RESPONSE TO THE INDEPENDENT PENSIONS REVIEW'S FINAL REPORT

Transport for London

27 September 2022

EVERY JOURNEY MATTERS

Transport for London

Response to the Independent Pensions Review's Final Report

27 September 2022

1. Purpose

1.1. Since the delivery of the Independent Pensions Review's Final Report (the Final Report) on 28 March 2022, HM Government (the Government) has required that TfL provide further information in relation to its response to the Final Report and a narrower list of options for further consideration. The Funding Agreement dated 30 August 2022[1] (the Funding Agreement) from the Government, included the requirements that:

"38. The Mayor's December 2020 Independent Review of TfL recognised that TfL's pension scheme is expensive, outdated and in need of modernisation. As part of this funding settlement, the Mayor commits to ensuring TfL's pension fund is financially sustainable and to protecting members' benefits built up to date.

39. Therefore, TfL will consider the findings of the Independent Review of the TfL Pension Fund and, by 13 September, provide a response to the Final Report alongside a workplan, setting out the steps that would be necessary for moving TfL's Pension Fund into a long-term, financially sustainable position. This workplan must include detail on what resources will be committed to achieving this objective. TfL and HMG officials will meet on 20 September to discuss TfL's workplan, progress to date and next steps. By the 30 September 2022, TfL will submit two categories of options for future service reform with no more than two sub-options under each, all of which will aim to reduce future service liabilities by circa £100m. TfL will set out their rationale as to why other potential options for reform have been ruled out. TfL will also provide:

a. core design principles for each sub-option (including but not limited to: salary risk, retirement age, indexation and possible accrual rates);

b. an assessment of how each sub-option meets key criteria related to: deliverability; affordability; (assessment of cost savings); sustainability (risk); fairness; and how it compares to other equivalent pension schemes;

c. its view on what HMG support is needed to progress the shortlisted options alongside proposals for how past service liabilities will be managed under these proposals.

40. TfL and the Mayor will agree with HMG a final detailed proposal for any recommended changes to both future service benefits and past service liabilities, and an implementation plan by no later than 31 January 2023. Should the recommended

[1] Link to Extraordinary Funding and Financing Settlement Letter, 30 August 2022: https://content.tfl.gov.uk/tfl-settlement-letter-30-august-2022.pdf

approach require TfL to consult members, TfL will commence consultation by 1 May 2023. TfL will be expected to provide regular substantive progress updates during the Funding Period."

1.2. The date set out in paragraph 39 of the Funding Agreement, in relation to TfL's response to the Final Report, has subsequently been extended by two weeks from 13 September 2022 to 27 September 2022. Similarly, the date of the meeting with DfT and the date for the submission of two categories of options for future service referred to in paragraph 39 have also been extended by two weeks, from the 20 September 2022 and 30 September 2022 to the 4 October 2022 and 14 October 2022, respectively.

1.3. This paper seeks to address the 27 September 2022 requirement, providing TfL's response to the Final Report and a workplan setting out the steps that would be necessary for moving the TfL Pension Fund (the Scheme) into a long-term, financially sustainable position. It should be noted that this workplan remains subject to change based on the nature and requirements associated with any specific options that TfL may consider further going forwards.

2. Executive Summary

2.1. The Final Report was delivered to the Government in accordance with TfL's funding agreements, on 28 March 2022. The Final Report included commentary and analysis of TfL's current pension arrangements and some options for reform, along with further information on the management of past service liabilities and implementation considerations.

2.2. It is overwhelmingly clear from the Final Report that the anomalous private sector nature of the Scheme, within the remit of the Pensions Regulator (tPR), means it is carrying unnecessary cost and risk. This is not appropriate for a public sector organisation. In its current form, there is a 1 in 20 risk that the Scheme could be in a £4bn deficit position by 2024, which could require contributions of around £700m a year for 6 years to pay off[2]. This risk is greater than it would otherwise be if the Scheme were to be treated as a public sector scheme, compounded by an expectation from tPR for relatively short recovery periods. In TfL's view, this treatment (including payment of levies required of private sector schemes) is exceptionally poor value for money.

2.3. On a public sector basis, the Scheme's funding position would improve dramatically to a material surplus position, currently estimated to be around £2bn. The risk of deficits arising in the future, as a public sector scheme, would depend on how a re-classification to a public sector scheme were delivered. If an unfunded public sector scheme were used, these risks would be eliminated entirely. If a funded public sector scheme were used, deficits could arise in the future; but this risk would be lower, with significant initial resilience in the funding position to absorb any downside events and with longer recovery periods available to rectify any deficit arising. In either case, public sector treatment would provide significant value on a whole of public sector basis.

[2] Based on the maximum length of time tPR currently expects a scheme with a strong employer to remedy its deficit.

2.4. Reform of future service is expected to exacerbate this risk and result in the crystallisation of significant past service deficits (for example, if the Scheme were to close to future accrual). The substantial additional contributions that would be required in this circumstance for past service would not be consistent with ensuring a financially sustainable pensions arrangement, or a sustainable TfL, going forwards as the extent of contributions required would be unaffordable.

2.5. It is simply not possible for TfL to address these risks on its own. The management of risk in relation to past service (with or without reform) requires Government support; for example, through legislation to enable a transfer of past service to a public sector scheme or the provision of a Crown Guarantee. TfL, therefore, cannot practically progress any reform of future service without a clear indication from the Government that it will concurrently work with, and support, TfL with the management of past service liabilities.

2.6. In summary, TfL's additional views on the key points from the Final Report are as follows:

- The Scheme is one of the only significant benefits beyond pay available to TfL employees and is highly valued. Therefore, any changes to the Scheme will have knock-on consequences for benefits and remuneration elsewhere. This is critically important in the context of TfL's ability to recruit and retain staff, particularly given the current challenges TfL is facing in this area and where, for a proportion of employees, base pay is already behind market rates.

- All members' benefits built up to date in the Scheme must be protected. The mechanism for this will require further consideration as options are developed to ensure fairness between different groups of members.

- Any changes which reduce TfL's pensions contributions, currently around £330m per annum, will proportionately reduce members future benefits. For example, a savings target of £100m per annum for future service against TfL's current level of pensions costs would result in significant and unacceptable impacts on members' future benefits, with an average reduction of around a third in the benefits members may build up in the future (although this impact would not be felt equally with younger members and newer entrants suffering a greater impact than older members). Options set out in the Final Report (and subsequent analysis by TfL) demonstrate that this would also result in lower benefits being offered to members than in comparable public sector organisations.

