Are your Members Winners or Losers?

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Whilst the active population in private sector DB schemes had shrunk to only 1.0 million in 2020 compared to 2.4 million ten years ago there are still 9.9 million members relying on DB pensions to provide for them in retirement[1].
Our analysis shows that the governance of DB schemes can affect member outcomes significantly. Our examples in this paper show that members could be over 15% worse off simply because of governance decisions around member options terms, member communications and the ability of the Trustee (and their advisors) to negotiate suitable protections for their scheme with corporate sponsors.
This paper considers those member outcomes in more detail and makes suggestions for the industry to consider further.

Areas where good DB governance can affect member outcomes

MEMBER OPTIONS

All DB schemes have two main member options which can vary significantly even where a pension scheme offers the same core benefits:

• **Commutation terms**
Members are allowed to commute up to 25% of the value of their DB pension tax free, but the range in approaches to calculating commutation factors can give vastly different benefits for those who wish to take up this option. A member who gives up £5,000 p.a. for tax free cash and is fortunate enough to be in a scheme with high factors could receive £50,000 more in overall value than a member in a scheme with lower factors.

• **Transfer Value terms**
Under legislation, transfer values are required to be, as a minimum, the best estimate of the expected cost of providing members' benefits in a scheme, unless they are being reduced for underfunding. In practice, this means that transfer values are driven almost entirely by the scheme's investment strategy. Assuming a 4% return on equity over gilts, a scheme with 10% in equity would likely provide a transfer value for a 40 year old member which is more than 50% bigger that of a scheme with 60% invested in equity even where members have identical benefits.

There are, as illustrated by the transfer example, scheme specific reasons why some factors could vary but decision makers should recognise the resultant impact on value for money for members. In addition to this, many schemes offer additional options including pension increase exchanges, pension levelling options and partial transfers which create value for members as they can chose a pension structure which suits them without transferring, or transferring in full, to a DC world.

COMMUNICATION AND ADMINISTRATION

Communication with DB members often serves one of two purposes; to inform members about the scheme or to help them take decisions.

• **Communications to inform**
There is a wide variation here. Some schemes simply provide documents they are required to by law and others provide a wide array of communications including annual newsletters, information about the scheme and information about the trustees. These remind members that they are part of a valuable pension scheme which often encourages them to engage with administrators and have a better understanding of their benefits. This increases the chances of these members making better financial decisions.

[1] Source for all figures: PPF Purple Book 2020 and PPF Purple Book 2010

• **Communications to help members take decisions**
Whilst all schemes provide members with information around their leaver benefits, their retirement benefits and their transfer benefits (on request) the quality of these communications varies hugely. Some will simply provide a member with a multitude of options with limited explanations whilst other schemes provide more information (some even in a video format) to help members understand their options and make the right decisions.

An Example: A DB Transfer

A DB pension can be a very significant part of an individual member's wealth and their decisions around the retirement period are crucial – for example, whether they wish to transfer out to a DC arrangement and take advantage of greater flexibility and differing death benefits. Schemes which have online access to information and provide members with explanations of transfer value options or independent financial advice will be providing significantly greater value than those who don't.

INTEGRATED RISK MANAGEMENT

The concept of integrated risk management was introduced to the industry in 2015 and encourages both trustees and corporate sponsors of DB pension schemes to put in place a suitably integrated investment strategy, funding strategy and covenant support to ensure best outcomes for members.

This is a highly complex area which requires trustees to have a strong understanding of the advice they receive from their advisors, strong negotiation skills and the time to regularly monitor the position.

The outcome for members in two otherwise identical schemes could be significantly different if one trustee board had strong governance around IRM and took some actions to protect the scheme at the appropriate time. A scheme which appropriately de-risks assets in the right circumstances or puts in place some additional security for the pension scheme as part of an agreement with the sponsor would be in a much stronger position than one who took neither of these actions.

CORE GOVERNANCE

The structure and approach of any board of trustees will often determine how strong their wider governance approach is. Boards need to be motivated, well diversified and appropriately sized to make good decisions and ensure the scheme is running effectively. An effective trustee board will also commission high quality advice, use modern technology, be well-chaired and have open and honest debates between themselves and with their advisors.

What could the member impact be?

To consider the impact on members, let's consider two members in two separate DB schemes. These schemes have exactly the same DB benefit structure, the same funding level, a sponsor with similar covenant and identical scheme rules. Both members are deferred members who were made unemployed from a job not connected with the pension scheme at age 60. The only difference between these schemes is governance. Scheme A provides generous member options, has a high level of communication and has a highly engaged and diversely skilled trustee board. The other scheme has low engagement from the board, is oversized and undertrained, and has below market member options and poor communication. Additionally, the trustees of Scheme A ran a strong negotiation with the sponsoring employer and put in place an escrow account to top up the scheme in the event of sponsor insolvency. Unfortunately, both of the employers went under when these members were aged 63. What could the member impacts be?

