AlixPartners is a global consultancy practice providing, amongst other things, advice on mergers and acquisitions, debt raising, financial restructuring, operational improvement and turnaround and litigation support. Within this we provide advice in connection with defined benefit (DB) pension scheme valuations and restructuring. We have been involved in some of the largest restructuring and M&A transactions and have significant experience in regulatory enforcement proceedings and therefore have perspectives that we would like to contribute, broadly covering the scope of the Inquiry.

The authors of this document are Gary Squires and Robin Knight. We are both partners in AlixPartners Services UK LLP, with significant experience of working in restructuring, M&A and pensions situations. Gary is a leading expert in DB pension scheme restructuring and employer covenant in the UK as well as an experienced insolvency practitioner, while Robin has significant experience working alongside governments, financial stakeholders and companies in the UK and overseas, dealing with high profile restructuring engagements.

1. Executive summary

1.1. Given the growth in deficits which is due, amongst other things, to continuing downward pressure on gilt yields and increasing longevity, it is clear that there is increasing pressure on sponsor finances and, as a result, increasing risk to members and the Pension Protection Fund (PPF). This has manifested in the recent high profile situations that have contributed to the initiation of the Inquiry.

1.2. It is inevitable that there will be situations in which sponsors fail, leaving underfunded schemes, which is reflected in the existence of the PPF. Based on our experience, we see potential opportunities to preserve greater value and employment when sponsors become financially distressed and need to be restructured.

1.3. Addressing DB deficits involves balancing the interests and risks of stakeholders and the regulatory framework designed to strike that balance needs to reflect government policy. We address some of the tensions that we see in our client engagements and highlight some areas where policy makers might consider seeking to shift the balance of policy and its execution through regulation. We also suggest some levers for change that policy makers might consider if they conclude that the current balance should shift.

1.4. The objectives set for the Pensions Regulator (tPR), perhaps purposefully, appear difficult to reconcile, particularly in distress situations. Possibly because of this some of tPR’s considerable powers are rarely used and some have never been used.

1.5. The theme running through our observations and proposals is that tPR’s objectives and powers could be rebalanced towards preserving economic
value and employment in distress situations and away from cross subsidy of failing companies through the PPF levy.

2. **Context and observations**

2.1. In summary, tPR's objectives are to protect members’ benefits, protect the PPF, protect employment and minimise the impact on the sustainable growth of the employer (http://www.thepensionsregulator.gov.uk/about-us/our-objectives.aspx).

2.2. For reasons we set out below we believe that, as laudable as they may be individually, these objectives often conflict with one another, particularly in distressed situations, and can cause opportunities to preserve value to be lost, ultimately at greater cost to the levy payer.

2.3. Exercise of regulatory powers can take a long time because tPR must apply to the Determinations Panel (DP) through a process that can take months or years to run its course. Consequently, tPR can be unable to use its powers promptly or proactively even when the situation is time critical.

2.4. In June 2014 tPR published a series of documents covering its regulatory strategy and policy and an updated Code of Practice no. 3 (CoP3) ‘Funding Defined Benefits’ (http://www.thepensionsregulator.gov.uk/codes/code-funding-defined-benefits.aspx). This was further advanced by the integrated risk management (IRM) guidance issued in December 2015 (http://www.thepensionsregulator.gov.uk/guidance/guidance-integrated-risk-management.aspx). This guidance has significant implications for the operation of DB pension schemes and is relevant to the Inquiry.

**Integrated risk management**

2.5. The integrated approach encouraged by tPR involves reinforcing the link between the strength of the employer covenant (essentially the long term credit risk in the employer), the scheme’s investment strategy (trustees can take higher investment risk in seeking returns when supported by stronger employers), and the prudence in the discount rates compared to expected investment returns. While this is logical, it can break down at the stressed end of the scale, where weaker employer support requires greater prudence and less reliance on investment returns, but where employers are cash constrained and unable to pay adequate contributions. In these circumstances, taking excessive, unsupported investment risk essentially amounts to ‘gaming’ the PPF because trustees can perceive little downside to members in the event of unsupportable adverse experience.