- Defined Contribution (DC) and Collective Money Purchase (CMP) arrangements should be ruled out as options for future service reform due to considerations around fairness, adequacy, certainty of income in retirement and recruitment and retention.

- Any changes to TfL's pension arrangements will take years and not months to implement and will be very dependent on the support of the Government who will need to work collaboratively with TfL. This is because restrictive Scheme rules mean, that in virtually all reform options, legislation would be necessary.

- Pensions reform is complex, and considerations require a careful balance to be struck between matters such as cost savings, future volatility and risk and the impact on members benefits and the challenging types of implementation matters that would need to be addressed if reform were to be pursued in the future.

2.7. TfL will look further at these matters and a more detailed review of options in the 14 October 2022 paper required by the Government in accordance with the Funding Agreement.

2.8. **The options referred to in this paper are not proposals for reform**. A “do nothing” option remains and the implementation of anything else will remain subject to further detailed work, the availability of appropriate legislation, relevant consultation with members (and their representatives) and TfL’s decision-making processes.

3. Background to the Scheme

Context

3.1. The Scheme is TfL’s main pension arrangement for its permanent employees. The Scheme is a funded occupational pension scheme set up under trust and is separate and distinct from TfL and its subsidiaries. TfL is the principal employer of the Scheme and TfL Trustee Company Limited, an independent body, is the trustee of the Scheme (the Trustee).

3.2. The Scheme has over 85,000 members of which over 25,000 are active members. The Scheme remains open to new joiners and the future accrual of benefits. It is also TfL’s designated scheme for auto-enrolment purposes.

3.3. The Scheme is a defined benefit (DB) scheme, where the benefit formula is linked to the member’s “final salary” on retirement, death or earlier leaving (whichever happens first). It is also a “balance of cost” scheme, whereby members currently pay a fixed contribution rate equal to 5 per cent of their salary, with TfL meeting any costs over and above this.

3.4. The Scheme is the primary benefit offered to TfL permanent employees as part of the total reward package and is highly valued. The Scheme is a key enabler for TfL to attract and retain talent in the organisation, especially in roles where base pay is significantly behind market rates.

3.5. Funding of the Scheme must be agreed between TfL and the Trustee (having both taken separate actuarial advice). The Scheme has some restrictive rules: any deficit must be made up in a ten-year period[3]; and changes to future service benefits require agreement of a majority of members[4] – in practice a member veto.

2018 Valuation

3.6. The valuation of the scheme as at 31 March 2018 showed the Scheme funding position in a deficit (where assets were not sufficient to meet liabilities) of £603m. Based on this valuation, TfL was paying an employer contribution to the Scheme of 33.3 per cent of pensionable pay. This comprised 26.9 per cent to meet the costs of future service accrual plus 6.4 per cent to address the past service deficit.

3.7. As part of this valuation a contingent funding framework was agreed. This means that additional deficit contributions of up to £25m (indexed) per annum become payable between valuations if the Scheme's funding position deteriorates.

[3] See Rule 16 (4) of the Scheme Rules
[4] See Rule 44 of the Scheme Rules

3.8. As a result of this valuation, the total cost to TfL of pensions contributions reached around £400m.

2021 Valuation

3.9. The valuation of the Scheme as at 31 March 2021 was completed in March 2022. This valuation resulted in a surplus (where assets were greater than liabilities) of £179m. Based on this valuation, TfL's employer contributions to the Scheme reduced to 27.3 per cent, paid solely in relation to the costs of future service because the surplus meant deficit reduction contributions in relation to past service were no longer required. This resulted in a reduction to the TfL's pension costs to an average of around £330m per annum, a saving of around £70m per annum. This saving makes up a significant proportion of the £100m potential saving identified by the TfL Independent Review in its earlier report, published in December 2020 before the 2021 valuation has been completed, explained further in section 4 below.

3.10. The contingent funding framework has remained, but no contingent payment is required for the 2022/23 financial year owing to the continued surplus position within the Scheme as at the annual assessment date of 31 March 2022.

Future valuations

3.11. The cost to TfL of the Scheme has generally increased on average over the last two decades as it has grown in size and certain factors, such as longevity and gilt yields, have risen and fallen respectively. As with any DB arrangement, the primary risk in relation to the Scheme is the potential for volatility in the funding position (as a result of matters such as investment risk, salary risk, inflation risk, longevity risk and other demographic factors) which may impact the valuation of assets and liabilities in relation to past service, potentially leading to deficits in the Scheme's funding position arising and increases in the cost of future service accrual. In its current form, there is a 1 in 20 risk (based on actuarial Value at Risk (VaR) modelling) of a £4bn deficit in the Scheme's funding position by 2024 (that is, assuming no changes to the scheme design, no changes to its classification as a private sector scheme and assuming no support is provided for past service liabilities) which could require contributions of around £700m a year for 6 years to pay off[5]. This risk remains a key concern for TfL.

3.12. These risks inherent in the Scheme are compounded by the Scheme's classification as a private sector scheme, despite the fact that TfL is a public sector statutory body. This has led to, and continues to present, additional unnecessary cost and risk. It is an historical anomaly that the Scheme was set up in this way.

3.13. As a private sector scheme, the Scheme falls within the remit of tPR. tPR therefore assesses the Scheme in line with other private sector DB schemes rather than on a public sector basis. Notwithstanding the fact that TfL, as a public sector body, has a significantly stronger covenant than nearly all private sector sponsors and has no shareholders to whom it is required to maximise dividends, tPR expects TfL to fund the Scheme in a similar way to other private sector sponsors. All other things being equal, this results in larger funding requirements than if the Scheme was considered to be a public sector scheme (or if TfL used one of the public sector schemes for its pensions provision), thus requiring TfL to divert a larger amount of funding to pensions payments instead of vital transport investment.

[5] Based on the maximum length of time The Pensions Regulator currently expects a scheme with a strong employer to remedy its deficit.

4. TfL Independent Review December 2020

4.1. In July 2020, the Mayor of London and the Board of Transport for London set up a panel to conduct an Independent Review (the TfL Independent Review) to investigate options across TfL's finances for providing TfL with long-term financial sustainability. The TfL Independent Review published its report in December 2020[6].

