Written evidence from Employer Covenant Working Group (PPF0038)

1. The **Employer Covenant Working Group Limited** (“ECWG”) is an organisation formed in 2012 and incorporated in 2015 with the following objectives:

   1.1. To discuss technical, legal and regulatory issues relevant to providing financial advice to clients – trustees or sponsoring employers – on matters connected with the employer covenant;
   1.2. To participate in discussions on relevant matter with bodies such as the Pensions Regulator (“tPR), Pensions Protection Fund (“PPF”) and, where appropriate, to promote the views of the ECWG with those bodies;
   1.3. To produce and circulate reports, guidance and other documents related to the employer covenant or associated matters; and
   1.4. To act as a vehicle for raising the profile and standards of, and promoting, the employer covenant financial advisory industry generally amongst the pension community, including trade bodies, regulatory bodies, professional groups and potential clients.

**Executive summary**

2. The ECWG is a body formed to promote high quality financial advice on the “employer covenant”. The comments below are based on our members’ collective experience of how pension liabilities are being dealt with generally in the UK by stakeholders and tPR.

3. We recognise that pensions regulation should reflect policy decisions on how stakeholder interests and risks should be balanced. We highlight in our submission some of the tensions our members experience in their work, highlight some of the problems these can create and suggest solutions that policy makers might adopt, should they see fit.

4. The current regime appears to work satisfactorily when there is a good balance of risk between the scheme and its employer; but there are some situations where the balance is not sustainable, for example where accrued scheme liabilities are disproportionate to the size of the employer and there is no real prospect of it being able to grow its way out of the problem, or where the employer is financially stressed. It is in these situations the rigidities in the regulatory system are proving problematic.

5. Successive layers of regulation have converted a pensions promise into a guarantee. Rigidities in the system and market practice are promoting ”de-risking” which can put more pressure on the employer covenant.

6. tPR is now emphasising the need for schemes and sponsors to work together and to look at risk in the round, but grounded in covenant. We support the steps tPR is taking here. However, with each of the parties involved owing duties to a range of stakeholders, there is a question whether tPR’s competing objectives towards the PPF and towards sustainable growth are manageable with the current resource allocation and ”cliff edge” approach to benefit protection (the limited scope for compromise between members receiving their benefits in full or being restricted to PPF benefits).
7. In practice the regulatory powers are extensive but rarely used. It may be appropriate to enable the tPR the remit to act more flexibly before resorting to consideration of these. While pre clearance of transactions may have unintended consequences, it may be worth exploring ways for more active engagement with tPR at key stages.

The adequacy of defined benefit pension scheme regulation

8. Our members advise scheme trustees, scheme sponsors and their stakeholders. We advise in relation to schemes of a broad size, millions to billions of assets and liabilities, and health (ranging from healthy and well-funded schemes to those of more stressed in nature, whether scheme or sponsor driven). Our perspective and comments are based on shared experience of advising on covenant since 2004.

9. Our experience is based on behaviours that are driven by:

9.1. a requirement for schemes to be fully funded on a technical provision basis and trustees to act prudently with a primary responsibility to the scheme members;
9.2. Companies, and their boards, having a primary objective to act in the best interest of shareholders. They have to balance how they allocate capital in relation to shareholder return, investing in the business and managing the liabilities of the business, the most material often being the defined benefit (“DB”) pension scheme. This is also a liability that is measured differently on an accounting or scheme funding basis. Our experience shows that there can be tension around the allocation of capital;
9.3. Trustees being aware of the impact that their approach has on the sponsor and a tendency to take account of it; and
9.4. Our understanding of the legal position is that trustees have no responsibility to take account of the interest of the PPF, albeit the PPF acts as an insurer of last resort for schemes when their sponsors fail.

10. Where schemes and their sponsors are balanced in terms of their size, their covenant, the investment risks and cash flows, the current regime appears to work effectively. Employers recognise the trustees as a party with a legitimate interest in the business. Whilst there are occasionally exceptions, generally in corporate transactions, buyers and sellers are aware of the system, they negotiate with pension scheme trustees and offer mitigation where the scheme is affected. However, given the increasing tendency not to apply for Clearance there may be benefit in providing trustees with an avenue through which they can register (or have addressed) any concerns they may have.

