

# Deregulatory Review of Private Pensions

## Response by Prudential plc

### Introduction

We approach this consultation primarily from the perspective of a company which, as far as the pensions market is concerned, currently focuses on providing defined contribution pension scheme solutions to the market both in the pre-retirement and post retirement phases.

### Risk sharing

#### **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?**

More analysis would have to be done on risk sharing to review the price of the risk-sharing element and whether this is better for members. The result may vary from individual to individual depending on their circumstances. The risk may also be more extreme as the individual approaches pension age.

Risks may already be shared by insurance companies when pensions start, depending on the member's choice of annuity - sometimes that is essential for the annuitant but sometimes the annuitant may be able to share risk for potentially greater reward. For example, if an individual is able to take the risk that an annuity income may reduce, then he or she could remain invested in a wide range of assets rather than move to bonds or gilts.

Of course, any potential benefit to the employee results in costs or risks being accepted by the employer. It's important that employers supporting a risk-shared scheme understand the risks and costs they accept in providing the "guarantee" element, and also the high costs associated with the running of such a scheme.

#### **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?**

Many employers have moved, or are moving, from a defined benefit environment to reduce the risks to the employer (among other things). However, we have no evidence that would suggest that employers wish to share more risk than under defined contribution schemes.

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

We are not aware of the present framework preventing risk sharing schemes being adopted (but we do not actively pursue them so we may not be best placed to comment). Nor do we see creativity limited by the framework.

**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?**

Disclosure regulations should require clear communication of the proposition to the member, drawing out the risks, benefits and costs as appropriate.

**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?**

Communicating the differences between certain types of schemes, and the risks to members, is complex. The key issue will be to try to explain the differences in a way in which people are willing to engage and can understand the key aspects from their perspective. This would be assisted by having only a limited number of pension scheme designs.

**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?**

The legislation covering PPF and wind ups would need to make it clear whether risk sharing schemes were included or not.

## **Limited price indexation of pensions in payment**

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

This will depend on the individual circumstances of the scheme and the employer. For example, although removing LPI may produce some cost savings for the scheme, it also has a negative impact on the benefit promise made to employees.

Where companies have made benefit promises to their employees and enjoyed commercial advantage from doing so (e.g. in terms of recruitment/retention) there is a strong risk that removing an element of this promise would have a negative impact on employee relations. In addition any saving on future scheme costs may be replaced by more immediate costs in terms of wage compensation for the loss of prospective benefits.

Therefore, while we expect that some schemes will explore the potential for replacing or removing LPI, we do not believe that many schemes would actually alter their existing benefit promise, for service already completed.

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

No. The cost of LPI for pensions in payment is of secondary order compared to factors such as longevity risk and investment performance. The risks and costs inherent in these factors will continue to be the main driver for employer's decisions.

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

We have not seen substantive evidence that demand for risk-sharing schemes is dependent on whether LPI is mandatory or optional, or evidence that employers would remove LPI if it were no longer mandatory. Therefore we do not believe that there is sufficient evidence that changes to the LPI requirements would make the establishment of risk-sharing schemes more likely.

We believe that changes to the mandatory LPI rules should only be considered after detailed analysis of the practical impact on employer behaviour and on scheme members.

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

We do not believe that many schemes would opt to remove LPI and therefore would not expect there to be a significant impact on scheme costs.

### **5) Are there particular approaches to LPI that appeal to you? Why?**

Any approach to LPI must be simple for members to understand and for schemes to administer. In addition, it is important that any change to the LPI rules does not make it more difficult for schemes or annuity providers to match the benefit promise with suitable assets.

Complex and/or variable indexation rules increase the cost of providing benefits by the scheme and/or through annuity buy-outs. They also create additional asset: liability mismatching and reinvestment risk.

Complex approaches also reduce the ability of members to understand the benefits they are being promised and make the provision of information to members more complex and costly to provide.

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

If the members' pensions reflect the accrued value of the LPI foregone in respect of past service then presumably the effect of the removal of LPI for past accruals would be cost neutral.

If LPI were removed only in respect of future service, then the level of cost saving and the impact on members would depend on:

- the maturity of the scheme (i.e. the length of time members will accrue benefits without LPI) and
- the number of active members affected by the change (i.e. the number of members who will accrue benefits without LPI).

This is further complicated by the fact that many defined benefit schemes are currently closed to new members, so leavers are not being replaced by new members, so there is no stabilising impact from new members.

