INTRODUCTION

1. The Government is committed to ensuring that people have a secure retirement. Recent attention has rightly focused on widening pension saving through auto-enrolment and ensuring savings are in good quality schemes. But equally important to the Government is maintaining and where necessary strengthening the legislation already in place which seeks to protect members of existing defined benefit occupational pension schemes while at the same time not inhibiting corporate activity.

2. There is a comprehensive pension protection system in place. Because of the Committee’s focus, this evidence concentrates on two elements:

   a. the Pension Regulator (TPR) which protects the benefits of members of occupational pension schemes, including defined benefit schemes. Additionally it has an objective to protect the PPF; and

   b. the Pension Protection Fund (PPF) which offers compensation to members of eligible schemes where an employer gets into financial difficulties and is no longer able to meet its pension commitments.

3. The Government works to ensure that the pensions protection system remains fit for purpose and equal to emerging challenges. It is for this reason that a core element of the new Pensions Bill will be the provision of essential protections for people in Master Trusts. This legislation will potentially benefit millions of automatically enrolled users.

**Defined Benefit pension schemes**

4. Defined benefit occupational pension schemes are set up under trust. This means the scheme is run by a group of trustees who hold the assets of the pension scheme on trust and have a fiduciary duty to protect scheme members’ collective interests. They are, therefore, the first line of defence for scheme members.

5. Because defined benefit schemes promise a specific level of benefit, they require an ultimate guarantor, in order to ensure the scheme can pay the promised pensions over time. This guarantor is normally the sponsoring employer. Most employers take their responsibility seriously and do support their pension schemes.

6. Additionally, because they promise a specific level of benefits, defined benefit occupational pension schemes are particularly at risk from increases in longevity, inflation and asset performance.

**Scheme funding**
7. There is a statutory funding objective for a scheme to have sufficient assets to meet its liabilities as they fall due. The legislative framework allows for flexibility in how trustees and the employers reach agreement on meeting this requirement. The framework does not require that schemes are funded to a point whereby full benefits could be secured with an insurance company (buy out levels). This means there will, inevitably, be situations where the sponsoring employer becomes insolvent, there are insufficient assets in the scheme to buy out all the benefits and the employer cannot make up the shortfall. This is especially the position in the current interest rate environment, where the costs of annuitisation have increased significantly.

The Pensions Regulator

8. The Pensions Regulator (TPR) was established under the Pensions Act 2004 to regulate workplace pensions. It was intended that TPR would take a risk based, proactive approach and it was given a wide range of powers and responsibilities. Its current objectives are to:

- protect the benefits of members of occupational pension schemes.
- protect the benefits of members of personal pension schemes (where there is a direct payment arrangement on behalf of the employer).
- promote, and to improve understanding of the good administration of work-based pension schemes.
- reduce the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund (PPF).
- maximise employer compliance with employer duties and the employment safeguards in relation to automatic enrolment introduced by the Pensions Act 2008.
- minimise any adverse impact on the sustainable growth of an employer (in relation to the exercise of the Regulator’s functions under Part 3 of the Pensions Act 2004 only; those powers relating to scheme funding).

The Pension Protection Fund

9. The PPF is an independent public corporation established under the Pensions Act 2004. It protects members of eligible defined benefit occupational pension schemes (and the defined benefit element of hybrid schemes) by paying compensation where:
   - an employer has a qualifying insolvency event after 5 April 2005;
   - there is no scheme rescue; and
   - there are insufficient assets in the scheme to buy out benefits at PPF compensation levels.

10. The PPF is funded by means of a pension protection levy charged to all eligible schemes (partly based on the risk of the scheme entering the PPF) plus any assets remaining in schemes which transfer to the PPF, any recoveries from the employer and ongoing investment returns.

11. The PPF pays compensation at 100 per cent of the pension in payment if the member was above the scheme pension age at the insolvency event and 90 per cent
(subject to a maximum cap) if the member was under scheme pension age at this date. The PPF operate standardised rules regarding matters like revaluation and indexation.

12. During the passage of what became the 2004 Pensions Act, it was recognised that the PPF would create ‘moral hazard’: i.e. that unscrupulous employers might seek to side-step their responsibilities to a scheme and off-load it onto the PPF. This is why TPR has a specific objective to protect the PPF.

