Dear Sirs

Pension Protection Fund and Pensions Regulator inquiry

I am writing on behalf of the Association of Pension Lawyers (the "APL"). This response has been prepared by the Legislative and Parliamentary Committee of the APL (the "Committee") with input also from the Main Committee of the APL. The Association of Pension Lawyers represents members of the legal profession in the UK who specialise in pensions and pensions-related law. It has over 1000 members. It is a non-political, non-lobbying, not for profit organisation. We advise all sizes and types of pension schemes and have done so for more than 25 years.

A General comments

On the whole we think that pensions law does not need any radical overhaul. The scheme specific funding rules have considerable flexibility to cater for different economic circumstances and different circumstances of employers and schemes. The Pension Regulator's anti-avoidance powers are already wide and widening them further could hamper business.

It is worth noting that the beneficiaries of the BHS scheme will fare significantly better than those of the Maxwell pension schemes, which demonstrates that the law is now more protective of beneficiaries. Looking specifically at the BHS scenario, it seems to us that many of the events which caused concern took place before the Pensions Act 2004 came into force; the BHS case should therefore not be used to suggest that current law is fundamentally flawed.

The issue of the Pensions Regulator's regulatory powers has been considered and balanced before; the present structure was an attempt to balance various interests. The pension legislation was always intended to strike an appropriate balance between the interests of the various stakeholders. Any change to the balance may result in:

- greater burdens on employers and negative impact on UK business;
- increased unwillingness of investors to invest in any company or corporate group with a DB scheme because of regulatory exposure; and
- greater need for resourcing of the Pensions Regulator.

It has taken significant time for stakeholders to understand and work with the current framework. There is no silver bullet. The current framework is now working pretty well. Any changes should be
carefully considered as there is significant cost to adapt to change and any further cost for DB schemes and their sponsoring employers should be avoided unless a real and proportionate improvement can be achieved.

Pensions legislation can't prevent difficult economic times; similarly pensions legislation can't prevent a business which isn't viable from becoming insolvent.

Below we provide comments on each of the 5 areas where submissions were requested.

**B Defined benefit pensions regulation by the Pensions Regulator (tPR)**

1 **Introduction**

1.1 The Committee is only able to make observations by reference to cases in which its members have been involved or which are otherwise in the public domain (eg. as a result of a s.89 report by tPR or High Court litigation). These cases are necessarily limited and may not reflect the full range of regulatory activity. The observations below should be understood in that context.¹

1.2 For the purposes of this response we are concerned with those powers of tPR which are specific to DB regulation, in particular:

(a) "moral hazard" powers under ss28 to 56 Pensions Act 2004 (the "Act");

(b) scheme funding powers under s231 of the Act; and

(c) matters relating to the operation of the Employer Debt Regulations.

We also comment on the ancillary power under s72 of the Act for tPR to access information.

2 **Moral Hazard Powers**

**Adequacy of regulatory powers**

2.1 TPR's "moral hazard" powers are very wide. They enable tPR to impose Contribution Notices and Financial Support Directions in order to further its statutory objectives to protect members' benefits and reduce the risk of calls on the PPF. A summary of these powers and their potential reach is set out below.

¹ As an ancillary point, it may be helpful for tPR to publish a s.89 report in a greater number of cases where regulatory powers have been exercised or the exercise has been considered but the Regulator has concluded that it is not appropriate for it to use its powers (eg because an agreed outcome has been reached to the satisfaction of the Regulator). This would enable stakeholders to better understand (if accurate) that tPR exercises/considers exercising its powers more frequently than might appear to be the case, and the grounds on which such exercise has been made. However, the Regulator would need to be mindful of the balance which would need to be struck with its statutory duties of confidentiality and the impact that greater risk of publicity might have on the willingness of parties to discuss issues with the Regulator.
(a) **Contribution notice (CN)**

(i) A CN is a sanction requiring the recipient to make a financial contribution to the applicable scheme. The level of that contribution is a matter for tPR's discretion. There is limited guidance at present as to the principles which tPR should adopt when approaching quantum.

(ii) A CN can be imposed on an employer or any entity (including an individual director) who is "associated" or "connected" with that employer. The definitions of associated and connected are taken from the Insolvency Act 1986 and are very broad. In effect they enable tPR to extend financial liability for a DB scheme across a corporate group (i.e. beyond its sponsoring employers).

(iii) A CN can be imposed where (broadly) the target of a CN has been party to an act, or failure to act, the effect of which is either:

(A) to prevent a debt under s75 of the Act^2^ (a "section 75 debt") from becoming due, reduce the amount of that debt, or otherwise prevent it from being recovered; or

(B) to make it less likely that benefits from the scheme will be paid in full (the "material detriment test").

(iv) A warning notice in relation to the imposition of a CN can be issued for up to six years after the date of the relevant act, or failure to act (or the end of a series of acts/omissions).

(v) It must be reasonable for tPR to impose a CN, and to impose a CN in a particular amount. The Pensions Act 2004 sets out a list of factors which must be taken into account by tPR when exercising his discretion. This list is non-exhaustive.

(b) **Financial Support Direction (FSD)**

(i) An FSD requires the target of the FSD to put in place financial support for the applicable scheme.