In practice we believe that the negative impact on members' benefits mean that most schemes would decide not to remove LPI.

## **Revaluation of deferred pensions**

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

This will depend on the circumstances of the original scheme and of the employer.

However it is clear that introducing a new revaluation regime would introduce additional complexity into scheme administration, and corresponding complexity for scheme members.

In addition it is important to recognise that a new revaluation regime would produce further complexity and cost for schemes because of the lack of investment assets to match the various revaluation regimes applying to deferred benefits. The new mismatching and reinvestment risks would also increase the buy-out cost of securing members benefits through an insurance company.

In the circumstances we believe there needs to be a careful assessment of the practical impact on schemes, members and insurers before such a measure is introduced.

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

Clearly, reducing the revaluation basis for leavers would have a negative impact on their benefits and therefore is not in their best interests. Although, reducing the rate of revaluation would reduce costs for the employer we are not aware of any evidence that demonstrates that this measure would have a direct impact on the continued viability of sponsoring employers. Therefore the effect of this proposal is clearly negative for leavers, while its impact on stayers is unclear. In the circumstances we believe that reducing the rate of revaluation for deferred members could only be considered if there is clear evidence of a beneficial impact on the continued viability of sponsoring employers.

In addition, it is worth noting that, unless the revaluation basis applied under the Pension Protection Fund was also reduced to a minimum of 2.5% (from 5%), the deferred members are likely to be better off if the scheme/employer becomes insolvent than if the scheme and employer remain viable. This would be a perverse outcome.

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

A reduction in the cap would have most impact on younger employees. However these are less likely to be members of a defined benefit scheme and therefore this issue is unlikely to be of relevance to their mobility.

In practice we do not believe that a reduced revaluation cap would be a significant factor in most people's decision to change jobs. Where it is a significant factor we believe people are likely to include the impact of this in contract negotiations with their prospective employer.

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

We believe the introduction of a new revaluation basis for benefits accrued after 2008 would increase complexity, increase the cost of securing benefits through annuity buy-out and increase the cost and risks of investment matching. In practice therefore we believe that this measure would be unlikely to reduce scheme costs and could increase the cost of securing benefits for early leavers.

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

We do not believe this would have any impact on funding strategy. Liabilities have to be met as and when they fall due. This measure does not alter when benefits come into payment and therefore when schemes need to hold adequate funds and when they need to realise investments.

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

No, we believe other factors are more significant in any decision to close or retain a defined benefit scheme.

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

No. We do not believe this measure would increase demand for risk sharing schemes.

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

If reducing the revaluation basis increases complexity and investment risks then this measure may not produce any significant cost savings. It is also not clear that there is any evidence that reducing the cap would have a significant impact on the continued viability of an employer. In the circumstances we do not believe that it has been demonstrated that the reduction in member benefits is justified by reference to the impact on scheme costs.

## **Normal pension age**

**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?**

We believe that linking to a longevity index would be too complex for members of schemes as far as understanding their likely benefits is concerned. Linking to State Pension Age might be worth considering.

**2) If you believe that an NPA set to a longevity index is feasible, would changes to present regulation of pensions be necessary? What changes would be required?**

Not applicable

**3) Do you believe that established pension schemes should be allowed to set NPA to a longevity index, or to change NPA, in regard to the entire period of scheme membership? Why is this your view?**

This is part of benefit design considerations. Schemes should be free to set the benefit design in whatever way is appropriate for the membership profile within the framework of the legislation, although we do not believe linking to a longevity index is feasible. Issues such as member consent would clearly be important in relation to changes in pension age for accrued rights.

**4) If your answer to question (3) is “yes”, should there be statutory protection for members in respect of these changes? What sorts of protection would be appropriate? For example, should members nearing retirement be allowed to keep a lower NPA?**

The need for member consent would deal with this.

**5) If your answer to question (3) is yes, would this be only under particular circumstances? What circumstances? Should a rise in NPA be allowed even for schemes that are closed?**

The need for member consent would deal with this.

**6) Do you have any information on savings and costs in relation to your responses to the questions above?**

No

## **Legislative override**

**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?**

**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?**

**3) What form do you think any appropriate statutory override should take?**

There is insufficient time to assess whether we would wish to take advantage of any potential override provisions but we are content to provide a view in principle. There may be situations where a statutory override for future accrual may be useful and may be a preferable choice for members than closing the scheme to future accrual. To that extent, exploring whether such an option would be feasible given the potential problems you set out in paragraph 62 would be useful. We do not believe that a statutory override in relation to past service benefits is appropriate.

