1. Recent History of Pension Protection

The interaction between under-funded Defined Benefit pension schemes and company insolvencies has been a live one for the last twenty years or more. In the 1990s and early 2000s a number of companies became insolvent with pension fund deficits. The workers affected lost not only their jobs but part of their pensions as there was no insurance arrangement to help make up the shortfall in the pension.

There was considerable political pressure to address this situation and as a result the Pension Protection Fund was created and started operating in 2005 with funding coming from employer levies and from taking over the assets of wound-up DB pension schemes. In addition, a taxpayer-funded Financial Assistance Scheme was created to provide compensation in cases where insolvency happened post 1997 but before the creation of the PPF.

The good news is that the PPF weathered the 2008 financial crash and is in a relatively strong position to bear the impact of a large pension fund with a big deficit coming into the scheme. On current plans, the PPF is aiming to become self-sufficient by 2030, no longer needing a levy on employers but covering its liabilities through the investment returns on the assets it holds. Within a few years, the PPF will in effect be one of the largest occupational pension schemes in the land, though technically what it pays out are compensation payments rather than pensions.

2. The role of employers

During the 2010-2015 Parliament there was considerable pressure on Government to reduce the pressure on sponsoring employers to tackle their pension fund deficits. A combination of improving longevity and historically low interest rates meant that measured pension fund deficits were soaring. Employers were being asked not only to make contributions to meet the new liabilities that they were accruing but also to make ‘deficit recovery contributions’. It was argued that this was damaging to the viability of the sponsoring employers and it was also argued that this was unnecessary because ‘everyone knew’ that the current low interest rates were an aberration – higher interest rates would come soon and the huge deficits would melt away.

Whilst the Government resisted calls to make arbitrary adjustments to the way in which deficits were measured, it did make a change to the remit of the Pensions Regulator (tPR). TPR has a number of statutory objectives, including protecting the Pension Protection Fund, but it was given an additional duty in agreeing recovery plans for deficits to ‘..have regard to the sustainable growth of the sponsoring employer’. In simple terms, the Regulator was asked not to force employers to put so much money into their pension scheme that it would jeopardise the long-term prospects of the business.

It is important to bear in mind that tPR adopts a scheme-specific approach to tackling deficits. If it thinks that a firm has surplus cash and could easily deal with its pension fund deficit it will expect trustees and the employer to agree a relatively swift process of dealing with the deficit. But it can also allow a much longer period to recover the deficit if it thinks that this strikes the right balance between getting the deficit covered eventually and keeping
the sponsoring employer in business. It is reported that in the case of BHS a 23 year
recovery period was agreed. If true, this is an exceptionally long period and well out of line
with the norm.

It is also worth bearing in mind that schemes and their employers have in recent years been
‘running to stand still’. Because interest rates have continued to fall and longevity has
continued to improve, underlying deficits have tended to deteriorate. So even an employer
who agreed a recovery plan and sticks to it can find that at the next three-yearly revaluation
the deficit has gone up rather than down.

Analysis of all the remaining DB schemes suggests that there may be many hundreds of
‘zombie’ schemes. These are schemes where there is no realistic chance of the pensions
promises being met. They will generally have large deficits, long recovery plans and a weak
sponsoring employer. These schemes are generally ‘drifting’ towards the PPF but unless an
insolvency event occurs, they continue to limp along from year to year. The employer may
be meeting his annual payments, but the deficit can often be going up rather than down for
the reasons discussed earlier.

3. What to do about past promises

The fundamental problem with DB scheme deficits is that in general they relate to historic
periods of service. The vast majority of DB schemes are closed to new members and most
are closed to new accruals by existing members. But the cost of those past promises
continues to rise as people live longer and as discount rates for future liabilities fall. Because
past pension promises are surrounded by strict legislation, there is little that firms can do.
Whereas in some countries it would be possible to scale back pension promises – for example
by reducing inflation protection when money is tight in the fund, or even cutting pensions in
payment – in the UK these promises are regarded as an inalienable property right for as long
as the pension scheme is in operation.

Where the sponsoring employer becomes insolvent and an under-funded scheme enters the
PPF, the compensation that is payable does not wholly match the pension that would
otherwise have been paid. The basic level of compensation is 100% for those above scheme
pension age when the insolvency occurred but only 90% for those under pension age. In
addition, inflation protection (capped at 2.5%) is only available in respect of service since
1997, regardless of the rules of the scheme. There is also a cap on the largest payouts in
respect of those who were under pension age when the insolvency occurred. The 2014
Pensions Act provides primary powers for that cap to be scaled up for long-serving workers,
but those provisions have not yet been enacted.

4. Trade-offs

At the heart of this issue is the competing concerns of the different parties – people receiving
pensions from the scheme, people who will receive pensions in future, the sponsoring
employer, and the employees/shareholders/customers of the sponsoring employer.