11. Our comments therefore are focussed on the more stressed sector of the DB pension arena.

12. Liabilities relating to a pension commitment made, in some cases, decades ago are potentially unaffordable for a number of schemes and their employers. A Cass Business School Pensions Institute discussion paper issued in December 2015 suggested that

1,000 schemes are subject to unmanageable stresses and are very unlikely to pay future pensions in full to members and their dependents. Whilst there may be some debate over this number, what is evident from our members, is that the number is increasing. This is an area where we feel the pensions’ regulatory framework could in practice be more flexible, given that the options for corporates and trustees are currently limited.

**Observations around scheme design**

13. Initially DB pension provision in the UK provided a balance that worked:

13.1. For employees, provided some certainty around an income for life in retirement
13.2. For employers, provided a cost effective means of attracting and rewarding employees
13.3. For Government, provided a transfer of some responsibility for retirement provision to the private sector

14. Whilst there will always be exceptions to the rule, the schemes that exist today were generally not set up by reckless CEOs, CFOs or employment functions of corporates in a laissez-faire way. Employers understood that benefits were payable to pensioners for life but what they believed they were facilitating was pooling risk between those who lived for longer and those who died younger, not underwriting a situation where everyone lived much longer than expected.

15. The original design of schemes allowed for safety valves, which provided for benefits to be flexed and did not necessarily guarantee pension increases.

16. There has since been a persistent erosion of schemes’ funding positions driven by three key factors:

16.1. Adverse long-term investment market conditions;
16.2. Greater than expected increases in life expectancy; and
16.3. Unanticipated consequences of well-intentioned legislation and regulation that prevented the operation of the safety valves or in certain circumstances hard-wired the growth of the liabilities.

**Observations around the funding regime**

17. It was not anticipated when schemes were set up that certain assets available on the investment markets could have long periods of adverse performance or that employers would have to recognise that experience in a mark to market way, which may be inconsistent with the long-term nature of the benefits. At the same time deficits have continued to increase due to the manner in which liabilities have been calculated by reference to gilt yields.

18. Whilst the appropriateness of this approach is the domain of the actuarial profession it does raise a number of inherent questions or concerns for us in considering employer covenant, in particular if the approach damages the covenant by needing ever increasing levels of the sponsors’ free cash flows. We question whether there is an inconsistency
when the approach taken to mark-to-market valuations reflects volatility in the value of instruments that schemes do not necessarily hold.

19. We believe that this needs to be understood in the context of employer covenant as there is a danger that this can drive an assessment of liabilities that results in higher deficits. This may in turn drive trustees to be unnecessarily cautious and take action to de-risk in a way that puts further pressure on sponsor cash flows, making it even harder for them to fully fund schemes. If the sponsor does not believe that the valuation reflects the true funding needs of the scheme, this can create a dysfunctional relationship between the business and the scheme.

20. We would, however, also observe that this should not be an excuse for a corporate with a particularly strong covenant to ignore scheme funding or encourage an unduly risky investment strategy in the hope that investments will do all of the work in funding the scheme.

21. tPR’s Code of Practice on funding defined benefits states that discount rates used in setting Technical Provisions must be chosen prudently, taking into account either:

21.1 the yield on assets held by the scheme to fund future benefits and the anticipated future investment returns, and/or
21.2 the market redemption yields on government or high quality bonds.

22. Whilst this provides a choice of approaches, the market approach of late appears to have been to use discount rates based on fixed margins over gilt yields. This clearly has influenced many schemes to adopt discount rates on comparable bases.

**Integrated Risk Management**

23. tPR issued guidance in December 2015 on its expectations regarding Integrated Risk Management (“IRM”). We believe this is helpful and we believe there is a case for even greater emphasis to be place on IRM as part of regulation in the funding of DB pension schemes and its prominence in the valuation process.