## **Principles based regulation**

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

We support the idea of principles based approach to pensions legislation. But a vital point for many would be that any new legislation/regulation would need to make it clear that compliance with *existing* legislation automatically gives compliance with the *new* legislation. Consistency would also be needed between TPR and FSA to ensure that any areas of principles based legislation/regulation are consistent.

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

We have commented on disclosure in the next section.

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

If compliance with existing legislation/regulation automatically gave compliance with the new legislation/regulation, trustees may stick with existing systems and procedures, so there would be no particular cost saving.

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

Trustees may prefer the comfort factor that complying with detailed legislation brings and would not relish the prospect of having to review existing materials and processes – apart from the cost of doing this. However, if TPR produces Codes of Practice, complying with these codes, or existing legislation as in 3 above, will bring the same levels of comfort.

**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?**

A move to principle based regulation should not undermine the level of protection for members.

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

It will increase costs if more guidance and monitoring are deemed necessary.

**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, especially as TPR has already created an expectation of Codes of Practice, having already produced so much useful material.

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

There would clearly be costs in reviewing existing processes (unless there is a clear statement that compliance with existing legislation meets the initial requirements in the principles based approach). The process of reviewing could very well result in a general upgrading of the levels of understanding.

There would be a requirement for additional training for trustees to help them understand how to deal with principles based regulation.

## Disclosure

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

Yes, but again we would like to see a clear statement that that compliance with existing legislation meets the initial requirements in the principles based approach, to avoid the need for immediate reviews.

Any change required on moving to principles based regulation would have to satisfy cost benefit justification.

### **2) If the answer to question (1) is “yes”, do you feel that any of the approaches outlined above (or an alternative to those approaches) would be most appropriate and why?**

We believe that a principles based approach would work well for disclosure, provided that there is no requirement to change material immediately where schemes are complying with existing legislation (as already mentioned). This will help not only in the display of information but the timing of its issue. We do however believe that specific items should be prescribed so that core information is available consistently to members in all similar schemes. We therefore support the layout in paragraph 80 of the paper, though with more work to be done on what specific items should be displayed for different types of scheme.

If scheme rules are changed in a way which reduces contingent benefits, this must be done in accordance with scheme rules and no additional obligations should be imposed on the trustees. The exception would be where a pension sharing order on divorce had been made.

### **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?**

We do not believe requiring trustees to consult with or get permission from spouses or civil partners if the member chooses a single life pension is workable. The trustees may have no requirement to be aware of a spouse or civil partner (until the member's death) and would have to rely on the member to advise them. We believe that the information provided to members when exercising an open market option should help them to understand the important decisions they are making on the structure of pension they take. But we would not impose more obligations on trustees other than the provision of that information. We believe it would be sensible to pursue the detail of this through the current Treasury / DWP review of the open market option, rather than potentially duplicate issues. The exception would be on pension sharing on divorce, but this is already subject to appropriate disclosure timetables.

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

Disclosure in risk sharing schemes should explain in what ways risk are being shared and with whom. Information should make clear

- what the risk is to the members' benefits if the organisation sharing risk is unable to provide the finance needed for their share,
- who regulates them (if appropriate) to help ensure they have sufficient funds and
- information to help make an assessment of the risk.

It will be important in reviewing disclosure requirements to take into account what disclosure would apply to personal accounts when introduced.

**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?**

Any changes in disclosure regulation that required schemes to make changes (as opposed to providing flexibility for future change) would have to be cost benefit justified. There are several potential drivers for change in disclosure just now ranging from projection bases to changes for personal accounts. The cost benefit justification will be easier to make if all changes are bundled together rather than requiring a series of changes to the same documents.

## **Trustees**

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

Anecdotal evidence suggested that it would become more difficult to find volunteers for trustee positions. However, press coverage of all things “pensions” may have helped to maintain interest levels. The increasing complexity around trustees’ roles and responsibilities may have been a factor in limiting numbers, but this is clearly an area where the Pensions Regulatory has already done a lot of work to support trustees.

**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?**

We agree that conflicts of interest are inevitable, but not that any specific aspect of legislation is causing problems. We would be concerned that attempting to recognise conflicts of interest in legislation would merely serve to introduce further complexity. However, again, tPR have already published helpful information on conflicts of interest.

**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?**

We have concerns about the suggestion that trustees of pension schemes should be given exemptions that will not exist for other trustees. We would also be concerned about the potential loss of scope for compensation resulting from breaches of trustee duties and support the notion that acting reasonably does limit the need for indemnification (as set out in para 89).