SPECIFIC ISSUES RAISED BY THE COMMITTEE

The adequacy of defined benefit pension scheme regulation and regulatory powers, in general and specifically in relation to the pension schemes of complex and multi-national companies

13. All defined benefit pension schemes are set up under trust (with the exception of those set up under statute). This approach is a long-established one and has, in general, worked effectively for many years. Trustees are responsible for overseeing the day to day funding of the scheme and negotiate funding plans with the employer. They are expected to protect their members’ interests and can approach TPR for assistance where they have concerns over the scheme. TPR has powers to remove and replace trustees with an independent trustee (or supplement the existing trustee board with an independent trustee) should it have concerns in respect of the existing trustees’ capability or behaviour.

14. Valuations establishing a pension scheme’s funding position are undertaken and must happen at least every three years. Where the pension scheme is in deficit, trustees are required to negotiate and agree a deficit recovery plan with the sponsoring employer, which is submitted to TPR, which will consider whether it is necessary to intervene. Trustees are required to notify TPR of certain scheme-related significant events. Employers are required to notify TPR of events that have implications for the covenant for the pension scheme. For example, where the employer is a company, the employer must notify TPR if a controlling company gives up control of the employer company. It is also a notifiable event if the employer decides to cease business in the UK. Trustees should ideally notify TPR if they have any concerns around the implications of a sale or restructuring on the pension scheme – but this is not currently a statutory requirement. There is, however, a requirement on employers to notify TPR of any decision to take action which will, or is intended to, result in a debt which is, or may become, due to the scheme not being paid in full.

15. The Department expects employers to take their pension deficit seriously. If they wish to sell their business when the scheme has a significant deficit, the Department expects the employer to ensure the scheme can be properly supported and, where appropriate, use the established clearance process before a sale, to avoid future problems.
16. When a scheme is wound up by the employer the cost of providing the money needed to buy annuities to cover all accrued benefits ("the section 75 debt") falls on the person who counts as the employer for the purposes of the pension scheme.

17. Whilst a company continues to support its pension scheme the company structure is largely irrelevant. The sponsoring company will be considered a separate entity in relation to both the PPF levy and TPR. For example, a weak company inside a very strong multi-national will pay a levy based on its own situation, not the parent company.

18. It would be possible for a group to ensure that, before a scheme was wound up or the sponsoring employer became insolvent (and a section 75 debt was triggered) the company that was the legal sponsoring employer is put in a position in which it could not afford to pay the debt. Even if the rest of the company group was fully solvent, the trustees would not be able to recover the debt from any other companies in the group (assuming no guarantees were in place) and the scheme members would be left in what might be a very badly funded scheme. This particular risk largely relates to schemes in which a number of companies, often with a group structure, participate and pool their liabilities together in a multi-employer scheme, but it could also affect single employer schemes.

19. The actions taken by company groups might include withdrawing funding for the employer company, selling off its assets, paying a large dividend to strip out any assets in the company or transferring the employees to another company, such as a service company, which would then become the employer and which would never had traded, or have had any assets to speak of.

20. To deal with this sort of behaviour, TPR has what are known as anti-avoidance powers. These are:

   Contribution notices requiring a specified amount to be paid into the pension scheme by an individual or company where TPR has concluded there is a deliberate attempt to avoid a statutory debt either to the scheme or to the Board of the PPF or an act or deliberate failure to act has detrimentally affected in a material way the likelihood of the accrued scheme benefits being received; and

   Financial support directions where TPR can require support to be given by another employer, company or individual to an underfunded scheme if it has decided that the sponsoring employer is a service company or is insufficiently resourced; and there is a sufficiently resourced connected or associated party to support a final salary pension scheme within the group.

21. TPR operates a voluntary clearance procedure in relation to its anti-avoidance powers. This allows parties involved in corporate transactions and other events that could impact upon a pension scheme to seek assurance from the Regulator that it will not use its anti-avoidance powers in relation to the event as described in the clearance application.

22. TPR is an independent body sponsored by DWP. As part of this sponsorship, there are regular meetings with TPR at both official and Ministerial levels to discuss and
monitor performance. These meetings also provide a forum for TPR to raise any concerns it may have, such as TPR funding and for general discussion about any perceived limitations in its powers.

Use of these powers by The Pensions Regulator in recent cases, including BHS

23. Parliament has given TPR operational independence from the Government. It would not, therefore, be appropriate for the Government to comment on TPR’s use of the powers it has been given by Parliament, or to interfere in its investigations.

