrid schemes, career average schemes, etc.

6) What challenges do you see in the effective disclosure to members of the nature of the risks they are running and how their benefits may be affected in risk sharing schemes?

The challenge is as it always has been, information asymmetry. The sponsor and the trust know a lot more than the consumer. Trusts hide behind "we cannot risk any suggestion of financial advice" and "consult your IFA" to ensure relative ignorance is maintained. Sponsors take advantage of this ignorance, for instance offering under-value lump sums for pension foregone.

7) What should the role of the PPF be in risk sharing schemes? Are there changes to the present legislation pertaining to the levy and treatment of schemes on wind-up that would be necessary in order to fairly regulate these schemes?

There is potential for improving the fairness of PPF treatment, at the expense of complications. For example pension bought from the scheme using AVC money might be specially treated because the retiree had already paid for it in full, irrespective of sponsor contributions. However, on balance, it is best to keep the "safety-net" simple and universal.

Price Indexation of Pensions in Payment

28. The suggestion about what is sensible is just wrong. (See Q1)

The scheme member can never gain from inflation. If increases do not match inflation the sponsor gets a windfall gain from inflation. Insofar as producers have an influence on inflation, why would we want to create a situation where high inflation has added attraction for them?

There is no extra cost in inflation proofing – the cost remains roughly constant if the calculation is done in the pounds of a particular date, since investment

returns are highly correlated with inflation. There is a loss of windfall gain for the sponsor, but why should there be that gain at the expense of members?

30. We have not studied the Dutch model but if increases were less when the scheme was under-funded that would be a massive incentive for sponsors to under-fund; surely not something one wants to encourage. The Alan Pickering suggestion is better but has the usual "information asymmetry" problem – the scheme members will not be able to check whether they are actually being offered fair value.

32. The presentation of information in this paragraph is poor. *"All figures are in cash terms"* contradicts *"£28800 at 2008 prices".* Pounds from different years should not be shown in comparison, or aggregated – they are different units.

If the figures were presented as the value of the annual pension they would more clearly show the hardship being inflicted. At least you could have shown both cash and value tables.

Your bias also shows in not attempting to work out how much the reduced income for retirees would cost the Exchequer in means tested benefits. (The average occupational pension is reported as £5253 in http://www.incomesdata.co.uk/pensions/bulletin199.htm , not the £38990 of your example.)

The government has accepted that the appropriate link for state pensions is earnings. Most measures of poverty are related to earnings. A balanced presentation of the effect of a zero cap would present how pensions would progress relative to earnings, for zero, 2.5%, and 5% caps.

33. Because of information asymmetry, the take-up of optional inflation proofing would be lower than it ought to be, if we consider society's aim of avoiding poverty and state support in old age. (Analysts tell us that people generally overvalue immediate gain versus long term gain.)

34. Presumably the administrators in such difficulty are not yet computerised. Software dealing will LPI will have a table of dates, percentages, and caps in it. Changing the actual numbers in that table is a minor software change.

1) How likely are schemes to remove the promise of LPI for pension accruals going forward if they were allowed to do so?

Experience of the LPI 5% to LPI 2.5% change is that not only will the employer make the change, they will present it to the employees as something they were forced to do by the regulation change.

2) Would employers be more likely to continue defined benefit plans if LPI were made optional?

In the short term, yes, because of the opportunity to present a cheapening as a government initiative. In the long run, no, because the degraded scheme would not be valued by employees and hence not a good expense for the employer.

3) Would employers be more likely to establish risk sharing schemes if LPI were made optional?

Difficult to say. There are bigger issues in scheme design, some of which are more sensible ways of economising, eg career average.

4) Do you have any information on the impact that optional LPI would have on scheme costs?

Not specifically, but you could get a good idea by comparing the annuity rates for indexed and non-indexed annuities.

5) Are there particular approaches to LPI (see paragraph 30) that appeal to you? Why?

See our comments on paragraph 30.

6) Do you believe that the cost savings to pension schemes if LPI is no longer mandatory outweighs the reduction of benefits to members?

This question proposes a false balance. Dropping LPI is bad for everyone. It is bad for the members directly. It is bad for employers because such a scheme would not be valued by staff, and hence not a good use of company money in the long term. It would be bad for society because of the increased incidence of poverty in old age.

