DWP Consultation Paper Security and Stability in Defined Benefit Pension Schemes

Cardano response

May 14, 2017

1. Executive Summary

We welcome the government's consultation in to the security and stability of Defined Benefit (DB) schemes. Although there are few open schemes now, DB represents a £1.5 trillion system on which millions of people depend. To date, a total of 889 DB schemes have entered the Pension Protection Fund and we believe that another 1,000 sponsoring employers' organizations are set to become insolvent. The irony is that this pension crisis was entirely avoidable if tried-and-tested risk and investment management tools had been employed.

We find it difficult to respond to the detailed questions in this consultation paper since we fundamentally disagree with DWP on their assessment of the problem. Most of the consultation questions are conditional on the DWP assessment that problems are minor and that limited adjustments to the current regulation and supervision are sufficient. In contrast, we think that there is massive systemic risk. Since most DB schemes are closed, they are sensitive to tail risks in the financial markets, which also will affect their sponsors in a negative way.

We recommend that DWP lead by example and redo their analysis using the Integrated Risk Management framework to assess the overall system risk. Based on our assessment of the problem, we argue that DWP must provide clarity in the Pensions Regulator's (tPR) mandate and implement changes so that the PPF will be able to act as a more reliable backstop in the DB system. We cover these areas in Section 2 of our response.

In Section 3, we propose three key areas which DWP needs to reform to make the DB system more robust:

- Hold trustees accountable for financial outcomes
- Introduce strict regulatory guidance in IRM framework on risk and parameters
- Allow trustees to renegotiate liabilities

Once such reforms have been implemented, we are positive about the consolidation of smaller pension schemes into so-called Superfunds.

We welcome any further opportunity to discuss our proposals with the government.

2. Houston, we've had a problem

The harsh reality is that the performance of the DB pensions sector has been far from satisfactory for the last 10 years. The Pension Protection Fund 7800 Index reveals that the total funding deficit has grown by approximately £400 billion in the last decade if one strips out the large deficit repair contributions that have been made by sponsors. The 'Greatest Good for the Greatest Number' report by the Pensions Institute warned that approximately 1,000 sponsoring employers' businesses are set to become insolvent. A decade of bad performance has tough real-life consequences. Sponsors will default, jobs will be lost and a substantial number of scheme members will find themselves transferred to the Pension Protection Fund, losing a significant proportion of their benefits. The tragedy is that this outcome was entirely avoidable, had tried-and-tested risk and investment management tools been employed.

The recent cases of the British Steel Pension Scheme and British Home Stores have raised public awareness. However, these headline cases aside, data from the Pension Protection Fund shows that 116 schemes have entered the PPF between January 2015 and March 2017. Since inception in 2006, 889 schemes have entered the PPF.

The DWP Green Paper argues that the problems facing the DB sector are relatively small, implying that only minor changes are needed for schemes to safely deliver their pension promises.

We disagree with the DWP on their assessment of the DB problem. DB schemes are very sensitive to tail risks in the financial markets. Tail risks might be considered unlikely, but they are not improbable, and perfectly plausible market developments, such as a recession or another financial crisis, could lead to the system collapsing. In that situation, it is not just pension benefits that are on the line, but jobs will also disappear as sponsors default. To make things even worse, in a recession there will not be room for all members from distressed schemes in the DB lifeboat – the Pension Protection Fund.

In this section of our response we explain why we think there are significant DB problems and by not managing the tail risks we are bound to repeat the mistakes made for the last 10 years. It is time for the government to do what is needed – implement necessary reforms to regain the public's trust in the pensions system and save valuable jobs in the real economy. Given the financial outlooks, this should be done rather sooner than later.

2.1 The DB system risk is massive

- Closed DB schemes are soon to be cash flow negative
- Such schemes are extremely sensitive to tail risks in the economy – such as a recession or depression
- By ignoring tail risks, the DWP massively underestimates the system risk

We are surprised that there is such a large discrepancy between the DWP Green Paper and the PLSA DB Task Force report or the Pension Institute 'Greatest Good' report when assessing the scale the problem. Given that all have access to the same underlying information and data, we expected a closer consensus on the scale of the problem.