4.2. The TfL Independent Review suggested that savings might be achieved in TfL's pensions costs through both a modernisation of scheme design and by introducing support for the scheme's liabilities (the report referenced a Crown guarantee, but this support could be achieved in other ways with the Government's support).

4.3. The TfL Independent Review proposed that a combination of these **two** actions could reduce TfL's funding gap by a total £100m per annum. For that reason, it was clear that the potential savings identified were related to both the costs of future service **and** the cost of managing past service liabilities.

4.4. However, despite being based on the TfL Independent Review's findings, the cost saving target of £100m that the Government set out in the Funding Agreement is limited to future service alone. In TfL's view, therefore, the target saving in the Funding Agreement has not been properly defined.

4.5. This is particularly important when also taking into account that the TfL Independent Review's comments on pensions were written based on the 2018 Valuation, when the Scheme was in deficit. As a result of this deficit, TfL was, at the time, making deficit recovery contributions in relation to past service of approximately £75m per annum. Since then, the 2021 valuation has been completed and TfL is no longer paying these deficit recovery contributions, owing to a surplus in the Scheme funding position. As set out in paragraph 3.9, TfL's payments have already reduced by around £70m per annum as a result, on a basis that is comparable to values quoted by the TfL Independent Review.

4.6. In addition, the potential savings mentioned by the TfL Independent Review did not take account of changes which have been subsequently announced in relation to the alignment of RPI[7] with CPIH[8] from the early 2030's[9]. Had this been known, the value of potential savings cited by the TfL Independent Review would have inevitably been lower (by up to an estimated £55m), reflecting the reduced scope for potential savings in the way indexation applies to the Scheme (a move from RPI to CPI, as has been the case in the delivery of public sector pensions reform). Subsequent to the TfL Independent Review's findings, the alignment of RPI with CPIH has already been built into Scheme funding assumptions.

4.7. Therefore, the £100m savings target that the Government has set out in the Funding Agreement is now also materially out of date. Not only have the majority of the savings identified by the TfL Independent Review already been realised through the improved funding position of the Scheme at the 2021 valuation (given that costs have reduced by around £70m due to deficit reduction contributions no longer being paid), but the target level of savings itself should now be lower, reflecting changes which have already been taken into account in the way indexation will apply going forwards.

[6] See link: https://content.tfl.gov.uk/tfl-independent-panel-review-december-2020.pdf
[7] Retail Price Index (RPI)
[8] Consumer Price Index including owner occupier's housing costs (CPIH)
[9] See HM Treasury's "A Response to the Consultation on the Reform to Retail Prices Index (RPI) Methodology" dated 25 November2020

4.8. The recommendation of the TfL Independent Review (as the panel members noted they were not pensions experts) was to commission a review of the Scheme.

5. Government Requirements in TfL's Funding Agreements

5.1. Earlier funding agreements provided to TfL by the Government, dated 1 June 2021[10] and 25 February 2022[11], included a requirement by the Government for TfL to carry out a review of its pension scheme and options for reform with the explicit aim of moving the Scheme into a financially sustainable position. These requirements stated:

"TfL will carry out a review of their pension scheme and reform options with the explicit aim of moving TfL's Pension Fund into a financially sustainable position. TfL will provide a final list of assessed options under consideration by the Review to HMG by no later than 31 October 2021. TfL will deliver an interim report no later than 11 December 2021 and a final report including a recommended approach by no later than 31 March 2022. TfL will be expected to provide regular substantive progress updates as well as a detailed work plan setting out the steps it intends to take to deliver the reports by the relevant deadlines"; and

"TfL will continue to carry out a review of its pension scheme and reform options with the explicit aim of moving TfL's Pension Fund into a financially sustainable position. As part of the review of TfL's pension scheme, TfL will deliver a final report, including a recommended approach and implementation plan by no later than 31 March 2022. During the remainder of the Fourth Funding Period, TfL will be expected to provide regular substantive progress updates as well as a detailed work plan setting out the steps it intends to take to deliver the reports by the relevant deadlines."

5.2. In July 2021, TfL announced that Sir Brendan Barber had agreed to independently lead and facilitate the review, to be supported by Joanne Segars OBE. The Independent Review (the Review) was provided with terms of reference, which were agreed with Sir Brendan. These terms of reference set out, amongst other things, that the Review would assess TfL's current pension arrangements and identify and recommend options, which:

- Protect members' benefits built to date
- Are sustainable and affordable in the long term
- Are fair to employees, farepayers and taxpayers
- Are consistent with TfL's financial challenges ahead

5.3. TfL was required to submit three deliverables to the Government: a progress update by 31 October 2021[12], an Interim Report by 11 December 2021[13] and a Final Report (including a recommended approach) by 31 March 2022[14]. These deliverables were all submitted to the Government within the required deadlines.

[10] Link to Extraordinary Funding and Financing Settlement Letter, 1 June 2021: https://content.tfl.gov.uk/tfl-extraordinary-funding-and-financing-settlement-letter-1-june-2021.pdf
[11] Link to Extraordinary Funding and Financing Settlement Letter, 25 February 2022: https://content.tfl.gov.uk/tfl-extraordinary-funding-and-financing-settlement-letter-25-february-2022.pdf
[12] Link to progress update, 28 October 2021: https://content.tfl.gov.uk/tfl-interim-independent-pensions-review-october-2021.pdf
[13] Link to Interim Report, 9 December 2021: https://content.tfl.gov.uk/tfl-interim-independent-pensions-review-december-2021.pdf
[14] Link to Final Report, 28 March 2022: https://content.tfl.gov.uk/tfl-independent-pensions-review-march-2022.pdf

6. The Independent Pensions Review Findings

6.1. The Review conducted extensive evidence gathering, financial analysis and stakeholder engagement in an open and transparent manner against a very challenging and limited delivery timeframe in order to submit three reports to TfL (a progress update, an Interim Report and a Final Report). As set out above, these reports were, in turn, submitted to the Government in order to meet the required deliverables set out in the funding agreements.

6.2. This Review was being conducted concurrently to the 2021 valuation and this valuation was finalised at around the same time the Final Report was submitted.

