12th May 2017

CWU Submission to the Department for Work and Pensions on Security and Sustainability in Defined Benefit Pension Schemes

Introduction

1. The Communication Workers Union is the largest trade union for the communications industry in the UK, with approximately 192,000 members in the postal, telecoms, financial services and related sectors. We represent members in several Defined Benefit (DB) schemes, including the Royal Mail Pension Plan (RMPP), the Post Office section of the RMPP and the BT Pension Scheme.

2. The CWU welcomes the Department for Work and Pensions Green Paper on private sector DB pensions. We support the Government’s overall objectives of improving confidence in the DB pension system and securing the retirement incomes of today’s and future pensioners.

3. We believe it is unacceptable that, despite being generally affordable, DB pension schemes are being closed by employers who are turning to inferior Defined Contribution (DC) schemes in an effort to cut costs and maximise profits. We believe that a new regulatory approach is needed for scheme valuation methods and investment strategies to ensure DB pensions are manageable and sustainable for the long term.

Key points

- It is a serious concern that DB pension schemes are increasingly being closed to future accrual on grounds of affordability, when in most cases employers could continue to maintain these schemes. This is evidenced in the Green Paper, which reports that the number of members in schemes with affordability issues could be as low as 5%, and that an estimated 71% of FTSE 350 companies could clear the IAS19 DB deficits on their balance sheet with less than six months of the net cash generated.\(^1\)

- The ongoing shift away from DB pension schemes towards lower cost DC schemes has major implications for workers’ retirement prospects. The use of DC schemes moves the risk onto individual savers and hence ultimately onto governments due to an increased burden from means tested retirement income benefits. The lower average contribution rates and income levels from DC schemes will lead to a far poorer standard of living for pensioners and higher levels of pensioner poverty in future.\(^2\)

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\(^1\) Security and sustainability in Defined Benefit Pension Schemes, Department for Work and Pensions, February 2017, para 128, p.35

\(^2\) DWP, ibid, February 2017, para 106, p.29
• Over the last few years we have seen the closure of the Royal Mail, Post Office and BT defined benefit schemes to new members. During the last 18 months we have been informed of plans to close both the Royal Mail and Post Office DB schemes to future accrual. This is despite the Royal Mail Pension Plan’s position as the best funded scheme amongst the FTSE 100, and the Post Office scheme retaining a healthy surplus which could have been used to fund ongoing accrual for the time being.

• Closure of the Royal Mail and Post Office DB pension schemes is set to seriously reduce the pension benefits that our members can expect to receive when they retire. In Royal Mail, members face losing up to a third of their future pensions on average. For a 50 year old member earning £25,000 a year and retiring at 65, this would equate to a loss of £4,392 a year (£109,800 over 25 years).

• The CWU made a strong case against closure of the Post Office DB scheme last year, submitting a detailed body of evidence which demonstrated why closing the scheme was unjustified and unnecessary. However, after running what we consider was an inadequate and misleading consultation, the Post Office has pressed ahead regardless. We want to see powers introduced for the Pensions Regulator that enable it to effectively address, challenge and remedy failures of the kind committed by POL with regards to its duty to consult, which we believe were breached by POL in carrying out its statutory consultation exercise.

• The CWU has condemned Royal Mail’s decision to close its DB scheme, and we have put forward an alternative proposal for a defined benefit Wage in Retirement Scheme (WINRS) which would provide the company with a credible, cost efficient and lasting pension solution for all its employees. Unfortunately, despite expectations that the scheme would maintain the Company’s contribution rate at the current level of 17%, Royal Mail has rejected the proposal on grounds of affordability and risk.

• We believe that new rules and regulatory powers are urgently needed to ensure that pension trustees and sponsors take an approach to valuing pension schemes liabilities that avoids focusing on the impact of short term market movements. This should help to address the growing tendency for employers to respond to sudden increases in pension deficits by closing schemes to future accrual, and instead create an environment in which pensions are treated as long term investments.

• It is in the interests of both sponsoring employers and members for a scheme to be run cost efficiently. This means the investments should be made in assets of a good expected return. Gilts do not presently qualify as such, and schemes would do better to avoid investing in gilts where they cannot afford it and to avoid basing their discount rate on gilt yields.