24. We believe that for IRM to work it is essential for scheme trustees to get comfortable that investment strategy is consistent with the covenant. Provided the covenant supports the investment and funding risks being taken, this should enable liabilities to be valued by reference to discount rates based on yields of assets actually held by the scheme (whilst ensuring a prudent approach is still adopted), rather than a gilts based approach.

25. There may be a case for tPR to review its guidance to trustees to support taking account of the underlying, long-term nature of schemes based on the cash flow profile of benefits and maturity of the scheme.

26. We believe this could create a process whereby trustees and sponsors take a more holistic view when considering the position of the scheme – a focus on the balance between covenant, an investment strategy that the covenant can support and a funding approach which is consistent with the assets which the scheme is appropriately invested in. This,
we believe, could lead to better decision making and outcomes as well as helping to foster a more collaborative approach between trustees and sponsors.

27. Covenant assessment is clearly an important part of this process, but prior to 2004, there was no requirement to assess the financial position of the scheme sponsor. Even today whilst the challenges in funding schemes appear more acute and tPR’s view that covenant is critical to understanding how to appropriately fund schemes and consider investment strategy, there is no requirement to take independent covenant advice.

28. Other areas we believe worth considering include:

28.1. Requirements for trustee boards to produce an annual scheme risk and uncertainty statement, consistent with that required under corporate reporting, whereby the sponsor and the trustees agree the risks associated with the funding approach that is being taken and how they are being addressed.

28.2. Increasing the robustness and formality of contingency planning consistent with IRM. For example, agreeing and documenting steps parties will take to mitigate adverse experience in the funding position of the scheme.

29. The purpose of these documents would be to ensure stakeholder buy-in to the approach being adopted, to lend support to the existing statement of funding principles and address the challenges identified in point 19 and the behaviours they drive.

Observations around Trustee and Regulator’s duties

30. The complexity surrounding DB pension schemes means that in practice trustees’ actions can have consequences beyond just the interests of the scheme’s members.

31. The committee may wish to consider whether there is merit in clarifying, extending or changing the obligation and/or duties of trustees beyond their members or for that matter the duties of directors of sponsoring employers in relation to a pension scheme. However, we recognise that care is needed here as this may cut across years of established law and precedence in a number of areas including trust and corporate law.

32. tPR appears to have the almost impossible task balancing what, often appear to be, conflicting objectives, especially when there is a question as to whether the scheme will ever be fully funded. For example, it is not clear when tPR’s objective of safeguarding the PPF takes precedence over the objective of allowing employers to support growth, or the levels of investment risk that trustees should be permitted to take in pursuit of returns when employers are weak and unable to provide appropriate support to their schemes.

33. The ability of tPR to act early and definitively may be restricted by the potential conflicts between its statutory objectives and the resources available to it.
Increased flexibility of restructuring options

34. Even in situations where it is clear that the support available from the sponsor will not ultimately be sufficient to meet the pension promise in full and there is a PPF deficit, trustees are often unable to progress restructuring discussions with the employer unless it is on the brink of insolvency. Unfortunately, this is often too late for restructuring proposals to be progressed which could otherwise have potentially secured benefits for the members that are somewhere between PPF and full benefits (i.e. closer to the intended level) when they fall due. This would clearly be a much better outcome for the members, especially those who fall the wrong side of the current cliff-edge compensation design in the PPF, albeit, such compromise is generally viewed with suspicion and could jeopardise a scheme's eligibility to enter the PPF in a future insolvency of the sponsor.

35. Whilst we understand and recognise the need for caution, particularly where an alteration of past service benefit structures is being suggested, we believe there is a case for making regulatory changes, if necessary, to enable trustees, with the appropriate safeguards, to promote such changes which offer members a higher level of benefits than would otherwise be provided through the PPF. This approach could provide better outcomes for members and sponsors, as well as PPF levy payers. It is possible that this could be achieved through a rebalancing of tPR's objectives to permit a change in approach, and guidance from tPR, to allow trustees to consider steps that they could take to create an outcome that is in the best interest of the members.

