1 SUMMARY

1.1 The Pensions Regulator’s (TPR) powers are generally adequate but could be used more effectively and efficiently in practice to support trustees. Depending on the public policy decision over the extent to which TPR should become more proactively involved, there may be a need for minor legislative changes to TPR’s powers.

1.2 There are some questions around the fairness of the Pension Protection Fund (PPF) levy system, particularly in relation to those schemes with sponsoring employers who are not UK, EU or EEA based. We believe there is a case for minor legislative changes to address certain issues with the PPF.

1.3 There is no need to expand further the powers or responsibilities of DB scheme trustees, nor is there any appetite for this within the pensions industry.

1.4 There are a number of measures that could be considered to help employers manage their DB liabilities (which reflect the long term nature of their obligations), whilst safeguarding members’ rights.

1.5 Notwithstanding the above, we would caution against the introduction of a raft of new legislation or regulation. Many DB schemes are operating remarkably well given the challenging circumstances. For those that are not, it would be preferable to focus on better implementation and enforcement of the existing regulatory regime, rather than introducing wholesale changes.

1.6 More detail on all the above points is set out in our submission.

2 BACKGROUND

2.1 This submission is made by Gowling WLG (UK) LLP, an international law firm.

2.2 Our comments are based on our experience of acting for:

   (a) trustees of schemes of all types in all industries and sectors and ranging in value from approximately £50 million to £4.5 billion; and
   
   (b) national and international employers of all sizes who participate in many types of schemes.

2.3 Our UK pensions team is one of the largest such teams in the country, with over 50 specialist lawyers. The team has been repeatedly shortlisted for major industry awards and is recognised in relevant industry publications. We consider that our experience means we can provide a useful submission to the Committee to support and inform the debate around the future of DB pension schemes.
3 OUR SUBMISSION

3.1 Overall framework

It helps at the outset to set out briefly the overall framework within which DB pension schemes operate.¹

(a) A pension promise is simply a promise of future payment, and so in the absence of any other legal provisions, the employee starts from the same position as any other creditor. Most creditors would want protection against counterparty credit risk in relation to a long-term obligation, and as there is a public policy in favour of supporting individuals who wish to make provision for their retirement, it is logical for that public policy also to assist the employee by providing protection against the employer defaulting on the promise. (We do not comment on whether the public policy is right or not.)

(b) The pension scheme is legally required to exist under irrevocable trusts (i.e. there is legal separation from the employer via the use of trustees) and its assets cannot be mostly invested in the employer.

(c) There also exists a requirement for it to be funded to meet the statutory funding objective, or for a recovery plan to be in place if it is not, and for a deficit to be made good if the employer wishes to exit the pension scheme (via a “section 75 debt”).

(d) Next, there is protection in the form of TPR's “moral hazard” powers in respect of actions taken that might weaken the employer’s ability to make the payments required under (c).

(e) Finally, there is the PPF which provides compensation if, despite all the above steps, an employer fails and there is a deficit in its pension scheme.

This shows that the overall legal architecture to protect members already exists. The second level of enquiry therefore is to question the effectiveness of its constituent parts, to which we turn in the remainder of this submission.

3.2 Regulation by TPR

(a) Points (c) and (d) in paragraph 3.1 above are regulated by TPR, and in this section we set out comments on the effectiveness of this regime.

(b) TPR already has wide powers in relation to DB schemes. The prevailing view we hear is that these powers are adequate but could be used more effectively. There are arguments for TPR to be more proactive and interventionist (i.e. to become involved at an earlier stage before the problem or deadlock has arisen). The threat of a more interventionist regulator would strengthen the position of trustee boards in their negotiations with employers and assist trustees to engage more effectively with

¹ This submission relates solely to funded, occupational, registered pension schemes in the private sector.
employers at an earlier stage (thereby helping to avoid protracted negotiations). There is a perception that TPR is not always supporting trustees sufficiently.

(c) Considering first TPR’s role in funding negotiations: although we have seen successful instances of TPR using its “proactive engagement” system of discussing matters with trustees and employers before a valuation is signed, we are also aware of anecdotal evidence of TPR not supporting trustees when they have reached an impasse in negotiations. This may be due to resourcing constraints and the need for TPR to focus its energies on the schemes that are at the greatest risk of failure. However, when the recommendations of the Committee are formulated, it would be helpful if they can address the extent to which TPR is able to support trustees in funding negotiations.

