Written evidence from Allan Martin (PPF0032)

Background

I write as a professional independent trustee. I look after a dozen private sector pension schemes with total funds of approximately £1.5bn. In a few cases my company is the sole trustee. I am also an actuary undertaking occasional advisory and expert witness work. I was a practicing Scheme Actuary until 2010. I advised the (Social Security) Committee in 1997-8 on the subject of pensions and divorce.

In recent years I have presented to actuarial (I&FoA, KSS & ICA), trustee (APPT) and legal (APL) bodies on (1) public sector pensions and (2) insolvency prompted by pension debts (summary attached). I have petitioned the Court of Session and Sheriff Courts for unmanageable pension debts and assisted in the transfer of more than a dozen pension schemes to the PPF & FAS. As an individual/sole trader company I am sadly no longer on TPR Trustee Register, but my experience extends to (1) TPR Determinations Panel and (2) being replaced as a trustee for proper attention to legal, regulatory guidance and good governance issues.

Suggestions

The Committee will be very well briefed on most aspects of the inquiry points and I would therefore like to limit myself to the following points.

1. Pension promises are deferred pay and they should only be compromised or reduced in clearly defined circumstances. I believe the existing insolvency legislation is sufficient to provide that determination. I think it would be potentially dangerous to depart from that assessment framework. I however concede that the Royal Mail Pension Scheme could be cited as just such a departure but there were arguably special circumstances, not least from a competition perspective.

2. I suggest the Committee carefully consider all S89 Reports from the Pensions Regulator (TPR). These might reasonably be supplemented by competitor input to the moral hazard aspect of pension debt compromise. I specifically suggest the Committee also carefully consider the Nortel case. TPR and PPF correctly fought this important battle for pension scheme members, PPF levy payers and international creditor justice. With increasing globalisation and internationalisation of business, the position of pension schemes as large secured or unsecured creditors warrants careful consideration. Particular attention may be devoted to the employer covenant aspects of the case in relation to international asset transfers. Post Brexit it will be also important to reassess all jurisdictional and enforcement issues.

3. The Chancellor of the Exchequer provided TPR with a third remit and conflict of interest to explicitly consider the sustainable growth of the sponsoring employer in March 2014. This basically shifted the balance of power in funding negotiations to employers. Thereafter I certainly noticed a reduction (to zero) in TPR questions and scrutiny of funding plans submitted. I merely invite the Committee to consider the financial impact on RBS of them not enforcing debenture terms on zombie companies.

4. I believe it is of fundamental importance that the Committee, all MPs, MEPs and ideally even the general public appreciate the underlying funding of pension schemes. As an Appendix to this submission I include a mortgage illustration or comparison that I used in the late 2000’s. The 60% “investment contribution” and 40% employer “cash contribution” was typical at the time. Such funding is not acceptable for life office annuities or indeed other insurance products.

Interest rates, post Brexit and another £70bn of QE, look set to stay “even lower for even longer” and the impact of DB pension funding will be significant. In particular any pension scheme
assuming investment returns (including heroic equity returns over base gilt yields) close to rates of pension benefit revaluation (in deferment) and pension increases (in payment) will see this “investment contribution” reduce to zero. Many more pension scheme deficits will therefore become unaffordable.

5. I suggest the pension scheme and sponsoring company accounts should include the key (prudent) technical provision funding assumptions e.g. Gilts + 2% pre and 0.5% post retirement. For additional lay appreciation of this assumption, the non-guaranteed investment return might be quantified in £ms and compared to the cash contributions paid. (I don’t know the BHS basis or figures but that might be worth publicly comparing to the £1 company value! Other “highly geared investment trusts with operating subsidiaries” in the travel business or building trade might also be considered for illustration.)

6. I was not directly involved in the compromise of the MIRA (Motor Industry Research Association) pension scheme, but I think the employer covenant issues, TPR conflicts of interest and last man standing scheme aspects warrant attention.

7. I suggest the Committee consider TPR Determinations Panel cases prepared. This should include the cases settled at the last minute where the prospect of public exposure and scrutiny was sufficient to achieve the desired enforcement. These fully researched cases might also be used by TPR as no-names examples of potential regulatory intervention to increase employer and trustee knowledge and understanding.

8. In respect of the sustainability of the Pension Protection Fund (PPF) I merely suggest (a) attention to the non-guaranteed “compensation” provided and (b) potential “nationalisation” by transfer to or absorbing into the £1.5tn UK’s unfunded public sector pension liability.

9. If an independent investment benchmark or measure was ever required I suggest reference to the public sector SCAPE discount rate and the Office of Budget Responsibility input to such. This long term rate based on UK economic growth may be useful for the sustainability of £2tn of funded pensions as well as £1.5tn of unfunded promises.

