Department for Work and Pensions
Security and Sustainability in Defined Benefit Pension Schemes
Institute for Family Business Response

1. Executive Summary

1.1 Many firms now have significant pension scheme obligations, and family business owners are committed to ensuring that their business is able to meet these sustainably whilst also investing in growth for the future.

1.2 We have serious concerns about the sustainability of the current arrangements for Deficit Repair Contributions, and the impact this is having on future growth and investment.

1.3 The current valuations system is too focused on solely using financial metrics, which is not appropriate for multigenerational family businesses.

1.4 We believe that both trustees and actuaries require improved guidance, including guidance specifically focused on the unique characteristics of multigenerational family firms.

1.5 Enabling more firms to move their indexation to CPI would help address some of these issues, and support the sustainability of both the defined benefit pensions' regime and the future growth of UK firms.

1.6 The benefits of any changes should be balanced against any potential increased administrative burden for schemes.

1. About Family Business

1.1 The Institute for Family Business (IFB) is a not for profit organisation, supporting and promoting the UK family-owned business sector through events, networking, representation, thought leadership and analysis.

1.2 We work closely with family firms to support them in growing enterprises for generations to come. A central part of our work is to provide educational resources and events designed to support business owners and those who work in family business. We aim to champion best practice within the family business community and help others to learn from these examples.

1.3 Family business is the backbone of our economy, and the bedrock of our communities. In the UK, family firms generate a quarter of GDP and employ over twelve million people. By their very nature, family businesses take a long term view, built on long-term stewardship of people and resources. Their commitment to passing something on to the next generation is locked into their corporate DNA.

1.4 The family business sector is extremely diverse. Family businesses come in all sizes, are found in all industries and across the whole country. Whilst the majority of family firms are small or micro businesses, there are over 17,000 medium and large firms. Family businesses are found in all parts of the UK. There are almost half a million family firms in the East of England, over one hundred thousand in Northern Ireland, and over three hundred thousand in Yorkshire.

1.5 Whilst family businesses generate a quarter of UK GDP[1], they recognise that success in business is about more than short term financial results. Success is about sustainable value creation. Family businesses perform better than non-family firms in non-financial metrics such as investing in their employees and in supporting communities.[2] And the best-run family businesses outlast others by a factor of two.[3]

2. Family Business and Defined Benefit Pensions

2.1 Family businesses have a long history of acting as responsible employers, and this includes their provision of pensions to their employees. Many firms now have significant pension scheme obligations, and family business owners are committed to ensuring that their business is able to meet these sustainably whilst also investing in growth for the future. Whilst firms may no longer accept new entrants into final salary schemes, those schemes remain a company liability until all beneficiaries of the scheme have passed away.

2.2 Family businesses, with their long term outlook and strong values, are committed to acting responsibly, but also recognise that investment and growth is essential if they are to be sustainable. Whilst the Pensions Regulator (TPR) has a stated objective to "minimise any adverse impact on the sustainable growth of an employer" we believe that the way in which deficits are calculated does impede investment in business growth.

2.3 Whilst responsible family firms are committed to ensuring that they are able to meet their pension commitments, many businesses feel that the current regime for calculating liabilities does not provide a reasonable representation of the liabilities on their balance sheets. Even where a family business is confident that it is able to meet the requirements of their scheme, the calculated deficit can be high. We would support measures to explore changes to the way in which the potential future costs are represented. This particularly impacts on family firms which do not usually have the same access to capital markets as other ownership models.

3. Funding and Investment

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

a) Are the flexibilities in setting the Statutory Funding Objective discount rate being used appropriately?

- *If not, why, and in which way are they not being used appropriately?*
- *What evidence is there to support this view?*
- *How could sponsors and trustees be better encouraged to use them?*

3.1 By their very nature, family businesses take a long term view, built on long-term stewardship of people and resources. In our view, the current valuations system is too focused on solely using financial metrics and that, particularly for multigenerational family businesses, this is not appropriate.