Revaluation of Deferred Pensions

36. Change of employment will often be a cause of deferment but leaving employment will also often be a cause. Allowing pensions in deferment to decay in value is discriminatory against women, who more often leave employment to undertake caring.

38. Where is the logic in noting that inflation has been higher than now? If those observers are expecting inflation to be low then it is irrelevant whether the cap is 5% or 50%. Those who advocate a lower cap can only be expecting the cap to be exceeded, and hoping to give the values of deferred pensions a series of blows.

40. Better presentation would provide both cash and value numbers, at least.

1) How likely are schemes to implement a reduction in revaluation if the cap on mandatory revaluation is reduced for accruals after 2008?

Too many are likely to take the opportunity to cheapen their scheme and blame it on regulatory changes.

2) Do you think that reducing the cap would maintain a fair balance between stayers and leavers in defined benefit schemes?

What makes you think there is a balance here? If the scheme is made worse for leavers it will not necessarily be made better for stayers. It is much more likely that shareholders of the sponsor will get the benefit.

3) Do you think that a reduced cap would have a significant impact on labour mobility?

Not as much impact as it should logically have, because of the information asymmetry.

4) Do you have any information on the impact that this change would have on scheme costs?

This is an actuarial calculation we are not qualified to make.

5) Would there be any impact on long term funding strategy if liabilities are measured based on a 2.5% cap?

This question is not clear to us. Every trust's long term funding strategy should aim to deliver pensions as they become payable, in a relatively safe and efficient way.

6) Would employers be more likely to continue defined benefit plans if revaluation is reduced?

In the short term, yes, because of the opportunity to present a cheapening as a government initiative. In the long run, no, because the degraded scheme would not be valued by employees and hence not be a good expense for the employer.

7) Would employers be more likely to implement risk-sharing schemes if the cap on revaluation is reduced?

Difficult to say. There are bigger issues in scheme design, some of which are more sensible ways of economising, eg career average.

8) Do you believe that the cost savings to schemes that would result from reduced revaluation outweighs the loss of benefit to members?

This question proposes a false balance. Reduced revaluation is bad for everyone. It is bad for the deferreds directly. It is bad for employers because such a scheme would not be valued by staff, and hence not a good use of

company money in the long term. It would be bad for society because of the impact on job mobility and the increased incidence of poverty in old age.

Normal Pension Age

46. One should be careful in referring to the "value" of a pension because there are both monetary and life-style values. What a retiree bought with contributions and work was the promise of a specified income for the remainder of his/her life. With increased longevity the retiree still has that, no more and no less.

48. Is it claimed that this is "ideal from the point of view of clarity, efficiency and fairness" ?

49. Maybe, but the scheme members did not stay in the scheme because of a promise about the actuarial value of what they would receive, they stayed on the promise of a specified pension for a lifetime.

1) Do you believe that an NPA set to a longevity index is feasible (leaving aside any application to past accruals)? Why or why not? What changes to present laws and procedures would be required?

It is feasible, in the sense that technicians could conceivably create a set of regulations to endorse it. However, adding this extra unknown to what employees have to consider when judging what the scheme is worth to them will cause many to simply give up over the complication and uncertainty.

One should note that longevity has not changed rapidly, it is the actuaries' assessment of longevity that has changed rapidly. In planning their lives, we would be asking employees to guess at something that actuaries have been unsuccessful in guessing.

A single longevity index could not be fair because of differences due to geographical location, poverty, type of work, etc.

Legislative Override

58,59. Those who live by the sword can expect to die by the sword. Many scheme members have found they can get no redress for unfairness because of the minutiae of deeds which they have never seen. If there is a case for a legislative override allowing trusts to do what they like then there is a bigger case for an enforceable general requirement that sponsors keep their promises even when the promises are not incorporated in the deeds.

The Pensions Ombudsman has suggested that such problems could be relieved by having a small set of standard deeds for schemes, as opposed to having almost every scheme with unique deeds. We agree with that.

1) Would a statutory override to provisions in scheme trust deeds and rules that prevent changes to rights attributable to future service be appropriate? If it would be appropriate only in some circumstances, what would those circumstances be?