This discrepancy illustrates the absurdity of today's situation, where the assessment of the health of DB schemes boils downs to subjective, and often unrealistic, assumptions made about the future developments of financial markets. Many of these assumptions are based on the same theoretical models that assumed the probability of a financial crisis of the magnitude experienced in 2008 to be so small that it could be neglected. We encourage politicians to ask their model builders a question inspired by Her Majesty, Queen Elizabeth II – how come no-one could foresee the current pension crisis?

For members, their DB scheme seems like a black box. Everything is perfectly fine, until it is not and members wake up to find they have been transferred to the PPF. It is a binary outcome which makes it near impossible for members to take proactive action and adjust their private situation. The robustness of a DB scheme requires solid risk management practices, where the economic risks are managed in such way that the scheme can weather tail events. A tail event is an unlikely, but not improbable, economic situation such as a recession, or even worse, a depression. For a closed DB scheme facing peak cashflow, the returns in each individual year do matter. It is therefore less useful to make use of long-term return expectations, instead it is crucial to manage tail risks in the short- and medium-term perspective, to prevent schemes facing a sinking giant's problem[1].

The difference between the DWP and PLSA's conclusions are mainly to be found in how the tail risk is formulated. Both analyses use relatively optimistic base scenarios, which can best described as '*return to historical average*'. To this they add a low yield scenario - '*continue in current situation*' - as an alternative. The low gilt yield scenario in the DWP Green Paper assumes that future yields remain at current levels as of March 31st, 2016 and that the sponsors pay higher deficit repair contributions over a longer time. The PLSA DB Task Force's corresponding scenario assumes that the interest rates stay low for longer and that eventually the long end of the yield curve will rise to 2%. In addition, the PLSA Task Force also assumed that the expected return on risk bearing assets are 0.5% lower than in their base case, while the deficit repair contributions remains unchanged.

In our opinion, neither the DWP nor the PLSA have applied anything near a realistic tail risk scenario to stress test what could happen in a more extreme situation. Both alternative scenarios are basically an extrapolation of the current economic reality to estimate the problem. In practice, we have not seen an economic downturn since 2008. The ballooning debt facing the economy will hamper economic growth going forward and we will be faced with a deleveraging of the debt mountain at some point in the future. It is not difficult to envision a hard landing, resulting in a long period with low growth and low real rates. Such a hard landing could result in a massive fall in asset prices and lead to a series of bankruptcies of sponsors which might break the system.

2.2 Restoring trust in pensions

- Downplaying the DB problem does not build trust, quite the contrary
- A system failure that could have been avoided will trigger a massive distrust in all forms of pension savings
- Trust can be regained by learning from past mistakes and applying sound risk management principles

We argue that public trust in DB pensions can be regained mainly by rebasing expectations, making the system more achievable and incentivising or forcing more robust risk management. This can only be accomplished by making changes to the system so that the economic risks are managed consciously and in some cases by adjusting the liabilities. The dire situation of the state-employee pension schemes in the USA is a warning of what could happen when hoping for the best and ignoring the worst.

Downplaying the potential significance of the DB problem, and assuming that the massive deficits that have built up will be removed by future investment returns and large contributions does not build trust, on the contrary, it sets the system up to fail. This strategy is equivalent of putting all the chips on red and hoping that the markets will return to normal (whatever that might be). If the investment outcomes come in significantly below the assumptions, the DB system could collapse under its own weight and drag many sponsors down with them in the fall. In that case, the chosen strategy will fuel a massive public distrust in all forms of pensions savings.

[1] Kocken, T. and J. Potters (2010), Sinking Giants, *Life & Pensions*, May 2010. https://www.cardano.com/en-GB/industry-insights/sinking-giants

Our recommendation to the DWP is to deal with the problem in a constructive and sustainable way that will make the British economy more robust. Such an approach will, over time, regain the public's trust in pensions. Telling the public that there is 'no reason to panic' and the industry to 'keep calm and carry on' means that the root causes behind the current problems will not be addressed and this will further erode the public's trust in pensions.

2.3 DWP should lead by example

- DWP should apply the IRM framework when analysing the system stability of the DB system
- DWP should provide clarity about tPR's mandate

From a member perspective, the government, via the Pensions Regulator, is the risk manager for the DB system. It therefore seems natural for DWP to apply the Integrated Risk Management (IRM) framework to assess the stability of the DB system and the strength of its lifeboat – the PPF. If the DWP does not diligently apply its own framework to manage the economic risk in the DB system, how can they expect trustees of individual schemes to do that at a higher standard?