• The Pensions Regulator should be given a new objective to promote an increase in the active membership of private sector DB schemes. An emphasis on future accrual would allow

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3 In Section C of the Royal Mail Pension Plan
trustees and sponsors to reduce their focus on cautious investments with lower returns, and bring attention back to the importance of making investments in growth assets.

Question 1
Are the current valuation measures the right ones for the purposes for which they are used?

4. The CWU is concerned that the DB scheme valuation system is inappropriately focused on short term risk. We believe there should be a different approach to valuation which ensures member benefits can be provided with a more manageable burden on employers in the medium to long term. The valuation system must therefore be designed to focus on reducing the level of volatility in the deficit measure, which would address the problem of pursuing an overly conservative investment strategy to mitigate this volatility.

5. We support the option of introducing ongoing risk based reporting and monitoring requirements which would ensure a continuous level of insight into the funding of a scheme, rather than relying solely on a snapshot once every three years. As the Green Paper suggests, the triennial valuation cycle may be focusing trustees and sponsors on managing the position at the valuation date, rather than taking an appropriate longer term approach to scheme funding. This is likely to be one driver of investment strategies in low risk, low-return assets like government gilts, which results in higher pension deficits, higher employer contributions, and a greater risk of scheme closure.

6. In light of the sharp decline in gilt yields since the EU referendum, it is even more important now that changes are made to ensure valuation measures are fit for purpose. Pensions experts have argued that given the expectation of lower gilt yields for longer, pension trustees and sponsors should revise their approach to valuing pension schemes liabilities. They should not overreact to the large deficit numbers being quoted, which represent a hypothetical scenario and do not reflect the reality of how most pension schemes will be managed over the next few years. There are diverse strategies available for managing pension assets and liabilities, including asset portfolios which are not primarily dependent on gilts.5

7. We believe that new rules and regulatory powers are urgently needed to ensure that pension trustees and sponsors take an approach to valuing schemes that avoids focusing on the impact of short term market movements. This should help to address the growing tendency for employers to respond to sudden increases in pension deficits by closing schemes to future accrual, and instead create an environment in which pensions are treated as long term investments.

5 Don’t overreact to vast pension scheme deficits: We need a new normal for how they’re measured, Raj Mody, City AM, 1st September 2016, accessed at: http://www.cityam.com/248535/dont-overreact-vast-pension-scheme-deficits-we-need-new
Question 2
Do members need to understand the funding position of their scheme, and if so what information would be helpful?

8. The CWU believes that the provision of more detailed information and guidance for members about scheme funding would be extremely helpful in ensuring that decisions are taken in the best interests of the scheme and its members.

9. Insufficient effort is made currently to ensure that scheme members are properly informed about the processes and considerations associated with pension scheme funding and valuation, and what this means for the level of risk to their pension scheme.

10. This can make it easier for employers to exaggerate any funding problems and means scheme members are more likely to be persuaded that DB pension changes or closures are inevitable, when this may be far from the case.

11. Last year Post Office Ltd (POL) proposed to close the POL section of the Royal Mail Pension Plan (RMPP) to future accrual in 2017, a move which appears to have been driven purely by a desire to cut costs out of the business.

12. As the CWU argued at the time, there was no need to close the scheme as a sizeable surplus remained which could have been drawn upon to continue the scheme. We consider that POL’s statutory consultation exercise on the closure of the scheme was inadequate and misleading, and that the Pensions Regulator has insufficient powers to address this problem.

13. In particular, we consider the consultation exercise was designed to scare members into believing their benefits were not secure, when that was in fact not the case. POL later modified their position on benefit security, after representations from CWU. POL also implied that the need to increase employer contributions was imminent i.e. by when POL wanted to terminate accrual, which was also not the case.

14. It is not only the lack of information therefore, but a problem of misinformation about pension schemes that we believe must be addressed.

15. We agree with the suggestions in the Green Paper that new rules should be introduced which mandate schemes to publish a range of valuation measures, and that there should be better communications about the meaning and context of valuations.