It is worth noting that some trustees have already acted in the belief that the sponsor has the power to override the deeds whatever the deeds say. (IBM UK Is an example, where employees were offered a choice between moving to a DC scheme or having significantly less salary deemed pensionable.) This view derives from the "South West Trains" precedent. Apparently employers only have to offer the employees choices about future pensions. Then when one of these choices (however bad the best of them is) is chosen by the employee it becomes part of the terms and conditions of the employee's employment. "South West Trains" has been interpreted as saying that once terms and conditions of employment have been agreed, the trustees must implement them, irrespective of conflict with the deeds.

OPA does not agree with this interpretation but where it is followed in practice it has the effect of a statutory override.

2) Do you believe that a statutory override to provisions in scheme trust deeds and rules that would prevent changes to rights already accrued would be appropriate? If it would be appropriate only in some circumstances, what would those circumstances be?
No.

Principles Based Regulation

66. Who were these stakeholders? They surely did not represent scheme members. The OPA wants an enforceable fair and open replacement for the "opt-out". The "principles" approach has not served members well in replacing the old "opt-out" for MNT selection. The principle that the process should be "fair and open" was lost between the Green Paper and the actual Act.

We are left with Regulator Codes of Practice that legally can be disregarded. (Yes, they have evidential admissibility but that is of little use – it only applies when there is something else bad in addition to disregard of the Code of Practice, and few scheme members have the money to use the courts). The Code of Practice, in turn, is mainly principles so that trusts can claim to meet the principles even where sensible prescriptive regulations would surely find them lacking.

The removal of the opt-out was signaled in the Child Support, Pensions and Social Security Act 2000 and reiterated in the Pensions Act 2004. Despite these years of lead time many companies are allowed to continue with the opt-out until October 2007 and the requirements for them to do anything after that are lax.

1) Do you think a principles based approach would be appropriate for pensions regulation? Why or why not?

In general, the approach has probably already been taken far enough. Lack of prescription creates uncertainty. Good trusts will do the right thing whether required to or not. Rogue trusts can exploit uncertainty, confident that there is enough fuzziness for them to be given the benefit of the doubt if a member challenges.

The consultation document generally assumes that simplicity requires no justification. (e.g. in paragraph 10). Simple arrangements are only preferable if they do the job. The motor car is far more complex than the horse and cart yet it replaced the horse and cart for good reasons.

MNT selection will be an indicator, once trusts get around to implementing. The principles approach has made a poor start but if the arrangements put in place actually prove to be “fair and open” it will be vindicated.

2) Are there particular areas of existing legislation that you consider particularly suitable for a principle based approach? If there are, why?

Of course, it depends what the principles are. We would like to see a principle that sponsors should keep their promises, even where those promises might not be legally enforceable under current legislation.

3) Do you believe there would be cost savings arising from a principles based approach? To whom would they accrue?

No.

4) What steps could be taken to allay concerns about the lack of certainty that is inherent in a principles based approach?

Adopt a more prescriptive approach.

5) Do you believe that a principles based approach will have any impact on member protection? If so, would this impact be positive or negative?

So far it has had a negative impact. Trusts will soon be operating without MNTs because the member representatives they now have were selected under opt-out. (As the Regulator says, they "do not count as MNTs under the requirements".) Those member representatives will be functioning without the empowerment and protection that the regulations give to MNTs.

6) What impact do you consider this may have on the running costs of the regulatory authority?

It is too early to say what costs the regulator will run in to, in investigating severe breaches of the Codes of Practice. The risk is that he will avoid investigating so as to keep costs down, as the Pensions Ombudsman has.

7) If a principles based approach were adopted do you think there would be a continuing need for codes of practice and guidance notes to supplement primary and secondary legislation?

Yes. Scheme members will not have the least idea what they can expect or challenge if it is all left to some vague legal skeleton.

8) What impact do you consider this may have on the levels of skills, knowledge and understanding of trustees, employers and their advisers?

Trustees and employers would gain from more prescriptive legislation – the right thing to do can then be looked up. Advisers would gain from a principles approach – they would offer expensive advice and symposia claiming to spell out what the principles really meant.

Disclosure

80. Consider the word "reasonably" in this example. Under current rules scheme members can find themselves entitled to no better actuarial report than one three years old. Given that stock markets are so volatile, and that the trustees have annual actuarial reviews, any "reasonable" person would hold that this was an "unreasonable" delay. But clearly the DWP thinks it reasonable. The only principle supported is that trustee convenience outweighs informing scheme members.