6.3. In summary, the Review's Final Report concluded that:

- *Current pensions provision is highly valued by employees, forms a crucial component of the overall remuneration and benefits package, and that there are currently sharp pressures on living costs.*
- *The Scheme's private sector classification should be addressed as it means the Scheme is carrying more risk and cost than might be appropriate for a public sector entity.*
- *TfL is facing enormous financial pressures and that, while the Scheme is currently well funded, this is due to the relatively high level of contributions required from TfL. These costs have increased substantially over the last 20 years and there are real risks of further future increases.*
- *Four broad options – the current Final Salary Scheme ("Do Nothing"), a modified Final Salary Scheme, CARE and CARE with tiered contributions were considered worthy of further consideration. Out of these four broad options considered (each with several sub options which varied more detailed design features):*
  - *The options that deliver the highest cost savings for TfL are likely to result in the greatest impacts in the value of benefits to members. These impacts on members may not be equally felt;*
  - *Some of the Career Average Revalued Earnings (CARE) options would be comparable to other public sector employees and could help with labour mobility and the mitigation of risk;*
  - *Retaining the link to final salary but amending other elements of the design of benefits could also make some savings and mitigate some risk;*
  - *Some options may better protect TfL from future risk than others;*
  - *Some options may make TfL's pension arrangements uncompetitive;*
  - *Deciding on any potential reform direction will require a careful balancing of all these factors.*
- *More radical reform options, including defined contribution (DC) and Collective Defined Contribution (CDC)*[15] *were rejected, principally because they would be highly unlikely to provide members with adequate benefits in retirement.*
- *Any change made to future service provision will have implications for past service and could result in a sudden maturing of the Scheme that increases the*

[15] Also known as Collective Money Purchase (CMP)

demands on TfL for additional funding. The two issues – past liabilities and future service – will need to be considered hand-in-hand.

- *TfL, the Trustee, other stakeholders and Central Government would all need to consider their positions in detail on all the highly complex issues around the processes – and potentially highly significant level of costs – in effecting any changes. Government, for example, would need to determine its appetite for legislative change if some options were to be formally proposed for implementation. It will not be a simple, or quick, process. Any changes, if implemented, are likely to take years, not months, to introduce.*

7. TfL's View of The Independent Pensions Review Findings

Current Scheme Design

7.1. The Scheme is one of the only significant benefits beyond pay available to TfL employees and is highly valued by them. Therefore, TfL agrees that any changes to the Scheme will have knock-on consequences for benefits and remuneration elsewhere. This is critically important in the context of TfL's ability to recruit and retain staff, particularly given the current challenges TfL is facing in this area and where, for a proportion of employees, base pay is already behind market rates. The Final Report highlights that any potential pensions reform should not simply be a "race to the bottom"; with fairness to employees, and the adequacy and certainty of pensions in retirement, being a material consideration.

7.2. However, TfL agrees with the Review's factual analysis that the existing pension arrangements have resulted in increased costs to TfL over the last twenty years – as has been the case in all DB arrangements elsewhere, owing to matters such as rising longevity and falling gilt yields.

7.3. Similarly, the current arrangements present TfL with potential risks around increases in costs in the future as the Scheme grows, due to possible future volatility underlying the funding position. The Scheme's funding position reported a surplus of £179m at the 2021 actuarial valuation. This valuation resulted in TfL's deficit recovery contributions payable reducing to zero. TfL agrees with the Final Report that there is a risk of significant deficit recovery contributions becoming payable in the future if a deficit is recognised at upcoming triennial valuations due to factors such as potential changes in investment performance and other factors. For example, there has been volatility in the funding position since the valuation date. Initially, the funding position improved further with a larger surplus estimated, but the more recent estimates have shown some significant movements in the value of assets and liabilities (owing primarily to volatility in the markets and substantial increases in inflation), resulting in a deficit. However, the funding position does appear to be improving again based on underlying asset recovery.

Private Sector Classification & Public Support Options

7.4. TfL strongly supports the Review's examination of the unnecessary cost and risk inherent in the current arrangements as a result of the Scheme's anomalous private sector classification. This is something that TfL has raised with the Government in the past and which is becoming increasingly critical to the sustainability of TfL's pension provision going forwards. This is particularly the case in the context of the new funding regime due to come into force before the 2024 actuarial valuation, which will bring in the requirements of the Pension Schemes Act 2021 for trustees to set a long-term funding objective to reduce reliance on the employer over time (where a scheme is closed to accrual), along with a consistent low-risk investment strategy. The Department for Work and Pensions (DWP) is currently consulting on the draft regulations to implement this regime and whilst these have been drafted to be more flexible for open schemes, the new regime may still lead to increased costs for TfL.

7.5. TfL notes that there is likely to be significant mutual benefit in a transfer of past service assets and liabilities to an existing or new unfunded public sector scheme, to both TfL and the Government; while ensuring members' benefits built up to date are secured. This would remove the Scheme from tPR's regulatory purview and could be delivered in such a way as to avoid the Government being responsible for risks that they would not control (for example, salary risks) while providing around £14bn of assets that the Government could deploy elsewhere owing to the way in which pensions assets and liabilities would be accounted for in the national accounts, where assets would no longer need to be matched to the liabilities.

7.6. TfL notes that there would also be merit in considering transferring past service assets and liabilities to an existing or new funded public sector arrangement; however, this is likely to be suboptimal compared to an unfunded basis. A funded public sector arrangement would also have the benefit of removing the Scheme from tPR's regulatory purview in relation to the funding of a private sector scheme and allow it to be funded on a similar basis to other public sector schemes. However, unlike a transfer to an unfunded public sector scheme, TfL would retain the risk of past service deficits arising in the future (so would not be as optimal from a risk perspective as an unfunded scheme), but it is likely to be far more manageable and a lower risk on a public sector basis than under the current private sector classification. Because of the way funded public sector arrangements are accounted for in the national accounts, the assets would not, however, be available for the Government to deploy elsewhere as they would still need to be matched to the liabilities.

7.7. The precise implications to TfL of providing pensions in the public sector (rather than the private sector) will depend on the future benefits provided and the mechanism used but could generate significant value on a whole of public sector basis. Importantly, as the assumptions used to assess the cost of these benefits (in a public sector scheme) do not fall under the purview of tPR, the prudence required to fund private sector schemes under the scheme funding legislation is essentially “stripped out” of this assessment. This means that the contributions required to provide a given level of benefits in the public sector are generally lower than in the private sector.