2.6. IRM highlights situations in which companies are realistically unlikely to be able to support their DB schemes. In such circumstances financial restructuring will often be required in order to preserve economic value in the interests of all creditors and to protect employment. Yet tPR and the PPF will only engage in such restructuring when insolvency is ‘inevitable’ within a year (http://www.thepensionsregulator.gov.uk/docs/regulated-apportionment-arrangements-statement-august-2010.pdf). This could be causing erosion of
value and prejudice to the PPF through drift (see 4 below) on a systemic level.

2.7. By way of supporting evidence, a central conclusion of the paper ‘the greatest good for the greatest number’ (Cass Business School and the Pensions Institute, December 2015, [http://www.pensions-institute.org/reports/GreatestGood.pdf](http://www.pensions-institute.org/reports/GreatestGood.pdf)) was that as a result of ‘stressed’ schemes, ‘the private sector, and the economy as a whole, will suffer a worst-case scenario, whereby about 1,000 sponsoring employers’ businesses – representing one sixth of the schemes in the PPF Index – are [currently] expected to become insolvent’. As time passes and more employers experience adverse business cycles and structural changes in their markets, and schemes themselves turn cash flow negative and start to run out of money, this stressed population is likely to grow.

**Deteriorating PPF position**

2.8. Deferring the crystallisation of schemes that are likely to terminate with the insolvency of the employer causes ‘PPF drift’; the phenomenon whereby over time, as members retire, resulting in the protection of their benefits, and pensions remain in full payment, the contingent liability that may ultimately fall on the PPF grows. This may prejudice the PPF and younger scheme members if the employer is unable to pay adequate contributions and ultimately fails.

**When schemes cause employer insolvency**

2.9. This raises the challenging question of when to recognise that there is no reasonable prospect of a scheme being fully funded, which would indicate employer insolvency.

2.10. Increasing sophistication and frequency in the application of stochastic modelling to pension scheme cash flows and ranges of funding outcomes is enabling greater objectivity and precision regarding the likely futures of schemes. Comparing the output of these models with employer cash flows and enterprise values can facilitate assessment of the ability of employers to support their schemes in the long term.

2.11. If because of the scale of a scheme and its deficit in relation to the employer, or other factors such as over indebtedness or adverse trading outlook of the employer, there is no reasonable prospect of a scheme being fully funded, there is a danger of a vicious downward spiral. If proactive steps are not taken to restructure such businesses, value in the employer can deteriorate further as the company can be starved of fresh capital for investment (because capital providers wish to see their investment put to work in the business rather than in funding legacy liabilities) and management loses motivation due to lack of incentive. Not only can loss of value result from deferring restructuring but also loss of employment.
Personal risks to directors

2.12. While tPR has its statutory objectives, directors have their own duties and, under the Insolvency Act, potentially face disqualification or personal liability for wrongful trading claims if they are unrealistic and fail to take every step to minimise the potential loss to creditors. The wrongful trading provisions of the Insolvency Act 1986 apply to directors, de facto and shadow directors who knew or should have realised at some point in time that there was no reasonable prospect of the company avoiding insolvent liquidation. This will depend on rational expectations as to the future. Wrongful trading convictions do not require criminal intent but lesser failings such as ‘confusion between aspiration and actuality’ and ‘wilfully blind optimism’. In order to establish liability the liquidator of the sponsor needs to establish insolvency at the time in question ‘on the balance of probabilities’, the civil burden of proof. This will be made more apparent in situations where there are unfunded pension obligations by the application of the modelling techniques referred to above. Yet tPR uses a different test to determine whether they should engage in restructuring, which is that insolvency should be ‘inevitable’, not likely ‘on the balance of probabilities’.

2.13. As far as DB pension schemes are concerned, steps to minimise losses could include closure to accrual or winding up, which would trigger s75 (buy-out) debts, crystallising the position and triggering sponsor insolvency proceedings as the final resort.

2.14. As well as exposing directors to disqualification and personal liability for the company’s debts, balance sheet insolvency can:
- enable creditors to seek winding up orders;
- trigger termination events in contracts and debt facilities;
- render transactions open to challenge by a subsequently appointed liquidator.

2.15. The mismatch between the requirements of the Insolvency Act and those of tPR is therefore putting directors of companies with ‘stressed’ schemes in an invidious position and can motivate behaviour that some might regard as inappropriate.