24. On a factual level, the existence of TPR’s anti-avoidance powers (which were strengthened in 2008) has generally acted as a deterrent and has enabled trustees and TPR to encourage better outcomes for schemes and members without actually invoking those powers. Recent cases investigated by the Regulator include the collapse of Lehman Brothers, where it successfully took the case all the way to the Supreme Court and secured £184m to secure the pensions of 2,500 scheme members. A complex investigation into the Carrington Wire Defined Benefit Pension Scheme resulted in a £8.5m settlement with two Russian companies.

Resourcing and prioritisation of TPR supervisory work

25. It is for TPR to decide what priority to give to individual strands of work and the Government does not interfere with this exercise of its functions. TPR’s regulatory approach is to educate and enable pension scheme trustees, so they can fulfil their responsibilities under the law and apply good practice in governance and administration. TPR will take enforcement action if it judges that education and enablement will not be sufficient to mitigate the risks to good member outcomes.

26. The activities described above are dependent on an appropriate level of resourcing. TPR is reducing its back office resources in order to protect the front line and, in turn, preserve and enhance its regulatory reach and impact.

27. TPR’s regulatory budget for the period 2016/17-2019/20 is in the table. The expected outturn for 2015/16 is included for comparative purposes. The increase in resourcing in 2016/17 and 2017/18 reflects planned increases in staff numbers to undertake new regulatory duties. The requirement for additional resources to carry out these duties is expected to reduce in 2018/19 and 2019/20, when TPR reduce its “back office” staff.

Table: TPR regulatory budget (excluding AE duties) - 2015/16-2019/20 – in £ millions

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<tr>
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<td>36.61</td>
<td>37.85</td>
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(1) Resources for 2017/18 and subsequent years are indicative and may be subject to change.
(2) TPR’s core regulatory expenditure is recoverable through the General Levy on pensions schemes.
(3) Core regulatory expenditure does not include expenditure on the Automatic Enrolment (AE) compliance regime which is operated by TPR. AE expenditure is not recoverable from pensions schemes.

Implications of the regulatory approach for company behaviour, including whether it mitigates or incentivises moral hazard

28. The existence of the anti-avoidance powers, in particular, has acted as a powerful deterrent allowing TPR to facilitate and work closely with trustees and employers to ensure an appropriate outcome for schemes and their members. The powers have also supported trustees, allowing them to better protect members’ interests in circumstances where an employer may not have considered the impact on the scheme.

29. However there may be situations where companies attempt to avoid their liabilities through restructuring deals or other means and TPR has to use its moral hazard powers “after the event” in order to seek appropriate mitigation for these actions.

The sustainability of the Pension Protection Fund

30. Even in the current climate the PPF remains robust and well-equipped to meet the challenges that exist. It has been protecting pension scheme members’ futures for over 10 years. The PPF is in a strong position: according to its last published accounts it has over £23bn of assets under management and £3.6bn in reserves. As of March 2015, the PPF was 115 per cent funded.

31. The Board publishes the PPF7800 index on a monthly basis to illustrate the amount of risk in the system due to scheme deficits. It estimates the funding level of all schemes assuming PPF-level benefits. At the end of April 2016, in relation to the 5,945 schemes in the Index::

- The aggregate deficit was estimated to be £270.2 billion.
- The funding ratio was 82.6 per cent.
- Total assets were £1,280.0 billion and total liabilities were £1,550.2 billion.
- 4,804 schemes were in deficit and 1,141 schemes in surplus.

Key risks to PPF resilience

32. Some of the key risks to the future of the PPF include:

- The extent to which pension schemes are underfunded;
- The impact of insolvencies – the number of insolvencies and the size of related scheme deficits; and
33. This demonstrates the importance of TPR’s role in ensuring that employers fund their schemes properly, and do not seek to avoid obligations. In addition, the Pensions Act 2004 is designed to enable the PPF to manage its liabilities sustainably. The Board:

- can increase the levy (subject to statutory controls); or
- could recommend to the Secretary of State that he makes an order to reduce the amount of compensation paid.

34. Whilst the PPF is an independent body, the Chief Executive of the PPF meets with the Minister for Pensions on a regular basis. This enables the Chief Executive to raise any issues that may concern him directly with the Minister. Legislation also requires the PPF to send the Secretary of State an annual report covering the PPF’s strategic direction and how this is kept under review. The Secretary of State lays this report before Parliament each year.