7.8. In terms of past service, we estimate that, if the current Scheme was transferred into the public sector, then this could give rise to a surplus of assets over liabilities of around £2bn, due to this additional prudence being removed. No assumptions have been made about a change in investment strategy in providing these estimates and hence this difference in the private/public sector funding positions relates entirely to the extra level of prudence being required by tPR in setting the discount rate assumption in a private sector funding regime.

7.9. In a funded public sector scheme, this surplus would provide a significant amount of resilience against potential future adverse experience and/or reduce future contributions and more appropriate (and less expensive) funding assumptions could be used going forwards, thereby substantially reducing the risk of future deficits.

7.10. If transferred to the Government under an unfunded framework, then this surplus might be used in other ways; for example – as mentioned above, to accommodate any risks that HMG may perceive in certain assumptions outside HMG's control (such as salary growth) with any excess helping to fund TfL's capital programme (subject to further discussion with HMG). In the unfunded framework, no further surplus or deficits would arise in the future and hence the risk of regulatory intervention and any adverse future experience affecting the Scheme's assets would be entirely removed.

7.11. In addition, in both options, TfL would no longer be required to pay a Pension Protection Fund (PPF) levy (currently around £16m a year).

7.12. Alternatively, while TfL understands that the Government are averse to providing a Crown Guarantee, the Final Report correctly sets out that this would also have a material benefit for the Scheme. It would support the Scheme's pension liabilities in the extremely remote event of a TfL insolvency. A Crown Guarantee would underpin the Trustee's assessment of the sponsor covenant and hence provide support for a lower level of prudence in determining the Fund's Technical Provisions (that is, the value of its liabilities), which would be more akin to a public sector funding basis (even though the Scheme would remain a private sector scheme). The surplus could also be expected to rise to around £2bn on this basis. Scheme members whose scheme has a Crown Guarantee are not eligible for compensation from the PPF, as the Government would step in the event that TfL ceased to continue as a going concern. Therefore, tPR would not regulate the Scheme in the same way as a typical private sector scheme and the Scheme would also not be required to pay the PPF levy.

7.13. A Crown Guarantee would have no direct cost to the Government unless called - and as set out above, this is an extremely remote risk. Arrangements could be put in place to mitigate any transfer of risk or moral hazard type issues that may be of concern to the Government.

<u>Options for Future Scheme Design</u>

7.14. TfL also supports the principles and considerations upon which the Review concluded that DC and CMP arrangements should be ruled out as options for TfL's substantive future pensions offering. TfL agrees with the Review that it is appropriate and fair, that DB arrangements should continue to be provided to its employees going forwards; and that DC and CMP arrangements would lead to issues around fairness, adequacy and certainty of retirement benefits, along with compounding issues around recruitment and retention. These conclusions are consistent with those drawn by Lord Hutton in his review of public sector pensions provision[16] and, therefore, are consistent with the view that it is right that DB arrangements should continue to be provided as part of the public sector reward offering. A recent report[17] from the Pensions Policy Institute also noted that increased reliance on DC arrangements will mean that pensioners will face increased levels of financial risk and are less likely to reach retirement with sufficient savings to maintain their working-life standards of living in retirement, as DC contribution levels are far lower than those in DB.

[16] See Independent Public Service Pensions Commission: Interim Report dated 7 October 2010 and Final Report dated 10 March 2011

[17] See Pensions Policy Institute report: How will future pensioners use guaranteed income products? dated September 2022

7.15. TfL notes that the extensive modelling conducted by the Review and presented in the Final Report is a fair and factual representation of the options the Review chose in order to illustrate a range of outcomes, on TfL's costs, risk and on member benefits. Some of these options represent extreme examples for illustration and the Review was clear these options were not proposals for reform. TfL views the modelling conducted by the Review as very helpful in demonstrating the balance that must be struck between cost savings and/or risk on the one hand, and the reduction in members' benefits on the other.

7.16. The modelling shows that a savings target of £100m per annum for future service against TfL's current level of pensions costs would result in significant and unacceptable impacts on members' future benefits, with an average reduction of around a third to members' benefits built up in the future. This level of saving would also lead to benefits offered to members being lower than comparable public sector organisations. These impacts on future benefits would not be felt equally and could be much higher for those with less accrued past service, typically younger members and new or recent joiners.

7.17. TfL agrees with the Review that any significant impact on members' benefits must be viewed in the context of the wider prevailing recruitment and retention issues TfL faces, the cost-of-living crisis prevalent in the economy as a whole including the downward pressure on TfL's wider pay policy as a result of the funding agreements and any compounding effects that may have in the future.

7.18. TfL also agrees, as a point of principle, that adequate saving for retirement should be encouraged to enable a reasonable standard of living - rather than a member relying on state provision of benefits in retirement.

Transitional Considerations

7.19. TfL agrees with the Review that pensions reform is not a "quick fix" to the current funding challenges TfL faces. The Final Report sets out the extensive nature of the work that would be necessary to pursue pensions reform, including extensive preparations for consultation and engagement with the Trustee and active and prospective Scheme members and their representatives. Pensions reform, if pursued, would take significant time and would involve significant costs which are currently not budgeted.

7.20. The Final Report correctly sets out that all options that change future service benefits for Scheme members will require a minimum 60-day consultation as required by legislation but notes that changes of the nature proposed are likely to take much longer. Where there are impacts to benefits prospectively payable then there is a risk of significant risk disruption to our network. The extent of any such disruption is likely to be commensurate with the impact on individuals' pension savings.

7.21. The Final Report also notes that there are around 1,800 members that have "Protected Persons" status (arising from the LU PPP) and have statutory protection to either remain a member of the Scheme or receive benefits which are overall materially at least as good as those provided by the Scheme.

7.22. The Final Report also makes clear that the restrictive Scheme rules mean, that in virtually all reform options, legislation is necessary. This is consistent with TfL's assessment of the position under the Scheme rules. It is the case that, for these types of potential changes, the Scheme rules require the agreement of Trustee, the

Scheme Actuary and the majority agreement of all of the Scheme's members in general meeting. This effectively acts as a veto right for members as in practice, member consent is certain to be unachievable. Therefore, in virtually all options, Government support will be necessary (for example, for required legislation) prior to implementation. Further information on the Scheme rules and the amendment power contained therein is set out in Appendix 1.