Another peculiarity is that the Pensions Act 2013 tasked tPR with the added objective of "support[ing] scheme funding arrangements that are compatible with sustainable growth for a sponsoring employer". As was pointed out at the time of the consultation process, this objective is at odds with the primary objectives of tPR, and contributes to a lack of clarity in terms of tPR's mandate. We argue that tPR should focus solely on the stability of the DB schemes and the seaworthiness of the PPF lifeboat in a financial storm. To do that in an IRM framework, it is better adding flexibility in dealing with situations where the DB pension promise is simply unaffordable by making it possible for trustees to change the liabilities, as outlined in Section 3.3.

2.4 Make the PPF route robust to tail risks

- The statutory PPF route is merely an industry insurance financed by a levy (insurance premium)
- An 'economically fair' insurance premium will introduce transparency, by making the underlying economic risk visible on the sponsors balance sheet
- This will benefit both sponsor and scheme members. Sponsors will be incentivised to close the funding gap and shareholders will benefit from better insights in the financial risks for the sponsor company

The PPF is frequently portrayed as the back stop in the system, but that misses the point. The PPF is merely an industry insurance, financed via a levy on remaining pension schemes. The PPF currently has a surplus of several billion pounds, which is there to cover risks related to their existing members, such as changes in life expectancy and adverse investment returns. It also provides some capacity to absorb new underfunded entrants to the PPF. However, the aggregate deficit (on the PPF basis) of pension funds eligible for the PPF is nearly £300bn. The PPF can absorb a very small number of bankruptcies, but it will not be able to withstand a series of business failures in a tail event. In a recession, the strain of supporting a massive influx of funds into the PPF would be borne by the surviving DB schemes through higher levies, just at a time when their funding levels are falling and corporate sponsors will probably be struggling financially. In this scenario, the PPF would be forced to cut benefits, further undermining confidence in the system.

As an industry insurance, the PPF should charge employers with schemes that are underfunded below the PPF level an 'economically fair' levy (i.e. insurance premium). Whilst this principle is broadly accepted, we do not believe that the PPF levy framework adequately embraces an integrated approach, as it does not realistically incorporate the sponsor’s ability to pay. Following the IRM framework, the insurance premium should include the financial strength of the sponsor and the economic risks in the DB scheme. These two risks are clearly interdependent in a tail event, such as a recession.

Applying an ‘economically fair’ levy will make it less (financially) attractive for strong sponsors to have an underfunded DB scheme with an aggressive investment strategy. Implementing an economically fair levy will improve transparency of the financial risks within the DB scheme. This will likely lead to schemes with higher funding ratios and less risky investment strategies. We are aware that financially weaker sponsors may not be able to pay an economically fair levy, so there might need for a transition period.

3. Addressing the problems

It seems clear to us that the DWP's preferred approach of only considering incremental changes for a small number of distressed schemes will not be enough. In this section, we outline how the problem could be addressed using tried-and-tested governance and risk management tools and techniques.

The recent introduction of the Integrated Risk Management framework by tPR is a good step in the right direction for managing risk in a DB scheme. The strength with IRM is that all risks of the scheme are viewed in an integrated framework. This could lead to sound risk management practices, but that requires three substantial changes to the current regulatory framework:

- Addressing the governance gap - improving accountability so that trustees and sponsors are accountable for financial outcomes
- Provide regulatory guidance on the overall risk level and the parameters to be used in the IRM framework when quantifying risk
- Allowing trustees in schemes with weak sponsors to restructure their liabilities, in order to make them achievable and more robust

Once these changes have been implemented, we believe that consolidation of smaller DB schemes into Superfunds would be very helpful. However, without successfully addressing these changes, Superfunds are likely to commit the same errors made by smaller funds.

Lesson from the Netherlands:

In 2007, most of the so-called DB schemes in the Netherlands got a new regulatory framework based on economic risks. The Dutch regulator, DNB, was given a strong mandate to police the new system. Although it was a complete make-over of the regulatory framework, the largest funds decided not to modernise their risk management practices.