(d) We turn next to TPR’s role when an event, such as a corporate transaction, occurs which could damage the strength of employer covenant supporting the pension scheme (a “Type A Event”). TPR’s moral hazard powers can be used where support is not put in place to mitigate the effect of a Type A Event. The powers are a disincentive to employers from not mitigating Type A Events. However, they are essentially reactive, being designed generally to be used after the damage to covenant has been done. There is little support for trustees who may be negotiating a mitigation package with an employer but who are not satisfied with the package that is on offer. Although TPR can and does ask to be kept informed in relation to such situations, we have seen in practice that TPR may be reluctant to take an active involvement, preferring to leave it to trustees and advisers to negotiate the best package possible. That approach makes sense in normal circumstances where the trustees and employers are genuinely trying to avoid any detriment to the security of member benefits. It leaves the risk that, if the trustees fail to obtain sufficient mitigation, the transaction proceeds anyway and by the time TPR seeks to enforce its moral hazard powers, the value may have moved beyond its reach.

(e) Again we express no view on the policy question of the extent to which TPR should be proactively involved in such transactions – it would not necessarily be possible or desirable for TPR’s approval to be a precondition to the completion of such transactions, but there is a scale of possible levels of proactive involvement. A possible middle ground would be to offer stronger proactive support to trustees in negotiations where the trustees ask for it on account of a valid concern that an inadequately-mitigated Type A Event is about to occur.

(f) Any changes on the above lines would entail a fundamental re-think about the approach TPR takes (including how it conducts investigations and gathers information) and the use of the resources available to it.

(g) There are also concerns about the extent of the international reach of TPR. The uncertainty around how far TPR can enforce its powers against overseas companies risks undermining the standing of TPR and its effectiveness. That in turn weakens the position of trustee boards and undermines their ability, for example, to secure appropriate support from overseas group companies. This perceived inability to pursue overseas companies does, on occasion, inform the behaviour of corporate
entities who consequently do not give sufficient priority (or resources) to their pension obligations. There are also concerns that this uncertainty has created a reluctance on the part of TPR to pursue (or even engage with) overseas companies.

(h) This is a complex legal area and one which is not entirely within the control of TPR or Parliament. We would envisage that enforcement within any of the EU or EEA countries would be easier or more likely to succeed (although whether Brexit will affect this remains to be seen) than an attempt at enforcing a financial support direction (FSD) or contribution notice (CN) in other countries. Further, in practice, TPR has had some success in enforcing FSDs, for example in the Sea Containers case where a US Court endorsed FSDs and held that they did not infringe the automatic stay on proceedings under Chapter 11 of the US Bankruptcy Code. However, contrast this to the view taken by the Ontario Superior Court of Justice (in the Nortel case) that any outcome of an FSD would be null and void in a Canadian insolvency process (although ultimately the trustees of the Nortel schemes were able to share in the residual assets of the Nortel entities).

3.3 The Pension Protection Fund

(a) Views diverge over the long term sustainability of the PPF and also the fairness of the current levy system.

(b) In relation to the issue of sustainability, there is uncertainty whether in the long term the PPF is sustainable given there will be fewer entities supporting it. There are also concerns about how the funding level of the PPF is currently measured and whether this accurately reflects its financial state (when compared to the funding standards to which occupational pension schemes are subject). Also, it is difficult to assess the potential impact on the PPF of the collapse of one or more FTSE 100 companies. We note, however, that the PPF has made plans for its long term sustainability, in its Long-Term Funding Strategy.

(c) As regards the current levy system, there is an argument that it does not make sense to charge the weakest funds and companies the higher levies as this is simply making pension benefits even more unaffordable for those companies already struggling, particularly if they suffer an adverse event. This is not a new argument. An alternative basis would be to look at the benefits payable by each scheme.

(d) A further question of fairness arises in relation to those pension schemes who have a non-EU/EEA employer. These schemes pay the levy but it is unclear whether they would actually be permitted to enter the PPF on the employer becoming insolvent. Currently, such a scheme would only be allowed entry into the PPF if a UK court exercised its discretion to order insolvency proceedings in the UK under the Insolvency Act and currently there is no guarantee that this would happen. Without that order of winding-up, entry into the PPF could not occur. Such employers and schemes do not currently fall within the so-called alternative PPF entry route either. Whilst we welcome changes to the PPF legislation made as a result of the Olympic Airlines decision, we believe the legislation could be extended further.
(e) The PPF legislation is also over-complicated, especially for multi-employer schemes. For example, there is a risk that a scheme could accidentally be left ineligible for the PPF (with the severe consequences that brings for members) owing to a technical failure (or trivial mistake) to ensure that its employers are "statutory employers" for the purposes of the legislation. There is scope to clarify and improve the legislation to avoid this risk.

3.4 The role and powers of pension scheme trustees

(a) The role and powers of pension scheme trustees have evolved considerably since the Pensions Act 1995 came into effect. In our experience, trustees have sufficient powers and responsibilities and there is no apparent need to expand those powers or responsibilities at present.