10. I know there are significant pension funding problems for charities and other not-for-profit organisations. Many such organisations undertake vital public service activities and some have been outsourced from central and local government. Asking the public for voluntary donations when ½ or 1/3 are destined to pay off historic pension debts is challenging to say the least. For this vital special group I suggest a radical alternative, namely nationalisation by transfer to the public sector where solvency is assessed by reference to the SCAPE discount rate (CPI+2.8%).

11. I do not advocate the reduction of accrued pensions, but if such a scenario was imposed, the obvious first reduction would be via adjustment of retirement date. The original pension promise could be linked to longevity e.g. expected payment for 20-25 years. Maintaining that time period via later commencement is most likely to be accepted by affected members (rather like tax payers and state pensions). The second obvious adjustment would be reduction of pension increases in payment – towards the CPI (max 2.5%) payable by the PPF. RPI reduction to CPI would also be consistent with state pensions (ignoring the triple lock). (One PPF transfer case where I was independent trustee involved horrendously expensive fixed 5% pension increases on pre 1998 accrual, the S75 liability was almost twice the S179 liability.)

12. Aside; I think the PPF has done and continues to do an excellent job. Their attention to interest rate and inflation hedging has been exemplary and a guide to the whole pensions industry. Dunn & Bradstreet insolvency assessment was an initial embarrassment but one that was appropriately addressed. Their attention to the requirements around debt compromise is similarly appropriate and has stood the test of time. I wait to see whether the British Steel Pension Scheme will change things.
I would be delighted to expand on any aspect of the above.

Allan C Martin

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Appendix; Pension Deficit Repayment Illustration

Unmanageable Pension UK Debts
Paper to International Congress of Actuaries
Washington DC March 2014
Appendix

Pension debt – Mortgage Illustration (2008)

- Consider borrowing £150,000 to buy a house from a high street bank
- Assume a 5% per annum interest rate
- Repayment over 12 years requires £16,500 per annum

- But why not borrow £450,000 and invest £300K in equities?
- Assume return on equities of 7.5% pa and loan interest at 5% pa;
- Pay off the loan at only £6,500 per annum
- Any endowment mortgage holders in the room?

(The client was 66% funded and was considering a 12 year recovery plan; 5% and 7.5% were typical bond and equity returns at the time. The deficit was close to £150m but the building industry connection prompted the housing analogy.)

The above illustrates the significant “investment contribution” made to making Recovery Plans affordable. Indeed TPR will undoubtedly have many cases on file, high and low risk cases, where even more heroic investment assumptions are made to balance the deficit recovery equation. (Very long recovery periods are a partial additional solution.)

In 2016 the scenario could become -

- Consider still repaying £150m of DB pension debt
- Liabilities increase on average at 3.5% (= average asset return)
- Repayment over 12 years previously required £6.5m per annum

- Even still assuming a real return on equities of 2.5% pa on part of the 66% funded scheme assets and
- Ignoring the rapidly maturing liabilities and future cash flow
- 2016 12 year Deficit Recovery Plan requires £15.5m per annum
- Any constituency companies affected?
November 2013 Paper; Unmanageable UK Pension Debts

This note summarises the key aspects of my talk on unmanageable UK pension debts. My aim is simply to introduce you to, or potentially just remind you of, the key disciplines surrounding a decision of whether a pension debt is or is not manageable. The areas covered are investment, employer covenant, actuarial, governance/regulatory and legal. I also add some references to further reading and regulatory action.

Investment

Trustees, as custodians of the pension promises, are expected to fund defined benefit (DB) pension arrangements on a “prudent” basis. The degree of prudence is dictated by The (UK) Pensions Regulator (TPR) via a scale of “gilts+” investment returns varying with the strength of the employer covenant. The stronger the employer covenant, the more optimistic the investment return allowed. Strictly speaking the scale is aspirational but ignoring regulators is not recommended. In practice investment risk and return are inextricably linked (more return ⇔ more risk) and attention to investment volatility is increasingly common. Flexibility is provided through “appropriate” recovery plans. Pension scheme cash flows play a major part in the necessary analysis and projection of recovery plans. The debt is unmanageable when even the most heroic investment return assumption doesn’t result in an affordable contribution.

Employer Covenant

Independent employer covenant or analysis of the sponsoring, participating, parent or other group companies will generally be central to any decisions on whether the pension debt is manageable or not. Company strength will depend and vary in respect of company assets and liabilities (and net assets), profitability, cash flow, ownership, industry, business prospects and competition. Other company and/or scheme specific factors may also be important.

The strength of the sponsor is frequently assessed on a scale of 1 – 5, ranging from weak to strong. Note the link to the investment optimism assumed in the funding calculations and the impact of any movement in the covenant assessment. A weakening of the covenant theoretically requires a strengthening of the funding target which, all other things being equal, requires additional cash contributions. In practice the trustee position has direct comparisons with banks and an increasing proportion of schemes have funding plans involving security for the normally or otherwise unsecured debt on wind up. Funding difficulties are also giving rise to innovative “asset-backed” funding solutions involving company products or other balance sheet items.