The largest funds assumed that the regulation would change if they ended up in financial trouble and therefore they thought it was rational to 'game the system' by taking excessive financial risks. Unfortunately, for many members, the gamble did not pay off and consequently pensions in payment had to be cut for the first time in 2013. It is worth pointing out that no-one was ever held accountable for this failure.

The lesson learned from the Netherlands is that without clear trustee accountability for the financial outcomes, even the best regulatory framework will fail to deliver security for the scheme members.

3.1 Governance gap - true accountability for the financial outcomes

Green Paper consultation question 3 g) is central and covered in this section.

- Trustees are neither in law, nor practice, truly accountable for the scheme deficit
- DB schemes should have a similar governance structures as for corporates, requiring separation of Executive and Non-Executive bodies

Despite risk management tools being introduced to the UK DB industry around 20 years ago, their take up has been slow and inadequate. Why has the industry been so slow to adopt best practice? It is our belief that a root cause of the problem is that in a traditional pension fund set-up, no-one is truly accountable for the financial outcomes. Neither the trustees nor the sponsor carry accountability – at least not in the conventional sense of the word - for rising deficits. Consequently, the response to address the rising deficits has been 'too little, too late'.

We attribute this governance gap to the Trust system, in which trustees are stewards acting as prudent lay people on behalf of the members. The trustees' primary responsibility is to pay the pensions when they fall due. Taking risk is acceptable provided it can be underpinned by the sponsor's covenant. Therefore, provided the sponsor is able to absorb potential losses, the trustees are perfectly entitled to take risks. The fact that these risks may produce repeatedly disappointing outcomes, could be dismissed as bad luck, and doesn't necessarily reflect poorly on the trustees. Quite the opposite, they will have fulfilled their obligations and the sponsor will simply have to put more money in to make good the losses.

On the other hand, whilst many sponsors seek to influence the trustees on investment strategy, it would be unheard of to have a CFO or CEO report to their main plc Board that the deficit had expanded because the sponsor had encouraged the trustees to take risks that hadn't come good.

We have a £1.5 trillion system on which millions of people depend, with vast governance infrastructures and networks of advisers, but no accountability for financial outcomes. Imagine the insurance industry had produced a collective £400 billion deterioration in solvency over the last decade, how many directors would have been replaced?

The clear majority of the individual trustees that we know are intelligent, extremely committed and diligent. For the avoidance of doubt, we are not criticising the competence or skillset of the trustees, just the fact that neither in law, nor practice, are they accountable for the deficit.

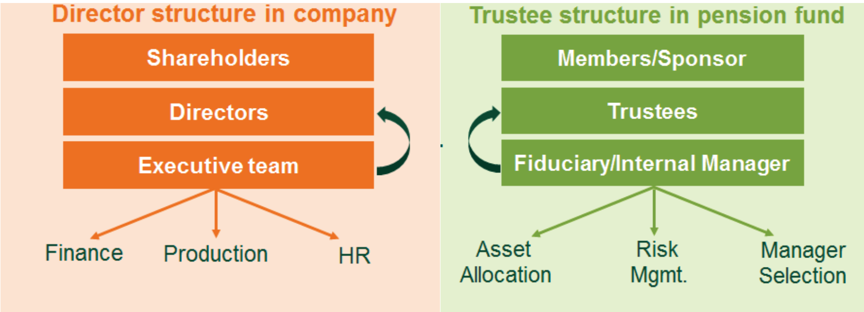
A solution inspired by corporate governance

The Cadbury Report sets out recommendations on general principles to assure proper corporate governance. This report was a response to a series of corporate scandals in the early 90s. These recommendations are reflected in the more recent OECD Principles of Corporate Governance.

Today, the corporate governance structure has three layers. Shareholders appoint a set of Directors whose task is to represent the interests of the shareholders. The Directors appoint an Executive team and set the strategy. The corporate Directors are accountable to the shareholders for the financial results. If the company does not deliver, the Directors will change the strategy and/or replace the Executive team.

Separation of non-executive Directors and the Executive team is considered an essential ingredient for success. This is where the main check and balance occurs – the Directors are competent but not necessarily experts in the field, but they can function as effective representatives of the shareholders because they appoint, manage and monitor professionals who are experts and can focus full time on delivering the strategy.