The fairness of the PPF levy system and its impact on businesses and scheme members

35. Legislation requires at least 80 per cent of the pension protection levy to be collected through a risk-based levy, which takes account of the risk of a scheme’s sponsoring employer becoming insolvent. The risk-based levy is only charged to schemes that are underfunded (based upon adjusted s.179 valuation information). Up to 20 per cent can be collected through a scheme-based levy. This levy is calculated using scheme liabilities and is payable by all eligible schemes. Legislation also places a cap on the highest amount the Board can charge (the levy ceiling) and the maximum year on year increase in the estimate.

36. The pension protection levy is charged annually; the levy year runs from 1 April to 31 March. The Board decides the total amount of levy it wishes to raise using the PPF’s Long Term Risk Model to estimate the amount of risk the PPF faces over the long term. Before the levy year begins, the Board is required by law to consult if any of the levy factors or levy rates differs from the previous year’s levy, and to publish an estimate of how much the rules collect. As well as annual consultations the PPF has additionally consulted prior to the two levy trienniums (which aim to provide stability of structure for the rules over a three year period). The biggest part of the consultation on the second triennium (covering the levy years 2015/16 to 2017/18) concerned the move of its insolvency risk provider to Experian.

37. In 2016/17 the Board’s levy estimate is £615 million, a reduction on the 2015/16 levy estimate which was £635 million.

38. Individual risk-based levy calculations start by establishing whether there is any scheme underfunding. If it exists, the amount of underfunding is multiplied by the insolvency risk (which for a single employer scheme is one of the ten levy rates based upon the insolvency risk score calculated by Experian using the PPF-specific...
39. The corporate structure that a sponsoring employer exists within can affect the calculation of the pension protection levy in the following ways. The Experian model which provides insolvency risk scores for the PPF categorises employers into one of eight scorecards. Different scorecards exist for independent and group companies and the group scorecards covering subsidiary companies includes a variable which reflects parental strength (using financial information for the group’s ultimate parent company). In addition if other group entities provide a guarantee to the pension scheme trustees (which would be triggered by the insolvency of the scheme employer) that is certified and accepted by the PPF, the insolvency risk of the guarantor can be used instead of the employer’s where this would reduce the levy.

40. Schemes can achieve a reduction in the levy charged to them if they can evidence improvements in the funding position of the scheme, for example by certifying Deficit-Reduction Contributions, or where secured guarantees are accepted by the PPF. Additionally where an unsecured guarantee provided by an associated company, is accepted by the PPF as genuinely reducing the risk in the scheme, this can reduce the levy, as the assessment of the guarantor’s risk of insolvency (if lower) will be taken into account.

41. Scheme trustees, employers, guarantors and duly authorised representatives are entitled to challenge their levy bill in certain circumstances. Details of how to appeal are provided on the PPF website.

42. The Board of the PPF is responsible for setting the levy and therefore the Government cannot comment on whether it is fair or not.

Long term funding strategy

43. The Board of the Pension Protection Fund has an objective that the PPF should be self-sufficient by its funding horizon, currently set as 2030. The Board aims to be self-sufficient by this time so that the fund will no longer be dependent on levy revenue to cover any deficit which may emerge post-2030 (although levy will still be collected where appropriate). This is because by this point in time the levy-paying DB universe is expected to be small and low risk, and collectable levy will be low relative to the size of the PPF.

44. Self-sufficiency is defined as being sufficiently well funded such that there is a 90 per cent probability that full compensation can be paid to all members. This equates to holding a ten per cent funding margin to protect against longevity risk, operational risk, the risk that CPI-linked liabilities have to be hedged using RPI-linked assets, and the risk of claims in excess of the levy. The PPF’s current goal is to be 110 per cent funded in 2030. The strategy was developed in consultation with actuaries, levy-payers and academics and reflected the recommendations of the National Audit Office value for money report (5 February 2010).

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1 At the start of each triennium this scaling factor is set by reference to the Board’s long term risk. The factor is then kept constant for the remaining two years, unless this would result in an estimate that would be outside an acceptable range e.g. would breach legislative requirements.
45. The PPF Board reviews the funding strategy on an annual basis. The most recent update to the strategy was published in July 2015. An updated strategy has been published alongside the PPF Annual Report and Accounts annually since 2012. At 31 March 2015 the PPF estimated the probability of achieving this target was 88 per cent.

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