This is an example of how easily stakeholders can agree on principles when they wildly disagree on what the principles imply.

81. Some breakdown of logic here. Why is it only "new or prospective" members who need to decide whether to stay in a scheme?

82. What an outrageously patronising view; that hiding information from members will increase their understanding!

1) Do you think that a principles based approach to disclosure would work?

It would work for those trustees who have no higher ambition than meeting the regulatory requirements. For scheme members it would make a bad situation worse.

3) If the answer to question (1) is "no" are there any other changes that should be made to improve the current disclosure regime?

Yes, the basic information that trustees have each year, about liabilities and fund strength, together with the main assumptions, should be made available

to members in the annual summary. This information is essential, so that members are able to assess the health of their fund.

Where the fund level is such that immediate windup would lead to the PPF the members should be told. Where the fund level is insufficient for full buy-out but sufficient for more than the PPF compensation the members should be given detail. Where the trust has made discretionary decisions that effect many members there should be a requirement for disclosure of the decision and the reason for it to all members. (So that the members can judge whether it is equitable.)

4) Do you think there are circumstances in which members and/or trustees should be required to consult with or get the permission of spouses and civil partners – for example, where changes to scheme rules reduce their contingent benefits, or when the member is choosing a single life pension?

There should be a requirement for the trustees to ensure the spouse is informed, but only when the potential event differs widely from a commonly held expectation. Thus a spouse who will get a pension of a 1/3 or more of the principal's pension would not need to be consulted. There is no need to consult in your second example because if the couple have not discussed the matter the spouse has no reason to expect a dual life pension.

5) Do you agree that there are particular disclosure issues in relation to risk sharing schemes? How should these issues be handled?

Yes. The issues should be handled by more disclosure. For example it is not adequate to have longevity assumptions expressed as tables that the member has not seen and can only acquire expensively. Members should be told how conservative the assumptions are in relation to assumptions used by other trusts.

6) Do you think that trustees should be required to provide more information at the point of retirement? What sorts of information should they provide?

Yes. Where there is a discretionary element in pensions increases, for example, they should be required to give scenarios of how the member's finances could vary drastically according to the discretionary choices. The point is not that the member cannot make these calculations for himself/herself, but that the administration running a little computer program to produce the figures is a lot less trouble than the member would have in doing the calculations.

Trustees

86. We have anecdotal evidence of trustees unwilling to continue their roles because the company appointed majority on the Board acts to prevent them getting the data they require to be effective, and stifles their initiatives.

87. Reducing conflicts of interest is good governance. Since when has good governance equated to less effectiveness?

1) Is it more difficult to find and retain suitable volunteers for trustee positions? If so, why do you think this is the case?

There is evidence, where MNT selection is by election, that the number of candidates has been reducing from election to election. One reason is that the intended purpose of MNTs – to give members more influence in the running of their schemes – is not being realised.

It should also be noted that employee MNTs are in a difficult position, sometimes having to question the logic of other trustees who outrank them in the company organisation and who can have a big influence on their career prospects.

More volunteers to become a trustee would be forthcoming if the boards invited more recently retired pensioners who have the time to fulfill these duties

2) If conflict of interest is an issue, do you believe that conflicts are inevitable, or are there specific aspects of regulation that are causing individuals to be needlessly concerned that they may be compromised?

Why is this question an "or" question? Of course some conflicts of interest are inevitable. The problem is with major conflicts of interest, as when the Human Resources Director of a company develops a scheme redesign, promotes it on the trust, and votes for it in the trust decision.

Individuals are rarely needlessly concerned that they may be compromised. Individuals are often compromised but unaware or unconcerned about it.

3) If personal liability is an issue, are there steps that could be taken under the law that would protect both the trustees and the members' interests? Would a statutory exemption of trustees from all or most liabilities incurred in the course of their functions be advisable?

There is already an effective statutory exemption. The Trust Law hurdles in proving trustee behaviour unsatisfactory are enormously high. ("On the balance of probabilities" is not sufficient. "Beyond reasonable doubt" is not sufficient.)

4) Do you believe that the current focus on trustee knowledge and understanding is discouraging individuals who have valuable expertise from volunteering to serve as trustees?