**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?**

No.

**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?**

No, although of course there is an automatic presumption that a professional trustee paid for services is supplying services that are fit for purpose.

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

It is important that this does not impact on scheme liabilities, as any increase could result in further changes away from DB structures and a move away from trust based employer schemes.

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

No, provided that tPR maintain their support material.

**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?**

This may result in some trustee places not being filled. But this will depend on many factors: the type of scheme, the size of the employer, how well the role of trustee is publicised, for example, perhaps even on whether or not there are trade unions recognised for collective bargaining.

## **Return of surplus to the employer**

**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, this could be a factor in some schemes, possibly influenced by how any surplus was addressed in the past.

**2) If the answer to question 1 is “yes”, is 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?**

Given the legislation changes from 6 April 2006 (allowing greater freedom in the level of pension savings) and that trustees have a responsibility to monitor funding,

balancing the interests of members and beneficiaries, it does seem unnecessarily complex to include any “refund” threshold in legislation. As with any other trustees decision, a “reasonable and fair” test needs to be applied.

**3) If the answer to question 1 is “yes”, is your concern the ability of the trustees to block return of surplus?**

No, as we believe that trustee fiduciary duties demand fairness, without the need for specifics in legislation.

**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?**

Yes, but because the value of the underlying investments will change between the point that this threshold is reached and the time that a repayment could be made, we believe that it would be more appropriate to allow scheme trustees to decide whether or not a refund should be made. There should be no need to have threshold fixed in legislation.

## **Section 67 Pensions Act 1995**

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

Yes.

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

We agree that it is a little too early to say whether the most recent changes resolve the concerns. However, we do share the concerns about the lack of clarity. Increased press coverage has, in turn, increased the public perception of pensions security, to the extent that even getting individual member consent may not protect trustees from later claims that members did not understand the significance or that, with the benefit of hindsight, actuarial equivalence was not borne out practice. Even if a later claim is not substantiated, such a claim can attract disproportionate costs to respond, and may even involve trustees in having to get further legal advice.

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

We do not believe that there should be any exemption.

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

There should be scope for the scheme appointed actuary to decide on the basis, without the cost of having to have a separate “statutory” calculation.

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

If the scheme actuary and trustees have more flexibility in legislation, complicated definitions of subsisting rights would not be necessary.

## **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?**

We have some sympathy with the view that this will create problems in multi-employer schemes, but do not have specific details to support this.

**2) Are there ways in which the present legislation could be amended to minimise these problems, keeping in mind their purpose to protect members of the scheme and minimise calls on the PPF? For example, should the circumstances under which a section 75 debt is triggered in multi-employer schemes be changed?**

We do not have any evidence to support a change.

**3) Are present requirements or procedures relating to withdrawal arrangements too onerous? Which requirements and in what way?**

We do not have any evidence either way on these points.

## **FRS17**

**1) Do you consider FRS17 has had an impact on defined benefit pension provision by employers?**

We believe FRS17 has played a role in reminding and informing employers of the costs and risks inherent in their defined benefit pension scheme, though may also have been the last issue that prompted employers to move away from DB provision.

**2) If your answer is yes, please explain whether this impact has been good or bad, and why.**

Given that FRS17 has only applied for accounting periods beginning on or after 1 January 2005, we think it is too early to evidence what the practical impact has been on defined benefit provision. It is important to note however that the majority of defined benefit scheme closures occurred before the introduction of FRS17, the trend is merely continuing. This suggests that factors other than FRS17 are the main drivers for the approach employer's take towards their schemes.

## **Other issues**

### **Deregulating stakeholder pensions**

In the context of the introduction of personal accounts, we believe that you should also consider the extent to which legislation relating to stakeholder pensions should be deregulated.

We would encourage you to recommend the removal of all legislation relating to stakeholder pensions other than the protection for employers which have followed the designation process properly. In particular,

- employers should not be required to designate a stakeholder pension from some date shortly after Royal Assent of the Personal Accounts Bill. It cannot make sense for people to join a stakeholder scheme for just a couple of years or less if they will then enrol in personal accounts.
- employers should not have to continue facilitating contributions to stakeholder pensions as well as contributing to and facilitating contributions for personal accounts.
- personal accounts will replace stakeholder as the low cost basic pension product so there is no logic in continuing the legislative requirements. Existing members will be protected by their scheme rules.