The Pensions Regulator’s Powers

2.16. In certain circumstances, where parties fail to act in accordance with regulatory requirements or cause detriment to schemes, tPR may exercise powers to rectify the position. Powers include (but are not limited to):

2.16.1. The imposition of schedules of contributions under s231 PA2004
   To our knowledge this power has yet to be used.

2.16.2. The power to appoint Skilled Persons under s71 PA2004
   This power has been used rarely.
2.16.3. The power to appoint independent trustees (ITs) under s7(1) and 7(3) PA1995

This power has been used rarely.

2.16.4. The winding up of schemes under s11 PA1995

To our knowledge this power has yet to be used.

2.16.5. Powers to attach liabilities to connected and associated parties through Contribution Notices (s38 and s47 PA2004) and Financial Support Directions (s43 PA2004)

While these powers may be used at any time, to date enforcement measures have only been imposed through the DP in situations where the employer has entered insolvency proceedings, although the threat of their use has resulted in negotiated settlements.

The adequacy of regulation and regulatory powers

2.17. We would observe that, while they have been used sparingly, the powers of tPR are extensive, as set out above, particularly the power to look through the ‘corporate veil’. It would seem likely that policy could be designed to permit and require tPR to be more proactive and act more promptly, which could be achieved through a rebalancing of its objectives.

Implications for company behaviour

2.18. Corporate behaviour varies according to circumstances, which can be complex, but we make some general observations below regarding distressed situations.

2.19. Regarding scheme funding, because restructuring options are limited by the ‘insolvency is inevitable’ criterion and other requirements, the approach of companies in stressed situations naturally tends to be to conserve cash, limiting contributions and forcing trustees to take greater investment risk to fund the deficit. Some trustees are content to do this as, with the PPF providing a safety net, it is in members’ interests to keep the scheme going and there is limited downside. Notwithstanding their integrated scheme funding guidance, tPR also seems unwilling or unable to impose it at the stressed end of the scale, for example by winding up schemes that are posing a threat to the PPF in terms of drift or unsupported investment risk. We acknowledge the difficult task of balancing discouragement of ‘dumping’ on the PPF with exposing it to drift, but tPR seems to be more mindful of the former.

2.20. Regarding clearance, following its introduction in 2005, it was a relatively popular route to follow. However, given the time, uncertainty, effort and ‘price’ that tPR usually seeks to extract, it has become less popular and companies now seem generally to prefer to take their chances and negotiate later if tPR comes after them.
3. Potential solutions/amendments to regulatory powers and objectives

3.1. We set out below some suggestions as to how some of the issues we raise above may be addressed, should policy makers perceive the need.

Power to set investment strategy

3.2. A seemingly obvious gap in tPR’s powers is the ability to set investment strategy. Given the integrated approach to scheme funding it may be considered appropriate for tPR to have greater influence, particularly in situations where the PPF may be prejudiced by unsupported investment risk.

Permit downward adjustment of past service benefits

3.3. It is inevitable that there will be situations in which companies will be unable to fund past service benefits and this can be apparent for a long time before they run out of cash. As things stand companies must either be on the brink of cash flow insolvency before the PPF and tPR will engage in consensual restructuring, or actually enter into insolvency proceedings, which results in the scheme entering PPF assessment. This delay can permit erosion of value, which is in no one’s interests, and can mean loss of employment. An alternative, subject to appropriate checks and balances, would be to relax the prohibition imposed by s67 PA1995 on downward adjustment of past service benefits, which could help preserve corporate value and employment and permit members to do better than they would in the PPF, even if they would not receive their full entitlements.

Rebalance tPR’s objectives

3.4. While in our view integrated scheme funding is sound for the general population of schemes, at the stressed end of the scale the approach can break down. Permitting the pensions ‘can’ to be kicked down the road on a systemic level is likely to be prejudicial to the PPF and result in the cross subsidy of failing businesses by the levy payer. Aligning pensions law and practice with insolvency law and practice by permitting earlier PPF entry when schemes are unviable ‘on the balance of probabilities’, or at least before their employers are ‘inevitably’ insolvent within one year, would seem likely to reduce the burden that may fall on the levy payer in the long run. This would mean deprioritising the interests of members at the margin because earlier PPF entry would mean a shorter period of pensions remaining in full payment and fewer members achieving fuller protection of their benefits on retirement. While this may seem harsh and we sympathise with members who may be affected by it, we consider that a shift towards preserving value and employment and avoiding cross subsidy is worthy of consideration by policy makers.