The present regulatory regime regards past pension promises as sacrosanct. Even if making
good the shortfall means present employees getting no pay rises, customers paying higher
prices and shareholders getting lower dividends, businesses are expected to meet their deficit
reduction contributions – legally, the rights of present and future pensioners are absolute. As
noted above, the regulator can ‘ease off’ and give firms more time to pay, but only if it judges that this will ultimately put the employer in a stronger position to meet its liabilities.

Because past pension promises are sacrosanct, struggling firms with large deficits can find themselves in an impossible position. There might be an option for the business to be restructured or sold, but potential purchasers are put off by the fact that they would also be taking on the pension fund deficit, as appears to have been the case with potential purchasers of Tata Steel UK. This could lead to a situation where present-day workers lose jobs which could otherwise have been saved.

On occasion, the regulator will allow a firm to become insolvent, put the pension fund into the PPF and then effectively start operating again without the burden of the pension fund. But this would only be allowed if it was thought that it was inevitable that the scheme would end up in the PPF in any case, and in order to ‘make the best of a bad job’. But there are obviously huge ‘moral hazard’ issues here, and the Regulator is very keen to ensure that hundreds of employers with ‘zombie’ schemes do not simply dump their liabilities and walk away.

5. Solutions?

Solutions are few and far between. When there are expensive past promises which have to be met and insufficient assets to meet them, there are no easy answers. In particular, younger current employees may well resent the fact that not only do they not have access to high quality DB pensions for themselves but that they are, in effect, meeting the cost of generous pension promises to previous generations.

a) Option 1 – do nothing

There are no particularly palatable options and simply allowing the situation to drift on is an option – perhaps in the hope that a mixture of higher interest rates and higher inflation will ride to the rescue. But there is a danger that if the situation is allowed to drift then deficits will get worse and more under-funded schemes will end up in the PPF, reducing member benefits and increasing levy costs on remaining employers.

b) Option 2- water down pension promises – with member agreement

For workers who have DB pension rights but have not yet reached scheme pension age, the prospect of ending up in the PPF is not a good one, with a cut of at least 10% in their pension rights. One idea is that scheme members could be offered the chance to vote for their pension rights to be weakened (perhaps made conditional on the economic situation) if it was thought that this would do enough to keep the scheme out of the PPF in the event of an insolvency. However, as noted above, it is unlikely that those over pension age would be willing to sign up to this because their PPF compensation is relatively comprehensive. It would probably also need legislative change to make this possible.

c) Option 3 – water down pension promises – statutory action

If large pension fund deficits were leading directly to more insolvencies or were preventing firms from being sold or restructured then government might decide that enabling people to keep their jobs was more important than ensuring that full pension promises were kept. In
theory, government could legislate to weaken the duties on schemes to meet full pension promises, thereby reducing deficits. This would, of course, be hugely controversial and would involve repeal of aspects of the 1995 Pension Act. It would also be likely to be challenged as a potential breach of Article 1, Protocol 1 of the European Convention on Human Rights because of its impact on the property rights of present and future pensioners. But a government might consider this option as a way of ‘sharing the pain’ more evenly if the impact of DB deficits were seen to be damaging to jobs.

d) Option 4- ensure regulatory regime is effective

Cases like BHS certainly raise questions about the different elements in the existing regulatory regime and the role of trustees, professional advisers, employers and regulators. For example, it is vital that the Regulator is seen to be vigorous in ensuring that sponsoring employers do not ‘dump’ pension fund deficits, otherwise a very dangerous precedent would be set. Questions also need to be asked about why an exceptionally long recovery period was allowed and whether the BHS Trustees were well advised. Whilst changes to the regulatory regime will not deal with the fundamental problem that the value of pension promises exceeds the assets set aside to pay for them, it is possible that they could prevent the situation from getting worse.

e) Option 5 – take pro-active action on Zombie schemes

A concern about ‘zombie’ schemes where there is no realistic prospect of pension promises being met is that if nothing is done the situation could get worse. One scenario is that trustees judge that their only chance of dealing with the deficit is to go for high-risk but potentially high-return investments (akin to ‘betting the fund on the 3.30 at Haydock’). Whilst this might have a small chance of success, the downside risk is that the deficit could balloon, making the eventual hit on the PPF that much greater.

Whilst forcing an apparently solvent employer to wind up their pension scheme would be controversial, it may be that this would be less damaging than allowing the deficit to balloon.

Conclusions

None of the ‘solutions’ listed above deals with the fundamental point that there are insufficient assets put aside to meet the promises that have been made. For as long as the past promises are sacrosanct, all options are ‘making the best of a bad job’. But there may be ‘least worst’ options, and certainly ensuring that the regulatory regime is working as intended is essential.

Steve Webb, Minister for Pensions, 2010-2015, in a personal capacity.

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