For DB schemes, a similar governance structure could be implemented. The member representatives and sponsor appoint the Trustees, who should be held accountable for the financial outcomes. Core objectives of the trustees are to set the strategy and appoint and manage the day-to-day executive management along a set of key financial indicators. The profit maximization in corporate situations is replaced by achieving the pension promises without taking excessive financial risks. The Internal or Fiduciary Manager is the equivalent of the Executive team.



Comparing trustee and corporate governance structures

We argue that trustees should have the same accountability as directors of a corporate. We acknowledge that this will be a genuine change of role compared to the current situation and that it will make it more difficult to recruit trustees. But if the trustees do not take on this critical role, then who will?

3.2 Embedding proper Risk Management via regulatory guidance

Green Paper consultation questions 1 and 3 are generally addressed in this section.

- Clear regulatory guidance around the IRM framework is necessary to reduce the current possibilities of gaming the system
- IRM should focus on the economic risks in the scheme and the funding floor should be the buy-out value of PPF equivalent liabilities
- An economically fair PPF levy would reduce the gaming of the system

The current pension crisis was entirely avoidable had tried-and-tested risk and investment management tools been employed. Clearer regulation could have significantly helped to encourage trustees to adopt better risk management. This requires a combination of focussing on the true economic valuation of benefits (as opposed to Technical Provisions) to make sure risks are better measured and managed. The Pensions Regulator should be given a much clearer mandate in terms of enforcing prudent risk management, with an explicit view to minimising the chance that schemes end up underfunded, versus PPF equivalent benefits.

For almost all other financial institutions, we have seen massive regulatory developments in the aftermath of the financial crisis of 2008. The objective of these regulatory developments is to protect end consumers during the next financial crisis and make the financial system less fragile. For DB pensions, the current regulatory framework allows for (subjective) expert opinions when calculating technical provisions liabilities, deciding which risk metrics to use, and how to set risk thresholds. In other words, subjective expert assumptions of future investment returns and risk will affect the funding ratio and risk policy. This opens the whole system to gaming by employers and trustees, and makes it difficult to implement sound risk management practices.

We believe that the IRM framework is a good step towards achieving proper risk management practices, but without strict regulatory guidance on acceptable levels of risk and how to set the parameters, it is likely that many schemes will view it as a 'paper tiger'. Better prevention of the problem starts, in our view, by bringing clarity to the measurement of deficits and clarity around how tPR regulates risk management by trustees. Regulation should require trustees to monitor and manage the schemes, in the IRM framework, against an economic valuation of the benefits.

The buy-out value of PPF equivalent benefits should be used as the floor for underfunding. This could be achieved by applying an economically fair PPF levy (see Section 2.4), which would make the economic risk in the DB scheme transparent on the balance sheet of the sponsor. We believe that this will reduce the possibility of gaming the system and nudge trustees and sponsors towards a more robust management of risk in the scheme.

3.3 Allowing trustees to restructure liabilities

Green Paper consultation questions 4 and 5 are generally addressed in this section.

- More flexibility in dealing with situations where the DB pension promise is simply unaffordable
- Restructuring of liabilities could provide members with a better pension outcome than the statutory PPF route
- Addressing the moral hazard in the current system would reduce the possibility for employers to manipulate the system

For sponsors with little possibility of meeting their commitments, we believe it is essential to provide trustees with more flexibility to adjust the accrued benefits, as part of an integrated approach to seeking the best collective solution for members and sponsors alike. This needs to be an option in advance of a bankruptcy, to salvage value for their members. Greater flexibility would create the possibility for 'win-win' situations to be negotiated. In the IRM framework, this would be an additional tool for managing the risk in a sustainable way.

Inevitably, many businesses will not be able to meet their pensions obligations. Therefore, we need more flexibility to deal with these situations. The current law only provides one option to a business that cannot afford its pension promises – go bankrupt and pass the pension fund to the PPF. This is clearly a 'lose-lose' as the members take a heavy haircut to their pensions and shareholders suffer a complete loss of equity. It is not currently possible for trustees to renegotiate the pension contract before a bankruptcy to salvage value on behalf of their members. This must change. If permitted by law, 'pension fund restructuring' could provide members with a better pension outcome than the statutory PPF route and give additional breathing space for the company to find a solution that potentially could save thousands of jobs.