7.23. If the Scheme amendment power were to be used to implement changes to the current arrangements, due to the restrictions which apply to it under the Scheme rules, the members would have an effective "veto" regarding the proposal. It would theoretically be possible to reach the same position without relying on the Scheme amendment power by reaching direct contractual agreement with members either individually or via collective bargaining agreements, or by asking members to voluntarily opt-out of the Scheme. However, in practice, this approach is effectively subject to the same "veto" issue described above.

7.24. If the discontinuance / winding up of the Scheme were to be triggered, this would enable a closure of the Scheme to new members and future accrual (for benefits to then be provided via a new arrangement) without relying on the Scheme amendment power. However, only the Trustee has the power to do this, where it is satisfied that "to do so is necessary to protect the interests of the members"[18]. It is highly unlikely that the Trustee would feel able to agree to this, in particular as it would likely be perceived as an attempt to circumvent the restrictions in the Scheme amendment power/other restrictive aspects of the Scheme rules. Separately and perhaps more significantly, doing this would trigger a very substantial debt due from TfL to the Scheme, under section 75 Pensions Act 1995. This debt would be based on the amount, over and above the value of the Scheme assets, that the Scheme Actuary estimates would be required to meet specified expenses and fully buy out the Scheme benefits with annuities from a regulated insurer, which the Scheme Actuary estimated to be approximately £14bn as at 31 March 2021. This debt for TfL could not be avoided in practice. This approach is not, therefore, in practice feasible either.

7.25. By contrast, there are existing legislative options already in place for making changes to future service benefits, which would override the Scheme rules, such as the powers available to the Government under section 31 of the Public Service Pensions Act 2013 (although there would be other legislative mechanisms available to the Government to support any potential changes to future service benefits).

7.26. Notwithstanding this, the Scheme amendment power could potentially be used to change the benefits of new entrants only, after a specified date. This is because, in TfL's view, the restrictions set out in the Scheme amendment power do not apply to individuals who have not yet joined the Scheme. The member "veto" referred to above would not, therefore, apply for new entrants. The Scheme amendment power could also be changed so that its restrictions do not apply to any benefits subsequently built up by new entrants as opposed to existing members.

7.27. However, as the Final Report correctly cautions, given benefits that members have accrued to date must be protected and, depending on how reform of future service is carried out, there are substantial risks that unaffordable past service deficits may be

[18] See Rule 45B of the Scheme rules

crystalised, as described further below. Again, this is consistent with TfL's view of the potential impacts of future service reform on past service liabilities.

Implementation Considerations

7.28. TfL recognises that any reform options that result in a closure of the Scheme to new members and future accrual would have a material impact on the funding position for any past service benefits remaining in the Scheme. If future service benefits are provided via another arrangement, then the Scheme will close to new entrants and accrual, crystallising an end point by which all benefits will be paid. Given the current investment strategy of the Scheme reflects its open status and therefore its long-term nature, this would be expected to lead to the Trustee wanting to de-risk the strategy (which currently targets a large proportion of assets in higher risk return-seeking assets, such as equities and illiquid alternative assets, to generate higher returns than if lower risk investments were held).

7.29. Whilst the extent of the de-risking in the short to medium term would depend on the Trustee's views, some immediate de-risking may be likely, given the current membership profile of the Scheme with around 40 per cent of its liabilities being pensioners, compared to the current target asset allocation, with nearly 75 per cent of assets in equities and alternative investments. In addition, and at the very least, the Trustee will need to plan for future de-risking and the consequent reduction in investment returns over time. This is because it is not usually appropriate for a scheme to have such high holdings in more volatile assets or less liquid assets as it matures without retaining significant reliance on the employer.

7.30. This also needs to be considered in the context of the new funding regime due to come into force before the 2024 actuarial valuation; this will bring in the requirements of the Pension Schemes Act 2021 for trustees to set a long-term funding objective to reduce reliance on the employer over time as a scheme matures, along with a consistent low-risk investment strategy.

7.31. The DWP has recently launched a consultation on the draft regulations needed and tPR still needs to finish consulting on the details of the regime. Whilst it is expected that schemes can continue to take a bespoke approach to funding, justifying the risks being taken where trustees consider these are supported by an employer's covenant, it might be expected that the Scheme would have close scrutiny from tPR. Whilst DWP's draft funding regulations have been drafted to be suitably flexible for open schemes (with more detail expected to be included in forthcoming guidance to be published by tPR), it is highly likely that the new regime would lead to significant additional costs for TfL if the Scheme were to close. There would also always remain the risk that tPR required the Scheme to be funded more prudently than the Trustee and TfL agreed.

7.32. It would be the expectation, therefore, that the impact of closure of the Scheme future accrual and new entrants would lead to an immediate increase in the deficit and hence contributions required, reflecting both some immediate de-risking and further de-risking over time to a low-risk position. For illustration, this could result in a deficit of around £6bn (as at 31 March 2021), which could require additional contributions (compared to today) of over £1bn p.a. over 6 years (the maximum length of time tPR currently expects a scheme with a strong employer to remedy its deficit, albeit this may change in the new funding regime) or up to around an additional £700m p.a. over 10 years (the maximum recovery period permitted under the Scheme rules). The additional contributions would therefore be expected to more than offset any potential savings that may be possible from the potential reform of future service, for at least the medium term.

7.33. In the case where a new arrangement was provided for new entrants only, and existing members continued to accrue benefits in accordance with the existing benefit structure in the Scheme, then the implications for past service would materialise in a similar way to that set out above. This is because closing the Scheme to new entrants still crystallises an end point by which all benefits expect to be paid, albeit the impact would be less severe.

7.34. The key difference is that because existing members would continue to accrue benefits in the Scheme, the Scheme would mature at a slower rate. It may therefore be reasonable to assume that any de-risking of the investment strategy would be carried out at a slower rate, although noting that TfL would still be required to comply with the new funding regime for private sector schemes. For illustration, it might be assumed that no immediate de-risking would be carried out, but that de-risking would be carried out gradually to target a low-risk investment strategy in around 20 years. It is estimated that this could lead to an immediate deficit materialising of up to around £3bn, which could require additional contributions (compared to today) of up to £550m p.a. over 6 years or £350m over 10 years.