MEMBER A

The member in the first scheme decided to retire early having received regular high quality communications from the scheme at age 60 (3 years ago). They converted an early retirement pension of £7,500 p.a. into cash (based on a commutation factor of 25), giving a lump sum of £40,000 and a remaining pension of £5,900 p.a. When the sponsor became insolvent the escrow account was implemented and the scheme was able to recover 95% of all members benefits.

By the time this member died at age 85 he would have received around £225,000 in total.

MEMBER B

This member was unaware that his DB scheme offered early retirement until he was 62 due to poor communication from the scheme. He then retired and converted an early retirement pension of £8,500 p.a. (based on a commutation factor of 15) into a lump sum of £39,200 and a remaining pension of £5,900 p.a. At age 63, he then received a letter to say his pension was being reduced to 90% of its value and it would be paid from the PPF.

By the time member B died at age 85 he would have received around £190,000 in total.

Over their lifetime, member A will receive around £35,000 more income compared to Member B as well as receiving that income when he lost his job rather than at a later date. This outcome is at least partly as a result of how the scheme was governed and run.

The impact on these members will have been more than just financial – member A will have had income at a time he most needed it (when he lost his job) whereas member B will have not and may have suffered both financial and mental hardship.

How can the governance gap be addressed?

DB CHAIR STATEMENT

In a DC world trustees have to report on value for members in the DC Chair's Statement which forms part of the annual Trustee Report and Accounts. Whilst it is doubtful whether many members read this Chair Statement, the existence of it has given DC governance a significantly higher priority for trustee boards. Early indications suggested that the forthcoming 'DB Chair Statement' could also require DB Trustees to consider 'value for members' or at least 'value for money' given that many DB members are no longer directly contributing to a scheme. However, the latest consultation from The Pensions Regulator (TPR) on the new DB Funding Code referred to a 'Statement of Strategy' does not include reference to 'value for member' or the impact of broader governance. We suggest that this could be a missed opportunity and a requirement for a DB Chair Statement might increase DB governance standards.

MINIMUM GOVERNANCE STANDARDS

Given the potentially significant impact on member outcomes depending on governance standards we welcome the recently introduced accreditation requirements for professional trustees and TPR's wider focus on high quality governance. There are some arguments for taking this further and asking Chairs of DB pension schemes to review their governance against a form of minimum standard in the areas set out in this note in addition to a requirement that it is commented on in a DB Chair Statement.

There are downsides to this approach which, if not managed appropriately, could turn into a "box ticking exercise" and distract trustees from the issues of the day, but we believe there should be industry debate on whether this could improve member outcomes and governance levels of DB pension schemes.

THE COST AND TIME DEBATE

Good governance clearly costs schemes money and takes significant time to undertake. There are obvious conflicts here for trustees and corporate sponsors, as the more they spend on governance the less may be available for members in the event of corporate insolvency or less will be available for the sponsor to invest in their business. Similarly many trustees aren't professionals, have limited time available but still add significant diversity and value to trustee boards.

We believe the key task for trustees is to consider these areas deeply and regularly ask themselves the question – is our governance approach resulting in acceptable outcomes for members. This should be considered alongside the regular debates many trustee boards have about the cost of running their pension scheme. There are a number of options available to trustees to improve governance ranging from simply reviewing their member communications and their approach to negotiation with their corporate sponsor, to changing the trustee board make up or even reviewing advisors/considering a DB mastertrust.

Conclusion

Whilst we believe it is an unrealistic aspiration for members in all DB schemes which provide similar benefits to receive the same value for money we do believe trustees and advisors should give this greater consideration. The way in which DB schemes are managed can create or destroy value as illustrated by our examples and there are ways in which DB schemes can access that value (advisor reviews, consolidation in all its various forms, consideration of professional trustees). Requiring trustees to report on this through a DB Chair Statement or similar document should, we believe, drive standards and result in better overall outcomes for DB pension scheme members.

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APPENDIX

The calculations in this note are based on example schemes and are approximate.
For the difference in cash equivalent transfer values an equity risk premium over gilts of 4% p.a. was used.
For the additional member value from commutation factors of commuting £5,000 p.a. of pension commutation factors of 15 and 25 were used.
The following assumptions were made in the member example calculation.
Member A
Commutation Factor at Age 60 – 25.
Member B
Commutation Factor at Age 62 – 12
Both Members
Early Retirement Factor 5% p.a. compound
Revaluation (in deferment and in payment) 2% p.a.
Assumed to die at age 85

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