Possibly. Those who are discouraged may not be the best of candidates.

5) Would your answers to any of the above questions depend in part on whether the trustee involved is a professional trustee, paid for his or her services to the scheme?

Yes. Much depends on who appointed the professional trustee. If the Regulator did so, conflict of interest concern is removed. If the sponsor did the hiring and firing then a concern about conflict of interest remains.

6) What would the impact of any change in this area be on scheme liabilities?

Possibly a reduction in conflicts of interest would lead to more of the sponsor's promises being kept, and hence increased liabilities.

7) Do you think moving to principles based regulation would have an impact on retaining or recruiting trustees?

It would make matters worse. MNTs would know that the fuzzy regulations would make it more difficult for them to query the advice from advisers.

8) What bearing do your views in relation to the above bring to the proposal that at least 50% of trustee boards should be member trustees?

50% MNTs works well in some schemes that have 50% but for others it may not be a great help because it will increase the power of the chairman, who holds the casting vote in a divisive situation. Far too few trusts have an independent chairman. Too many chairman see their role as one of persuading the trustees to adopt the chairman's opinion.

A better approach would be to empower all member representatives. For example, the Regulator might have a code of practice saying that it is unreasonable to keep MNTs deprived of information that could be provided at low cost.

Nevertheless the Warwick agreement provided for 50% to be member trustees and it would be untrustworthy of the government to break that agreement.

There is some merit in the suggestion that the 50% should be 50% of those trustees who are present or past employees of the sponsor.

More MNTs will make possible a better match between MNT characteristics and the demographics of the membership, which is desirable.

Return of Surplus to the Employer

97. It is disappointing that you do not comment on the role of taxation when employers take money from pension funds. This money should be taxed; it would be wrong if the company was permitted to use the pension fund as an investment vehicle, enjoying tax advantages designed for pension

schemes without using the returns for pensions. If the level of taxation is appropriate then that does restrict the funds to a pensions purpose. That is for good reasons.

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?

If it does, then the employers are not being sensible. The surplus is not "trapped", it can be used to provide contribution holidays. Meanwhile it is invested in a tax-benign manner. Even if the surplus outlasts the last surviving beneficiary, most trust deeds provide for it to be returned to the sponsor.

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 at a premium over the buyout level of funding, or some other level of funding?

There is no evidence that a threshold is necessary – a period of contribution holidays will reduce any "excessive" surplus. If there is to be a threshold it should be high, in recognition that both assets and liabilities are volatile and the calculation of surplus is a snapshot. Contribution holidays can only be justified when there is a surplus in excess of the buy-out level.

Section 67

1) Does section 67 as currently drafted continue to stop trustees from making small changes that would help their schemes run more efficiently?

We have seen no evidence of this.

2) Are the procedures set out in Section 67 too complex and, if so, how should they be simplified?

The current procedures are simple, as you summarise in paragraph 102. If anything they are too simple, because they omit any procedure by which a scheme member can check that the "actuarial equivalence" calculation was done fairly.

3) Under what circumstances do you think an exemption from section 67 – whether or not it retains its current form – would be justified?

Taking from members what they have already earned would require exceptional justification. Perhaps if Parliament decided more money was needed for its activities and Parliament decided to take that money from pensions funds, then fairness would dictate that benefits already earned should take some of the blow. But even then it might be Parliament's intention that sponsors took the blow.

4) Do you believe that it would be useful to allow some leeway for changes in actuarial value? To what degree?

If there is to be leeway it should be in the members' favour, allowing changes only if actuarially better for the member. This would allow for the uncertainties in the actuarial basis used.

5) Would it be helpful to define the "subsisting rights" in more detail? How would you define them?

Something is wrong if these rights need clarification. How can the members know what they are entitled to if the trustees don't?

Employer Debt

1) Do you believe that the operation of present section 75 and its regulations create unnecessary problems? When and why do these problems arise?

Section 75 gives rise to some problems but they may be necessary in order to keep the regulations simple. Employers over-estimate the problem of being required to make extra contributions. The extra is invested in a good place and eventually used to reduce company contributions.

Note

The period allowed for responses to this document is short. This is a particular problem for an organisation like OPA which is comprised of independent associations. The associations need time (and possibly meetings) in order to take positions. The Alliance needs time to amalgamate these views.

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