16. We also want to see powers introduced for the Pensions Regulator that enable it to effectively address, challenge and remedy failures of the kind committed by POL with regards to its duty to consult, which we believe were breached by POL in carrying out its statutory consultation exercise. This should include the power to alter any listed change made following a failure to comply with the consultation requirements. It should also include tougher financial penalties for failure to comply with the duty to consult than the minimum £5,000 and maximum £50,000 fine currently in place.

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Question 3
Is there any evidence to support the view that current investment choices may be sub-optimal? If yes, what are the main drivers of these behaviours and how could they be changed?

17. Yes, we believe there is evidence that current investment choices by pension funds are not fit to ensure that schemes can be maintained in a sustainable way.

18. As the Green Paper notes, there can be little doubt that schemes have chosen to invest less in return seeking assets over recent years, with the proportion of scheme assets held in equities falling from around 60% to 30%, and the proportion invested in government and corporate bonds rising from 30% to 50% over the last decade.\(^7\)

19. As a result, sponsors are having to pay more towards their schemes than would be required if higher returns on assets were achieved. Whilst the evidence shows that most companies could nevertheless continue to fund their schemes, employers are increasingly pointing to the sudden rise in required contribution levels as an excuse for closing their DB scheme.

20. Royal Mail has this year announced plans to close its DB pension scheme, despite its position as the best funded scheme amongst the FTSE 100. This is based on expectations that the Company’s ongoing cash contributions will rise from £400 million to over £1 billion if changes are not made. As a result, members of the scheme face losing up to a third of their future pensions on average. For a 50 year old member\(^8\) earning £25,000 a year and retiring at 65, this would equate to a loss of £4,392 a year (£109,800 over 25 years).

21. The CWU has condemned Royal Mail’s decision to close its DB scheme, and we have put forward an alternative proposal for a defined benefit Wage in Retirement Scheme (WINRS) which would provide the company with a credible, cost efficient and lasting pension solution for all its employees. Unfortunately, despite expectations that the scheme would maintain the Company’s contribution rate at the current level of 17%, Royal Mail has rejected the proposal on grounds of affordability and risk.

22. The CWU finds it disproportionate and unacceptable that whilst claiming that its pension scheme is no longer affordable and rejecting the CWU’s WINRS proposal, Royal Mail has a commitment to growing shareholder dividends. The Company has paid out dividends totalling £638 million since it was privatised in October 2013. This focus on the interests of shareholders before pension scheme members is typical of a wider trend. As the Green Paper notes, FTSE 350 companies paid around 11 times as much in dividends as they did in Deficit Repair Contributions (DRCs) according to the latest available data.

23. Returning to the central question of investment choices, the enormous hike in Royal Mail’s expected annual pension payments has been brought about by an overly conservative investment strategy. This is driven by a focus on reducing the impact of short term market volatility, and by the need to match assets to liabilities due to the absence of new members and new accrual.

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\(^7\) DWP, ibid, February 2017, para 181, p.45

\(^8\) In Section C of the Royal Mail Pension Plan
24. However, it is in the interests of both sponsoring employers and members for a scheme to be run cost efficiently. This means the investments should be made in assets of a good expected return. The discount rate for valuing benefits should be a prudent estimate of the return on these assets. With gilt prices being so high and gilt yields so low, gilts do not presently qualify as “assets of good expected return”. Schemes would do better to avoid investing in gilts where they cannot afford it and to avoid basing their discount rate on gilt yields. Whilst pension schemes languish as a result of cautious investment strategies, the wealthiest 1,000 people and families in Britain saw their fortunes rise 14 per cent on last year to £658 billion on the back of soaring equities.9

25. In addition, the Pensions Regulator emphasises the funding of accrued benefits before the continuation of accrual. We believe this to be problematic, as an open to new entrants scheme is easier to manage than a terminated accrual scheme. Focusing on the funding of accrued benefits places a counter-productive emphasis on security (resulting in ever higher gilt based funding targets and ever lower returns on cautious investments) which drives up deficit contributions.

26. We believe that to address these problems, the Pensions Regulator should be given a new objective: to promote an increase in the active membership of private sector DB schemes. Active membership in DB schemes has 2.6 million in 2008 to 1.6 million in 2016.10 The Pension Regulator’s target could be to rebuild DB schemes to a 2008 level of active membership as a minimum. An emphasis on future accrual would bring attention back to the importance of cost efficiency and investment in growth assets.