36. It may be helpful to give tPR a policy imperative and the power to agree to more flexible solutions, including increased equity stakes in sponsoring employers for the benefit of the scheme and the power to amend (or approve the amendment of) scheme structures and past service benefits, in appropriate circumstances, if it believes on the balance of probabilities that this will improve the outcome for scheme members. Checks and balances would clearly be needed to safeguard members and could include:

36.1. Both the sponsor and the trustees agreeing that the current position is not sustainable;
36.2. That the revised benefits, taking account of the likelihood of them being paid, are no worse than those provided by the PPF
36.3. The requirement for tPR to approve such proposals
36.4. Consultation with members (albeit 100% agreement may not be practical or possible).

37. Another issue potentially impacting on the ability of a scheme to progress a restructuring proposal is the PPF and tPR’s requirement that ‘insolvency is inevitable’ before they will engage in restructuring negotiations. We appreciate the difficulty in providing a definition for the ‘inevitability of insolvency’, in particular given the potential impact on and of other legislation (i.e. the Insolvency and Enterprise Acts) but a clearer understanding of the circumstances when insolvency is considered inevitable or where a scheme restructuring might be considered by tPR and the PPF may allow employers and trustees to focus resources appropriately when considering the future options available.
Clearance process and transactions

38. tPR’s risk-based approach, combined with the way in which the clearance system operates, can lead to trustees of smaller schemes or those that are not perceived to present a risk to the PPF, feeling they are left with limited negotiating power in transactional situations.

39. As a result, sponsors are increasingly not applying for clearance, leaving trustees who consider their scheme has suffered a ‘Type A’ event to negotiate without regulatory support. tPR may consider using its anti-avoidance powers, however these actions require material levels of support and resource and it can only progress a limited number of cases at any one time; historically these actions have largely been used following sponsor insolvency rather than at the time when support might be more effective.

40. The recent BHS matter has given rise to consideration as to whether the transactions that either involve dilution of either all or part of the covenant, and/or involve a significant change to the sponsor’s capital structure should require engagement with tPR.

41. However, if a transaction is considered to be detrimental to the future funding position of a scheme then this would already appear to fall within the scope of tPR’s 'moral hazard' powers. Whether the current requirements for the issuance of a contribution notice are sufficiently broad to allow tPR to consider their use in these circumstances may be an area of consideration for the committee. In addition, the committee could consider whether it would be appropriate to reinforce the rights of trustees to appeal such transactions to tPR and the scope for tPR to engage following such an appeal.

42. We note, however, that careful consideration will be required to ensure any definition of the type of transaction that it is intended to be caught is prescriptive enough so as to avoid becoming an impediment to otherwise normal corporate activity.

tPR powers

43. To our knowledge, powers such as s.231 of PA 2004 (power to set contributions) and s11 PA 1995 have never been used by tPR.

44. CN/FSD powers have been used rarely and mainly following insolvency and therefore have been retrospectively used where value has been eroded.

45. The s.71 skilled person regime is rarely used. In order to support decision making and to accelerate decisions, the committee may wish to consider enhancing the skilled person’s regime to provide greater support to tPR. The limited use of this option may be as a result of a requirement to go to the Determinations Panel and we think this process may be able to be streamlined with the cost of the skilled persons being met by the parties to relevant transactions.

46. There is a question as to how effective tPR’s anti-avoidance powers are in relation to foreign jurisdictions. If it is considered these powers are not effective or adequate to recover value for schemes the committee may therefore consider whether tPR needs a
policy imperative to consider what steps it could take to avoid value becoming remote from the covenant.

47. We suggest that consideration should be given to simplifying powers such as the power to set contributions (s.231) for use in the event tPR is satisfied the outcome of scheme funding negotiations prove unsatisfactory. We note tPR does not have the power to set investment strategy, which in the context of IRM raises the question as to whether they have the full suite of powers to discharge their current objectives.

48. tPR’s power to wind up schemes (s.11) could be amended so that it can be used in broader circumstances than purely in the interests of the generality of members, for example to include circumstances where the PPF is being prejudiced by drift.

Legal disclaimer

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September 2016