3.2 For example, in certain cases it might be appropriate for a multigenerational family business to apply a higher discount rate, because of their longer term approach and outlook. Where trustees and the company agree that a higher discount rate is appropriate, and in the interests of the

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[1] Oxford Economics and IFB Research Foundation (2016) *The State of the Nation: The UK Family Business Sector 2015/16*

[2] M Institute and IFB Research Foundation (2012) *Sustainable Value Creation*

[3] Miller, D and Le Breton-Miller, I. (2005) *Managing for the Long Run: Lessons in Competitive Advantage From Great Family Businesses*

company and the scheme members, multigenerational family businesses should have the flexibility to introduce this.

3.3 Whilst there is flexibility within the discount rate system at present, in our view this is not always well enough understood particularly within the context of multigenerational family businesses.

3.4 We believe that both trustees and actuaries require improved guidance, including guidance specifically focused on the unique characteristics of multigenerational family firms. Trustees and actuaries should be encouraged to take a more holistic view, broadening their considerations from solely financial metrics. Developing guidance which specifically refers to the different characteristics of multi-generational businesses (including long term outlook, the way in which investment decisions are made, etc) would help to better educate trustees, and empower them to make informed use of the flexibilities within the current system. We would welcome the opportunity to work with The Pensions Regulator on updated guidance.

b) Should we consider shorter valuation cycles for high risk schemes, and longer cycles for those that present a lower risk?

- *What should constitute a high or low risk?*
- *Or should a risk based reporting and monitoring regime be considered?*

3.5 Shorter valuation cycles could lead to greater administrative costs for those least able to bear them. The Government should carefully consider the proportionality of any additional costs, and seek to streamline costs to reduce the overall administrative burden on schemes.

c) Should the time available to complete valuations be reduced from 15 months?

- *What would be an appropriate length of time to allow?*

3.6 We do not believe that the time available to complete valuations should be reduced. During this period it is important that a range of stakeholders are consulted, and it is important that the necessary time is taken to make the best decisions for the scheme members and the scheme sponsors.

d) Should other measures or valuation approaches, for example stochastic modelling, be mandated or encouraged?

- *If so, which ones and for what purpose?*
- *How would the information provided to the Regulator to explain the agreed recovery plan differ from that at present?*
- *What would the costs be, and would they outweigh the benefits?*

3.7 We do not believe there is any evidence to support a view that changing the modelling approaches will bring any additional benefits, and we are concerned it would impose further administrative costs on schemes.

Question 2: Do members need to understand the funding position of their scheme, and if so what information would be helpful?

a) Should schemes do more to keep their members informed about the funding position of their schemes?

b) Do we need Government communications to provide information to the wider public and media about the degree of certainty and risk in the regime?

- *What difference could this make?*

3.8 Members already have a right to request information from the scheme, and we believe those existing measures are suitable. We do not believe that providing more information to all scheme members will provide any additional benefit, but would place a significant additional financial burden on schemes.

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?

a) *Do trustees/funds have adequate and sufficient investment options on offer in the market?*
   - *Is there anything Government could do to address any issues?*

3.9 In our view this is an issue for the industry rather than for Government intervention.

b) *Do members need to understand the investment decisions that are being made?*
   - *If yes, are there any specific decisions that need articulating?*

3.10 We do not believe that there is a need for member to be provided more information on the investment decisions being made. Defined benefit pensions are based on salary and length of service, investment decisions should not ultimately affect the amount of pensions a member receives when they retire. Providing information on investment decisions may cause avoidable stress for scheme members, whilst also imposing an additional administrative burden on the schemes.

c) *Would it be appropriate for the Regulator to take a lead in influencing or determining an acceptable overall level of risk for a scheme in a more open and transparent way?*

3.11 We believe this would be both inappropriate and impractical. Companies and trustees, with a close understanding of the business and scheme, are the most appropriate people to be making these decisions. We do not believe that the regulator would have the capacity to assess the needs of each scheme individually, and any one size fits all framework would not be appropriate.

g) *Are measures needed to improve trustee decision making: skills such as enhanced training, more Regulator guidance, or the professionalisation of trustees?*

3.12 We believe that trustees require improved guidance and training, including guidance specifically focused on the unique characteristics of multigenerational family firms. At the IFB we are also working with experts to provide access to additional training for trustees in family business schemes.