**Question 4**

*Is there a case for making special arrangements for schemes and sponsors in certain circumstances such as a different regime for employers who can afford to pay more, and/or new or enhanced flexibilities for stressed sponsors and schemes?*

27. As the Green Paper notes, the evidence suggests that most sponsors can manage their DB schemes including any Deficit Repair Contributions (DRCs) and some could potentially afford higher levels of contributions.11

28. We therefore reject the suggestion by some commentators that there should be a re-evaluation of the DB promise, necessitating the reduction of future benefits to take the pressure off employers, and to make the whole system more sustainable for the future.12 Neither do we agree with the view put forward by some commentators that indexation should be cut to reduce the burden on employers, as this would have a significant impact on members’ benefits.

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9 UK richest ‘keep calm and carry on making billions despite Brexit’, Metro, 8th May 2017
11 Security and sustainability in Defined Benefit Pension Schemes, Department for Work and Pensions, February 2017, para 207, p.52
12 DWP, ibid, February 2017, para 206, p.52
29. We welcome the Government’s position that it is not persuaded that there is a case for across the board changes that would reduce members’ benefits in order to relieve pressure on employers. And we fully support the Government’s view that ‘DB pensions are hard promises – they are debts like any others, and debts should be honoured where sponsoring employers are able to do so. Measures to reduce pensions would be highly controversial, and would have significant legal implications, given that a pension is regarded as deferred pay, and is the property of the member’.13

30. We accept however, that there may be a need to introduce special arrangements for schemes and sponsors in a minority of individual cases, if it helps to keep schemes open where they are genuinely facing problems with funding.

**Question 5**

**Do members need further protection, and should this be delivered by a stronger and more proactive Regulator, and/or trustees with enhanced powers?**

31. In response to the Green Paper’s conclusion that a significant majority of DB pension members can expect to receive their full pensions, we accept this is the case in relation to accrued benefits.

32. However, it must be recognised that the high level of closures of DB schemes to future accrual in recent years means that millions of scheme members will not receive the pension they would have expected had the scheme remained open. The Pension and Lifetime Savings Association (PLSA) Survey 2016 found that 43% of main DB schemes in the private sector are now completely closed to future accrual compared to 17% in 2010.14

33. We believe this must be a consideration when examining how the management of DB schemes affects members, and whether further protection is required. Ideally, the pensions regulatory framework should be set up with the aim of ensuring not only the protection of accrued benefits, but also the sustainability of future accrual. Taking this approach and creating an environment in which schemes invest in growth assets will also help to safeguard the Pension Protection Fund.

34. Nonetheless, we believe that more could be done to ensure that scheme members are protected from the underfunding of pensions or sponsor insolvencies and the consequent collapse of their pension. The loss of pension benefits for thousands of BHS workers, for example, should never have been allowed to happen, and steps should be taken to prevent similar situations occurring in the future.

35. We believe the Pensions Regulator should have the responsibility and the power to intervene swiftly and at an early stage to address cases where employers fail to make the contributions that are needed, or where corporate greed and negligence puts the future of a pension fund at risk. We also believe the Regulator should be more pro-active with the powers it already has, such as the power to impose a schedule of contributions.

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13 DWP, ibid, February 2017, para 208, p.52
14 Pension and Lifetime Savings Association, Annual Survey 2016, December 2016
36. We support the suggestion of strengthening the position of the trustees in protecting scheme members, including by requiring the employer to engage constructively with the trustees, and giving trustees the power to demand timely information from sponsors.

**Question 6**
Should Government act to encourage, incentivise, or in some circumstances mandate the consolidation of smaller schemes into vehicles with greater scale and better governance in order to reduce the risk to members in future from the running down of closed, especially smaller, DB schemes?

37. The CWU believes there is potential merit in making it easier to consolidate smaller pension schemes in order to improve efficiency and governance, and strengthen investment performance.

38. However, adequate protections would be required to ensure that scheme members do not lose out as a result of consolidation, given the considerable costs and administrative challenges of amalgamating different funds.

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