Employer covenant advice will also be important in considering the balance of available funds being allocated to (1) dividends, (2) investment in the business and (3) debt servicing. Regulatory attention will undoubtedly be focused on any disproportionate payments to the former, whilst H M Government is keen to ensure investment and jobs are not too impaired by the latter. The debt is unmanageable when 100% of available company cash isn’t sufficient to service the competing demands of investment in the business shareholder return and servicing the pension debt.

Actuarial

The assumptions underlying actuarial valuations are crucial in determining the monetary amount of the pension liability and hence the potential deficit. These assumptions are financial and statistical. The most debated statistical assumption is mortality, split between (1) a starting or base position (usually assessed via postcodes or other profiling techniques) and (2) allowance for future improvements in longevity.

Actuarial analysis and projection is important in considering (1) the sensitivity of the results to variation in individual assumptions (now a compulsory professional requirement), (2) the projection of scheme cash flows and (3) future liabilities on some (or all) of the funding basis, solvency costs or Pension Protection Fund (PPF, ⇔ PBGC) liabilities. The latter is termed “S179 drift” and increases in such liabilities may
influence other stakeholders. The debt is unmanageable when heroic actuarial assumptions (or internal actuarial Chinese Walls) become totally untenable.

**Governance/Regulatory Issues**

The governance framework of a pension scheme can be hugely important. TPR will certainly initially focus on three key aspects – trustee conflicts of interest, trustee knowledge and understanding, and independent employer covenant assessment.

Advice in this area will also be crucial in setting “affordable” contributions, the initial amount, the “shape”, increases in future contributions and any business or profit related aspects of such. If restructuring (debt for equity swap) is involved it will be safe to assume that such expert restructuring/corporate finance input and liaison with the PPF will take centre stage. The debt may become unmanageable when the lack of governance leads to operational farce.

**Legal**

Any individual Trust Deed & Rules will contain crucial powers in respect of pension debt management. The power of amendment may be initially suggested as key, however, in individual circumstances, who sets the employer contribution rate, who can hire and fire trustees, who can cease future benefit accrual or augment benefits, or who has the power of wind up etc. can be just as significant.

TPR also influences corporate behaviour, the funding target (technical provisions) and recovery plans. TPR’s “moral hazard” powers are arguably draconian; To date however they have been rarely used. The threat of Contribution Notices and Financial Support Directions has arguably been sufficient to influence many actions, inactions and deal structures.

When pension debts become unmanageable it is preferable for the directors of the sponsoring employer to take the necessary action towards insolvency. Occasionally however shareholders and/or management may be in denial and trustee action is required to force the situation. Wind up of the pension scheme and a S75 debt is a powerful catalyst but the power to wind up may not be available (and TPR may wish to leave the process to the trustee(s)). In such circumstances a court debt petition is required and unpaid expenses or default on an existing Schedule of Contributions is quicker and less costly than a S75 claim which requires audited accounts and actuarial valuation and certification. The pension debt is unmanageable when TPR liaison results in the use of Regulator powers.

**Conclusion**

Pension deficits are increasing with low real and nominal interest rates and improving longevity. Deficits are straining already struggling companies who may be contracting because of competition, technology or globalisation. Decisions around whether any pension debt ultimately becomes unmanageable will be a delicate balance of investment, legal, actuarial and covenant considerations. Time may often be the deciding factor as fears or just perceptions of a “zombie company” emerge – one existing only to service historic pension debts. The debt is unmanageable when the trustee has to force the insolvency of the sponsoring employer in order to fulfil their fiduciary duties. Is it any wonder that virtually all DB pension schemes are closed to new members and most are closing to future accrual?

**Further Reading**

Those interested in further reading on insolvency, conflicts of interest, unmanageable pension debts and previous restructurings are referred to (in no particular order) -

- TPR S89 Reports on Kodak, M F Global, UNIQ, UK Coal, Bonas, Great Lakes (Chemtura Group), British Midland, Sea Containers, Box Clever Pension Scheme (ITV), Polestar, Pittards, SR Technics
(Swissair), Telent (GEC Marconi), Hugh Mackay Retirement Benefits Scheme and G P Noble Trustees Limited  www.pensionsregulator.gov.uk (search S89 or company name)

- Press comment on Readers Digest and Dawson International.
- The Department for Business, Innovation & Skills (the old DTI) report on M G Rover http://www.bis.gov.uk/files/file52782.pdf
- The PPF guidance on acceptable compromise (S5.3) http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/insolvency_guidance.pdf

For future developments and evolving practice, watch out for future S89 reports court reports and appeals. If the private sector pension promises aren’t enough then watch out for further scrutiny of UK public sector promises where the public sector discount rate (reduced to CPI+3% in April 2011) is crucial to inter-generational equality.