7.35. In addition, if the Scheme were closed to new entrants, contributions towards future accrual for existing members would still be required to be made to the Scheme and the contribution rate required, as a percentage of salary, would be expected to increase as a consequence of allowance for future de-risking. It is estimated that this could increase by around 20 per cent of salary, resulting in further additional contributions of around £240m per annum based on the current salary roll (although we note that the salary roll would fall over time as members left/retired from the Scheme and were not replaced by new entrants). The potential additional contributions would be expected to more than offset any potential savings that may be possible from the potential reform of future service for new entrants, for at least the medium term.

7.36. Therefore, the significant additional contributions that would be required for past service would not be consistent with ensuring a financially sustainable pensions arrangement, or a financially sustainable TfL, going forwards. Therefore, as the Final Report made very clear, it is vital that past service liabilities need to be considered at the same time as future service reform; otherwise, additional funding from the Government would be required to meet any increased costs that could arise as a result absent any other intervention.

7.37. As with any funded DB scheme where pensions benefits members receive are pre-determined, notwithstanding any future service reform that may be considered, there is also the inherent risk that in the future that the costs to TfL of managing past service may increase in any event. While the Scheme is currently over 100 per cent funded, as referred to above, there is a 1 in 20 risk that a deficit of over £4bn could arise at the next actuarial valuation in 2024. Therefore, if the aim is for the Scheme to be placed in a sustainable position going forwards, the primary focus should be on ensuring that risks in relation to past service are addressed - with or without future service reform.

7.38. The Final Report highlights that there are very few affordable or practical options that may be considered in relation to the management of past service liabilities. These all require the Government's support. These options are essentially limited to those already outlined - transferring past service assets and liabilities to either new or existing public sector arrangement or the provision of a Crown Guarantee by the Government.

7.39. Given the issues around the restrictive Scheme rules and implications of reform for the management of past service assets and liabilities, the consideration of pensions reform is an area where the Government will need to work collaboratively with TfL to determine how these matters might be addressed. For the avoidance of doubt, it is TfL’s view that no substantive reform is possible without the Government's support.

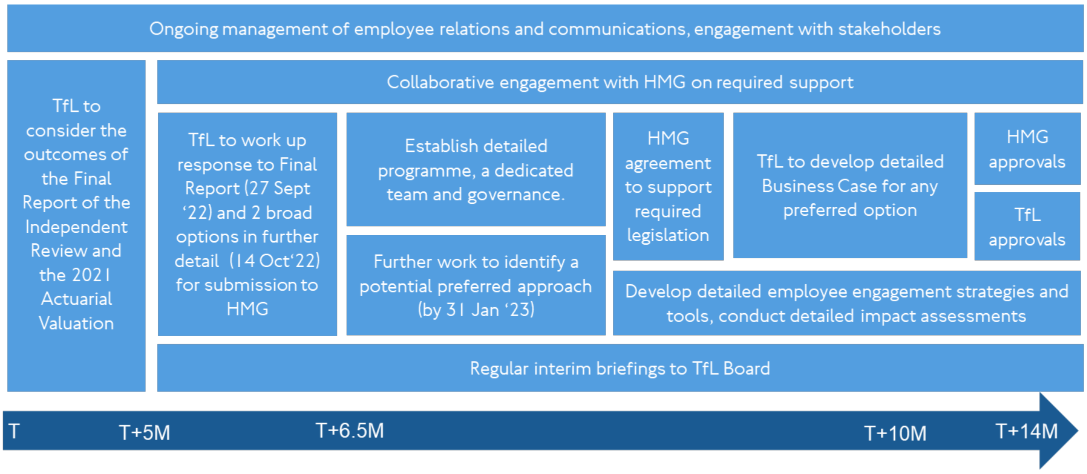
8. TfL Workplan

8.1. TfL has developed a timetable which summarises the steps necessary to get to a decision point in relation to any pensions reform. This timeline begins 1 April 2022 and its stages are based on the requirements the Government has now specified in the Funding Agreement. The timeline that the Government has set is highly challenging and there are risks to its deliverability. This includes the risks around the very limited time that the Government has made available for TfL to prepare for any required consultation with active and prospective members (and their representatives) as well as other stakeholders, which is likely to be extensive. In practice, this may take longer. This timetable is illustrated in Figure 1 below.

8.2. This phase would need to cover the detailed work required in order to meet the Government’s requirements to submit two broad options in further detail on 14 October 2022 and further work to develop any final detailed proposal for 31 January 2023. This will include preparatory work that would be required for an extensive communication and briefing process for employees, the preparation of a robust business case for change (if change is ultimately proposed) and detailed individual impact assessments, along with a detailed engagement with the Government in relation to support required to effect any change, engagement with the Trustee and tPR and obtaining relevant approvals in principle. In practice, some of these activities may run concurrently.

8.3. The consideration of any reform to the current pension benefits from an employee relations perspective should not be underestimated and will require considerable stakeholder engagement. There is significant risk of disruption to our network. TfL will require Government support for any impacts such action may have on costs and revenue including beyond the expiry of the Funding Agreement, if applicable.

Figure 1: Indicative Preparatory Phase Timetable



8.4. Further details of the activities in this workplan can be found in Table 1.

Table 1: Workplan Activities

Workplan Element	**Activities**
Resources	The establishment of a dedicated internal team with a dedicated Executive Committee Sponsor and representation from finance, legal, HR, employee relations, employee communications and programme/project management resources. This may require new roles being recruited. The procurement of expert delivery partner support (as appropriate) The provision of external advice from actuaries and legal advisers The procurement of systems tools that will enable further detailed impact assessments
Detailed Business Case/Option development	The development of a detailed, robust business case, including: - Further detailed design work in relation to potential Scheme design principles for future service - Further detailed work on options for the management of past service assets and liabilities - Further detailed consideration of delivery routes for any potential reform and their implications and consideration of how future service benefits will be provided (for example, through the existing scheme, an existing public sector scheme or a new arrangement) - Development of how any options under consideration would accommodate Protected Persons

	- Further actuarial modelling of any detailed design options – including in relation to savings, risk and impacts on members benefits - Actuarial and economic modelling to look at the distributional impacts of any options under consideration and "whole of public sector" impacts of any pensions changes - Further specification of Government support requirements - Consideration of future Scheme governance arrangements - Consideration of any administrative implications, such as payroll arrangements, accounting policies and systems and so on - Consideration of policy matters (set out further below)
Policy	Consideration of potential associated amendments to wider remuneration policies to mitigate impacts on recruitment and retention and the competitiveness of TfL's remuneration offering, including the potential development of transitional arrangements Consideration of any potential amendments to TfL's policy regarding auto-enrolment arrangements and provision for additional voluntary contributions Consideration of any wider implications for TfL's Business Planning process
Employees, Communications and Engagement	Significant communications activities and the establishment of education programmes/engagement events/media for members of the Scheme Potential further "Call for evidence" exercises on specific options under consideration Undertaking engagement with relevant stakeholders, including the Trade Unions, the Trustee and tPR Resource allocation and operational planning for any industrial relations risks The development of a plan for any required consultation, if relevant, and all necessary associated preparatory activities including where appropriate personalised individual statements.