3.13 This must, however, be a balanced approach. Onerous training requirements would act as a disincentive to individuals agreeing to act as trustees. Similarly requiring professionalization of trustees would reduce the availability of trustees with a thorough understanding of the business and scheme. Lay and family trustees, who have a thorough understanding of the business, are invaluable assets. Their understanding of the values of the business, and its long term approach, should be recognised as an asset.

4. Employer Contributions and Affordability

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?

a) *Do you have any evidence that Deficit Repair Contributions are currently unaffordable?*

4.1 We have serious concerns about the sustainability of the current arrangements for Deficit Repair Contributions, and the impact this is having on future growth and investment.

4.2 As a result, family firms are forced into finding funds to ‘plug’ the calculated deficit, significantly reducing the funds available to invest in growth. This applies a considerable constraint on the ability of family firms to invest in increasing productivity, creating employment and moving into export. All this is sacrificed, whilst at the same time the system provides no practical benefit to the members of the pension schemes themselves.

4.3 Family businesses are committed to their role as responsible employers, and they aspire to be responsible stewards. For family businesses to meet future commitments it is essential that they are able to invest in their future.

4.4 It is essential that TPR takes a proactive approach to reviewing the conditions for calculating deficits, and acceptable recovery period lengths, to ensure that otherwise viable companies are able to continue to invest, grow, and create employment. As part of this we believe that the assessment of pension provision in family businesses should take into account the different business model of this type of firm. Family firms typically take long-term decisions and seek to provide stable continued ownership.

b) Should we consider measures to encourage employers who have significant resources as well as significant DB deficits to repair those deficits more quickly?

- *If so, in what circumstances, and what might those measures be?*

4.5 This should not be considered if it would impede sustainable growth of the sponsoring business, as that growth is essential to both the future of the scheme but also current employees, future employment and economic growth.

c) If measures are needed for stressed sponsors and schemes, how could "stressed" be defined?

- *Should a general metric be used, or should this be decided on a case by case basis?*

4.6 This should be decided on a case by case basis. Each case should be judged on more than simple financial metrics, with the level of risk defined by the ability of sponsors to pay deficits in the long term and taking into account the long term approach of a multigenerational family business. This does however risk producing significant additional legal and advisory costs for those schemes least able to bear them.

d) Are there any circumstances where stressed employers should be able to separate from their schemes without having to demonstrate that they are likely to become insolvent in the near future?

4.7 This should be judged on a case by case basis, but must only be allowed in those cases where a genuine need is proved. Any additional schemes which enter the PPF will add significant additional costs to levy payers. Given the considerable levy costs already being paid, it is important to avoid adding to these in all but the most exceptional circumstances.

e) How would it be possible to avoid the moral hazard of employers manipulating such a system in order to off load their DB liabilities? Would some sort of 'quid pro quo' be appropriate to ensure the scheme is not disadvantaged relative to other creditors of the employer/stakeholders?

- *What could this look like?*

4.8 TPR would be required to undertake a thorough due diligence of the scheme, as it currently does.

f) Are there any circumstances where employers should be able to renegotiate DB pensions and reduce accrued benefits?

- *If so, in what circumstances?*

4.9 This may be possible or necessary if a scheme is very distressed. However, in our view in practice this would be very difficult for employers to do due to the larger message that could be inferred about the viability of the wider business.

g) Is there any evidence to suggest that there is an affordability crisis that would warrant permitting schemes to reduce indexation to the statutory minimum?

4.10 In our view there is evidence which shows there is a sustainability problem in the current pensions' regime. Western Pensions Solutions carried out research of 262 family-owned businesses with defined benefit pension schemes. Eighty three per cent (83%) of those firms were paying deficit contributions, and on average they were paying eight per cent (8%) PBT as deficit calculations.