(b) Linked to this are questions around the quality and standards of trusteeship, which are the subject of a separate consultation by TPR (21st Century Trusteeship and Governance), to which we have responded. We do not propose to go into details here but, although we believe there are measures that can be introduced to promote good governance, we caution against the introduction of further regulation. This is an area that small schemes are likely to find more challenging due to a lack of resources (and this is also covered by the TPR consultation).

3.5 Relationships between TPR, PPF, trustees and employers

Many schemes have trustees and employers who engage effectively and constructively with each other in order to try to balance the competing demands of members' interests and the ability of the employer to conduct its business. In those scenarios, there is little call for intervention from TPR (or the PPF). However, where that engagement or co-operation is not forthcoming, in order for trustees to be able to carry out their role, they need a well-functioning regulator supporting them. In this regard, we refer to our comments in paragraph 3.2 above.

3.6 The balance between meeting pension obligations and ensuring the ongoing viability of employers

(a) There are no easy solutions to achieving a balance between accrued pension rights and the ongoing viability of employers. However, it is important to remember that these are legally binding obligations which employers have voluntarily assumed (at least in the main part, although some obligations are derived from statutory requirements, such as statutory indexation and revaluation). This is an important principle and there would need to be very clear public policy reasons for allowing companies to avoid or dilute these obligations (a question that was central to the consultation on the British Steel Pension Scheme). There is, however, scope for debate over the extent to which an employer should be required to commit assets now in order to be able to fund the payment of such future obligations.

(b) We consider there to be a number of issues that could be examined with a view to relieving the immediate financial burden placed on employers while still safeguarding
members’ accrued benefits (and also reflecting that pensions are long term liabilities).

For example:

(i) allowing for more flexibility around the timing of actuarial valuations. This could take the form of extending the valuation cycle (say to 5 years) or moving away from a fixed valuation date and instead using an "average" over a period of time;

(ii) allowing longer recovery periods, if the employer covenant is strong enough. We welcome the change in approach by TPR which has stepped away from its 10 year rule of thumb for recovery period lengths;

(iii) reviewing the current technical provisions basis and in particular the use of gilts in the calculation of the technical provisions. The experience of many schemes in the aftermath of the EU referendum demonstrates that this is an area of concern: scheme deficits have increased significantly yet the benefits they pay and their employers’ covenants have not changed.

(iv) allowing a scheme whose employer is struggling to fund its obligations in full to apply a lower level of prudence for the more generous aspects of its benefit design (such as inflation-proofing, bearing in mind that these elements of pension benefits have been partly imposed on employers by statute and were not always envisaged at the time the schemes were established);

(v) a further debate on funding and investment, especially around whether extreme circumstances justify reduced investment matching and how far TPR is willing to accept this mismatch;

(vi) a review of the legislation that imposes a "section 75" debt when an employer exits a pension scheme. It is extremely complex legislation. It is also arguable that the legislation is disproportionate in requiring benefits to be funded to the level required to buy them out with an insurer, but there are valid arguments that this requirement is a fundamental part of the protection for members to stop employers walking away from their obligations without having paid the full cost of honouring those obligations (this is a policy question on which we do not comment);

(vii) greater support and encouragement for the development of innovative funding solutions, for example, asset-backed contribution arrangements (known as "ABCs"). If implemented properly, these are a "win-win" solution for employers and trustees, because they give trustees secured access to specified employer assets in the event of insolvency, but enable those assets still to be used by the employer for the purposes of its business, and allow for a longer recovery plan to be agreed. TPR’s practical guidance on these structures was sound, but it would have been possible to interpret TPR’s tone as one of suspicion or scepticism rather than encouragement. More positive support from TPR in the development of new funding ideas would be welcomed and appreciated.
From our experience, there seems to be little appetite for allowing employers further room to reduce benefits, even in exceptional circumstances.

(i) In circumstances of extreme distress, mechanisms already exist to enable this: members’ benefits can be reduced with their consent (but this may not be practicable) and where insolvency is otherwise inevitable, a scheme can be "abandoned" to save the employer's business, i.e. the scheme is dropped into the PPF (or bought out with an insurer if its assets are sufficient to buy greater benefits than PPF compensation but insufficient to buy full scheme benefits).

(ii) The legal process to enable this can be unnecessarily convoluted, however, creating a risk that employers that could have been saved are allowed to fail because of the difficulties in separating them from their pension scheme, even where that is in the overall best interests of its stakeholders.

(iii) It may also help to facilitate a middle ground for struggling employers, between those extreme solutions and carrying on with benefits remaining payable in full (where this would ultimately lead to insolvency). If trustees are satisfied that the scheme is inevitably headed for the PPF if nothing is done, but could afford to continue as an ongoing scheme with a less generous benefit design, there could be a mechanism introduced to enable this, and to scale benefits back up if the employer recovers, subject to the approval of TPR (so it is not solely a trustee decision).

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