	Extensive review of policies and individual contracts of employment regarding pensions provision and matters relating to the implied mutual duty of trust and confidence The provision, where necessary, of the ability for employees to receive independent financial advice Detailed Equality Impact Assessments
Governance	The establishment of a dedicated TfL programme including Executive Sponsorship arrangements, relevant reporting, meeting structure and governance/decision making arrangements. The establishment of an appropriate and robust budget for the programme and any relevant financial and procurement authorities The establishment of (or utilisation of existing) engagement forums with relevant stakeholders, including meeting schedules and development of specific terms of reference for engagement (as required). Obtaining Government commitment to provide required support (for example, legislative support) TfL approvals, as relevant. Any Scheme specific approvals/agreements required with the Trustee.

8.5. A more detailed implementation plan thereafter for any further phases would be necessarily specific to any proposals that may ultimately be made. The implementation and delivery phase would need to cover:

- detailed implementation steps for any required consultation with active and prospective members and their representatives including the Trade Unions
- the ongoing management of industrial relations, including resource allocation and operational planning for any industrial relations risk
- the finalisation of any agreements and approvals between TfL, the Government and the Trustee (including any processes required under the Scheme rules)
- the enactment of any necessary legislation
- the process of creating a new scheme or a new section of the Scheme (if relevant)
- the bulk transfer of the assets and liabilities (if relevant)
- obtaining consent from "protected persons" (as defined under Schedule 32 of the Greater London Authority Act) to the extent required

- the finalisation of any required documentation, systems and administrative changes
- remuneration policy changes
- final TfL approvals, and
- detailed confirmatory communications to affected members.

8.6. Potential reforms, subject to their precise nature and the route for delivery, are expected to take a minimum of 2-3 years to deliver, and in reality, are likely to take longer. The implementation and delivery phase will be heavily influenced by the speed at which the Government can agree to and enact required legislative support. The preparatory timetable that the Government has specified in the Funding Agreement is significantly shorter than has been the case for other reforms, such as the time it took the Government to introduce its pension reforms in 2015 following the publication of the Independent Public Service Pensions Commission report in March 2011 and the time it has taken the Royal Mail, for example, to develop, consult and achieve enactment by the Government of legislative change for their proposed reforms for a CMP arrangement.

8.7. Funding would need to be sought in order to develop and deliver any potential reform as TfL currently has no budget provision for this. A high-level estimate of these implementation costs could be in the order of £150m over a 2–3-year period, excluding the cost to TfL of the substance of any transitional arrangements, industrial action and any costs that the Government may incur in order to deliver necessary legislative changes. TfL would also ultimately need to pay any costs that the Trustee may incur as part of this process.

8.8. As stated at the start of this paper, and for the avoidance of doubt, **the options referred to in this paper are not proposals for reform**. A “do nothing” option remains and the implementation of anything else will remain subject to further detailed work, the availability of appropriate legislation, relevant consultation with members (and their representatives) and TfL’s decision-making processes.

Appendix 1: Restrictions on Amendment Power

The power to amend the Scheme rules lies with the Trustee, with confirmation from TfL (in its capacity as the Scheme's principal employer). However, there are particular restrictions on the use of that power which mean that in virtually all cases, the Government's support will be necessary in order to legislate for a specific statutory power allowing TfL to circumvent the restrictions under the Scheme amendment power.

In particular, the restrictions are that:

Rule 44(1)(b) - an amendment to either the contribution rate or benefits may only be made with the confirmation of the Scheme Actuary (which in practice is a requirement for consent); and

Rule 44(1)(c) - if any amendment to the benefits payable or prospectively payable to any person are adversely affected, such amendment may only be made by a resolution of members at a general meeting convened for that purpose.

In relation to the restriction at Rule 44(1)(b), the Scheme Actuary effectively has a veto in respect of contribution or benefit changes but, in TfL's view, the Scheme Actuary should only take into account funding (not benefit) matters when exercising that power.

In relation to the restriction in Rule 44(1)(c), this restriction applies to future service benefits and so fetters the ability of the Trustee and TfL to make an amendment which would adversely affect future service benefits under the Scheme unless a majority of members approved the amendment at a general meeting.

Accordingly, in order to make an amendment having an adverse impact on future service benefits under the Scheme, all members would need to be invited to a general meeting with a majority voting in favour of the amendment. Even if an amendment only affects active or prospective members, the vote must include deferred members and pensioners as well.

In practice, this will be near impossible. The Scheme rules provide for the conduct of general meetings. They provide that notice must be given to all members, and so, whilst not express, it is clear that the Scheme rules envisage that there must be a single meeting to which all members are invited to attend (even if they choose not to do so). Accordingly, it would require a suitable venue to be found for such a meeting (holding up to ~85,000 people). In our view, all members would need to be given the opportunity to attend (thus shutting down TfL for the period of the meeting and either side of it).

In the context of this workforce and their membership of the Scheme, even though proxy voting is permissible under the Scheme rules, it is for each member to determine whether they wish to appoint a proxy, and so, in practice, proxy voting is unlikely to be a solution. Indeed, the Scheme rules provide that a member may appoint proxies up to 48 hours before the general meeting and so TfL would have no certainty as to how many members would attend in person until that time.

Accordingly, the provision at Rule 44(1)(c) acts as an effective legal and practical fetter on the ability of TfL to use the Scheme amendment power to change future service benefits in a manner adverse to active and prospective members.

It is not possible to remove the restrictions in the Scheme amendment power. It is a general principle of trust law that an amendment power cannot be amended to allow for a subsequent amendment to other provisions in the relevant scheme rules which could not have been made had the amendment power not itself been amended.