4.11 However, the eight per cent (8%) average masks a diverse range, with many firms paying considering more: twenty one per cent (21%) of those firms were paying more than half of their PBT as deficit calculations, significantly reducing the funds available to those firms to invest in future growth.

4.12 It is our view that enabling more firms to move their indexation to CPI would help address some of these issues, and support the sustainability of both the defined benefit pension's regime and the future growth of UK firms.

h) Should the Government consider a statutory over-ride to allow schemes to move to a different index, provided that protection against inflation is maintained?

- *Should this also be for revaluation as well as indexation?*

4.13 The Government should introduce a statutory over-ride to allow all schemes to move to CPI. At present indexation is a lottery, with schemes of a certain age universally subject to RPI, due to the options available at the time rather than a deliberate choice to opt-in to this index. This would have to be done by statute or it would involve protracted court cases.

i) Should the Government consider allowing schemes to suspend indexation in some circumstances?

- *If so, in what circumstances?*

4.14 If the scheme is otherwise unaffordable, and this measure would address that, then in our view this should be allowed.

j) How would you prevent a sponsoring employer from only funding a scheme to a lower level in order to take advantage of such an easement?

4.15 In our view the existing rules are sufficient in this area.

k) Should Government consider allowing or requiring longer, deferred or back loaded recovery plans?

- *If so, in what circumstances?*
- *Should other changes be considered, such as the valuation method of Technical Provisions?*

4.16 In our view trustees need a better understanding of the flexibility already available within the system, and this could be addressed in revised guidance as discussed above. However additional options to go further should be allowed in special circumstances, for example when a business is restructuring. We would welcome the opportunity to talk to the Government and TPR about this further.

l) Should it be easier to take small pots as a lump sum through trivial commutation?

4.17 We support measures to make it easier for take small pots as a lump sum, as it is advantageous to the scheme member and reduces the administrative costs for the scheme.

4.18 In our view any member who has a pot of £30,000 or less in a scheme should be able to take that as a lump sum.

5. Member Protection (Q5)

Question 5: Do members need further protection, and should this be delivered by a stronger and more proactive Regulator, and/or trustees with enhances powers?

a) *Would greater clarity over the requirements for scheme funding be helpful to members and to sponsors?*
  - *If so, would this be better set out in detail in legislation or through increased guidance and standards from the Regulator?*

b) *Is it possible to design a system of compulsory proactive clearance by the Regulator of certain corporate transactions, without significant detriment to legitimate business activity?*
  - *If so how?*
  - *What are the risks of giving the Regulator the power to do this?*

5.1 We do not support a compulsory clearance system. Such a system would impede ordinary business activity, and result in additional large advisory fees and a significant extra administrative burden. This would reduce a business' ability to take on outside funding for growth, make joint ventures more difficult to undertake, and generally impact on a business' ability to grow.

c) *Should the Regulator be able to impose punitive fines for corporate transactions that are detrimental to schemes? If so, in what circumstances?*

5.2 TPR already has powers to reclaim funds. We believe that punitive fines would be a disproportionate step, and would make it significantly harder to sell businesses which have historic defined benefit schemes attached. It would make it harder to attract outside, particularly overseas, investment and hamper businesses ability to invest in growth.

d) *What safeguards could ensure that any additional powers given to the Regulator do not impact on the competitiveness of the UK business or the attractiveness of the UK market?*

5.3 In order to avoid impacting the competitiveness of UK businesses and the attractiveness of UK markets, the Regulator should not introduce the measures discussed in questions 4 b or c.

e) *Should the Regulator have new information gathering powers?*

5.4 In our view this would add significant extra cost with no clear or defined benefit.

f) *Should civil penalties be available for non-compliance?*

5.5 In our view the purpose of this proposal is unclear, and appears to be a disproportionate response to a limited number of instances. It is essential that TPR does not disproportionately penalise genuine oversights, in this potentially very complex technical area, when the target of their interest in those acting malevolently.