Of course, we recognise that through the RRA framework, exceptions can be made. However, the RRA framework is expensive and cumbersome, and leaves little room for adequate pre-emptive changes, as a prerequisite for an RRA is that the sponsor must face imminent and certain failure. In addition, if we are correct that the scale of the problem is severe then it is not a small minority of schemes that may need to go down this route. A structural framework with clear parameters for eligibility and flexibility will be required.

For an underfunded scheme with a weak sponsor, it's a question of when, rather than if, a haircut will be applied. The members should not have to wait and watch the pension fund enter the PPF – resulting in reduced benefits and having their pension assets parked in a conservative portfolio.

Like in almost every other aspect of commercial life, the trustees should have the power to negotiate with the sponsor and consider other options. These should include the power to cut accrued benefits, thereby alleviating the financial burden the sponsor cannot afford. We think that trustees should have the power to cut accrued benefits below the PPF level if that is done in conjunction with the introduction of a risk-sharing component, such that in aggregate members will likely do better than going into the PPF.

This would allow trustees to convert an insolvent DB scheme that represents a fatal noose around the neck of its sponsor, into a hybrid scheme that offers DB benefits at a substantially reduced and affordable level with some contingent upside if investment performance is good. This would allow a 'win-win' outcome - members continue to save for their future instead of locking into the reduced benefits the PPF offers, and the sponsor is released from an unaffordable burden.

Our biggest concern is to avoid the moral hazard of employers to manipulate the system. We argue that it could be counteracted by addressing and removing the current possibilities to game the system by introducing an economically fair levy for the PPF (Section 2.4) and stricter regulatory guidance (Section 3.2). To protect the members, we suggest a process where tPR reviews and approves proposed changes to the benefits.

3.4 Consolidation of smaller schemes

Green Paper consultation question 6 is generally addressed in this section.

- Consolidation into Superfunds are helpful, but will not solve the underlying problems, without the other measures recommended in this paper
- Standardization of the liabilities is a practical pre-requisite for consolidation
- Without sponsor covenant, sound risk management and strict regulatory guidance are necessary for protecting members

Provided the proposals outlined in this consultation response are adopted, we believe that consolidation of smaller DB schemes into Superfunds would be very helpful. However, moving towards Superfunds without successfully addressing these changes (i.e. accountability, risk management and benefit restructuring) is not going to solve the underlying problems.

For smaller DB schemes, we argue that a full consolidation is the only meaningful form of consolidation. A full consolidation creates larger pools in which the individual longevity can be shared. In addition, it eliminates the need for the smaller scheme to retain a separate governance structure.

Even if our proposed changes are implemented successfully, a transfer will be a complex legal matter involving several stakeholders. The legal costs that a smaller scheme will face when entering a consolidation vehicle need to kept under control. It is therefore likely that a standardization of the liability side will be a pre-requisite for the practical viability of consolidation. A standardized contract, based on the hybrid solution that we mentioned in Section 3.3 would provide one possible solution. In that case consolidation would allow the sponsor to walk away since the Superfund will take over the liabilities. Without an external covenant the Superfund would become a mutual pension scheme, which means that the scheme members must be prepared to share the downside. This increases the demand for sound risk management principles and strict regulation guidance to protect the members.

4. About Cardano

Founded in 2000, Cardano is a purpose-built risk and investment specialist, and financial pioneer. We are widely recognised as being the market leaders in the provision of specialised fiduciary management and investment advisory services.

We exist to help pension funds and the people they serve achieve their financial goals in a more resilient, realistic and responsible way. Our deep understanding of the causes and impact of risk, and how this can be managed to significantly improve financial performance and resilience, enables us to deliver planned and controlled performance for our clients, irrespective of economic conditions.

Our published fiduciary management track record shows that this multi-award winning approach has worked. We have consistently outperformed our clients' liabilities, with low levels of risk, over the last decade.

We currently employ 170 people based in London and Rotterdam with clients whose assets total in excess of £120bn. We have a team of 100 in London and we work with 23 UK pension schemes whose assets total over £50bn.