Enhance power to appoint professional independent trustees

3.5. In circumstances of distress lay trustees are often inexperienced and can suffer conflicts of interest (for instance because they include middle management who in their employee roles report to the senior management
with whom they would have to negotiate) and the power of trustee appointment usually rests with the company. It would be helpful in such situations if tPR could exercise the power to appoint ITs on request, or if it would protect the PPF, rather than only the ‘generality of members’, without having to seek DP approval.

**Confer on trustees a statutory duty of care to the PPF**

3.6. Currently, on our understanding of the legal position, trustees owe no duty of care to the PPF, so are able to take unsupported investment risk in the knowledge that there is only upside for members. It may be considered appropriate to confer a duty of care on trustees, so that faced with a weak covenant (and a PPF funding deficit) they do have to minimise unsupported risk in their investment strategy. This would be analogous to the duty of directors to shift their focus from promoting the interests of shareholders to protecting the interests of creditors when a company approaches insolvency.

**The power to block transactions**

3.7. There have been calls for tPR to be given the power to block corporate transactions. It is our view that for a number of reasons the power to block or delay transactions would present significant problems, including:

- it is not clear to us how the population of transactions that would come under scrutiny should be defined and the volume could be significant and volatile;
- this could require significantly greater resourcing and/or redeployment of resources that would arguably be better allocated in dealing proactively with stressed schemes;
- whether approving or blocking a transaction (depending on the circumstances), there is exposure to the risk of missing something material and therefore attracting significant criticism; and
- potential reputation damaging allegations of negligence or the stifling of commercial enterprise may result and consequently expose tPR to greater risk of judicial review and consequent monetary claims.

Our alternative suggestion is set out in the next section.

**Enhancement of the s71 Skilled Persons regime**

3.8. Reflecting to an extent reported comments in the media regarding the need for business insight and the experience of ‘poacher turned gamekeeper’ to be brought to bear at tPR, we have a proposal that originates in competition and insolvency law and practice, in which we see parallels with current considerations. In essence this would involve the delegation of aspects of tPR’s powers of inquiry to office holders in a similar way to the competition authorities’ appointment of monitoring and divestiture trustees and the insolvency practitioner regime operated by the Insolvency Service under the auspices of the BEI Department. In summary tPR, rather than blocking transactions, could retain the voluntary status of clearance and, at the cost of
the parties to a transaction and without applying to the DP, require the appointment of independent experts to identify any detriment arising from transactions and propose appropriate remedies. This might operate broadly as follows:

- any change in ultimate ownership and sale of substantially all of a business and assets of an employer must be notified to tPR (either before the transaction or within a defined period of it going unconditional);
- parties to such a transaction may apply for clearance, as presently, or present a case as to why clearance is not being sought;
- clearance may be granted on terms applied for or subject to revised terms;
- because trustees may lack independence or the necessary skills to assess and act on a situation, if clearance is not sought, or information is insufficient, or it is declined and the deal proceeds anyway, tPR may require nominated parties, at their own cost and without applying to the DP, to appoint a suitably qualified and experienced person, perhaps from a panel, to:
  - investigate the transaction/proposed transaction;
  - identify any detriment;
  - propose options to mitigate any detriment.

Mitigation may be agreed or tPR may apply to the DP to impose remedies.

3.9. In summary we propose that parties can either seek clearance or run the risk of having to fund an office holder to investigate a transaction after the event and be faced with mitigation that they had not factored into their considerations.

3.10. This would have a number of benefits, including:

- tPR could be more proactive and would not be delayed by having initially to apply to the DP;
- tPR could be more selective of the transactions it scrutinises;
- it could reduce the expense and disruption to tPR of the redeployment or addition of resources that would be required to meet an otherwise unpredictable work load;
- the cost of information gathering and initial assessment would be borne by the parties rather than the levy payer;
- appointing independent, suitably qualified office holders would help mitigate the risk of tPR being undermined by criticism or subjected to judicial review.
Clearly a lot more thought would need to be given to how such a regime would operate but we believe that a more robust regime could be constructed.

We would be pleased to help build on these proposals if any are thought to be suitable for further development.

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