g) *Should levy payers be asked to fund additional resources for the Regulator?*

5.6 In our view the cost of any additional resources for the Regulator should not be borne by levy payers. This risks adding further costs to those schemes who are least able to pay and risks more schemes becoming unsustainable.

h) Should trustees be given extra powers such as powers to demand timely information from sponsors, to strengthen their position?
- *If so, what extra powers might be helpful?*

5.7 Government and TPR should be promoting constructive relationships between trustees and sponsors, as this will ultimately benefit the decision making process. Trustees 'demanding' information could lead to adversarial relationships, which will not benefit trustees, sponsors or members.

i) Should trustees be consulted when the employer plans to pay dividends if the scheme is underfunded – and if so, at what level of funding?

5.8 If there is an agreed recovery plan in place, we do not believe that this is necessary or appropriate.

j) Is action needed to ensure that members are aware of the value of and risks to their DB pensions?

5.9 In our view this is another recommendation which would lead to an additional administrative burden for schemes, which provides no benefit to scheme members.

6. Consolidation of Schemes

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?

a) Is there anything in the existing legislative or regulatory system preventing schemes for consolidating?
- *How might such barriers be overcome?*

b) What other barriers are there which are preventing schemes from consolidating?
- *How might they be overcome?*

c) Should rules be changed to allow the reshaping of benefits without member consent?
- *In what circumstances?*
- *Should there be prescribed restrictions to the types or limits of such reshaping?*

d) Are costs and charges too high in DB schemes?

e) Should schemes be required to be more transparent about their costs or justify why they do not consolidate?
- *In what circumstances?*

f) Is there a case for mandatory consolidation?
- *In what circumstances?*

g) Should the Government encourage the use of consolidation vehicles, including DB master trusts? If so how might it do so?

h) Are further changes needed to the employer debt regime in multi-employer schemes to encourage further consolidation?

i) Is there a case for consolidation as a cheaper, but more efficient form of buy-out, with the employer and trustees discharged?
- *If so, (a) what should be the requirements for a scheme to enter such a consolidator, especially the level of funding; and (b), should the residual risk be borne by the member, or by the PPF?*

j) Should Government encourage creation of consolidation vehicles for stressed schemes?

k) Should employer debt legislation for multi-employer schemes require full buy-out and for the actuary to assess liabilities for an employer debt by estimating the cost of purchasing annuities?

6.1 Consolidation may be desirable for some schemes, particularly smaller schemes, as a means of reducing the costs and charges associated with running a defined benefit scheme. However, consolidation should not be mandatory as it may not be suitable for all.

6.2 Our conversations with family business owners indicate that there is a lack of awareness and understanding of the consolidation options available. Guidance should provide more information on consolidation, so that those schemes which might benefit from this option are able to find out more about whether it is suitable for the circumstances and how practically to go about consolidating.

7. Conclusions

7.1 Many firms now have significant pension scheme obligations, and family business owners are committed to ensuring that their business is able to meet these sustainably whilst also investing in growth for the future.

7.2 We have serious concerns about the sustainability of the current arrangements for Deficit Repair Contributions, and the impact this is having on future growth and investment. This needs to be addressed to ensure successful family firms are able to continue to invest in future employment and growth.

7.3 Both the current valuations system and guidance available are too focused on financial metrics, which is not appropriate for multigenerational family businesses. These should be updated and improved to take into account the unique characteristics of multigenerational family firms.

7.4 Enabling more firms to move their indexation to CPI would help address some of these issues, and support the sustainability of both the defined benefit pension's regime and the future growth of UK firms.

7.5 Consolidation may be desirable for some schemes, but our conversations with family business owners indicate that there is a lack of awareness and understanding of the consolidation options available.

7.6 The benefits of any changes should be balanced against any potential increased administrative burden for schemes. There are already significant administrative burdens and these should be reduced rather than added to.

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