(ii) An FSD can also be imposed on an employer and on entities which are associated or connected with that employer (see above). Unlike a CN, an FSD cannot be imposed on an individual.

(iii) An FSD is not "fault" based. The test for imposing an FSD is an objective test. An FSD can be imposed at any time that either:

(A) the employer is a service company; or

(B) the "insufficiently resourced" test is satisfied. In short, the insufficiently resourced test will be met if the employer has net assets

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^2^ i.e. the debt which arises on an employer to make up the funding deficit in a scheme on a full "buy-out" basis where the scheme winds up, the employer ceases to participate in the scheme or the employer suffers an insolvency event.
equal to less than 50% of its estimated s.75 liability and another entity (or another entity together with entities with which it is associated or connected) has assets equal to the shortfall to the 50% level in the s.75 deficit.³

(iv) It must be reasonable for tPR to impose an FSD. The Act sets out a list of factors which must be taken into account by tPR when exercising his discretion. This list is non exhaustive.

(v) The sanction for failure to comply with an FSD is a CN.

2.2 These powers are very wide reaching and can be exercised to capture entities which would otherwise have no obligation in relation to the relevant pension scheme. The Committee’s view is that they are sufficiently wide to enable tPR to facilitate or achieve financial support for a pension scheme without generally having a disproportionate bearing on corporate activity (see below for exceptions to this).

2.3 In our experience, the effect of the powers is largely preventative as opposed to curative: the risk of a sanction has largely caused sponsors and other entities involved in corporate activity to pay much closer attention to the position of the pension scheme in the context of corporate activity and to consider the provision of support/mitigation where the scheme may otherwise be disadvantaged. In this way, the existence of the powers has provided the improved protection for schemes that we understand they were intended to achieve. (We note in particular that the ability of tPR to impose a CN on an individual director, whilst not widely used, can act as a significant deterrent to behaviour which might otherwise be of concern to tPR.)

2.4 Notwithstanding our general observations outlined above, there are instances where the existence of a DB scheme coupled with the fact of tPR's powers (and their potential reach) can constrain commercial activity. For example, the Committee is aware of circumstances in which lenders have declined to lend in circumstances where there is the risk of financing being diverted to a DB scheme, and certain buyers will not (as a matter of policy) acquire entities with DB liabilities (given the risk of "contamination" of the wider corporate group). An extension to the scope of the existing powers could therefore have a negative impact on certain commercial activity (including ability to get funding) and consequently on the strength of the employer entities supporting the applicable schemes.

Application of regulatory powers

2.5 Given the breadth of tPR's moral hazard powers, the question of adequacy becomes one of tPR's practice in using its powers. So far as we are aware, tPR does not exercise its powers widely and, specifically, does not have an established practice of intervening and seeking to use its powers at an early stage (e.g. most cases where it has used its moral hazard powers (or threatened to do so) have been insolvency situations). We note this as an observation only and appreciate that the merit of implementing an early intervention approach (and the additional resourcing this would require) would need to be weighed against the potential advantages which could result from deploying that resource elsewhere (e.g. in respect of scheme funding – see below).

³ Note that once the "insufficiently resourced" test is satisfied an FSD can be imposed on any associated or connected entity – it need not have been taken into account for the purposes of meeting the test.
2.6 That said, the Committee is aware of a number of (unpublished) cases where tPR has used its powers at an early stage (prior to an insolvency), where that early intervention has been successful in protecting the scheme.

2.7 We understand that tPR has, in the past, suggested that the powers are not workable because of some of the ambiguities in the powers (the key example being what is or is not reasonable). In our view, the concept of reasonableness is at the heart of these powers and is essential to the existence of such powers not causing significant difficulties for corporate groups with DB schemes (e.g. if there was no concept of reasonableness such that the Regulator simply had discretion to make connected parties liable it would exacerbate the issues mentioned at 2.4 above). If the Regulator were to “test” its powers more readily, this would enable precedents to be established to provide more certainty.

Potential improvements to legislation

2.8 There are certain instances where the moral hazard legislation could be improved without being materially redrawn. Notably, the "insufficiently resourced" test for a FSD is complex and cumbersome, and cannot be easily monitored from time to time. Further, it can produce what appear to be arbitrary results: for example, if an employer can meet 49.5% of its s.75 liability a connected party can potentially be made liable for up to 100% of said liability, whereas if the employer can meet 50.1% of its liability then the connected party cannot be made to bear any of the liability. We query whether such a “cliff edge” was the policy intent.

3 Scheme funding and recovery plans

Adequacy of powers

3.1 TPR's powers in relation to scheme funding are also very wide. In short, under s231 of the Act, where tPR considers that the trustees have not complied with the requisite scheme funding legislation (which requires the application of a subjective approach) it may impose its decision.

Again, the Committee’s view is that these powers are adequate but that they are not always used to maximum effect – see below.

Application of powers

3.2 TPR has stated publicly that it considers itself to be a "referee not a player". Whilst we appreciate that tPR's preference is for parties to reach an acceptable consensus without the requirement for regulatory intervention, in our experience this approach often does not facilitate the provision of meaningful support or guidance to trustees (and indeed employers) during valuation discussions particularly where those discussions are challenging and agreement is difficult to reach.

3.3 First, where a funding agreement has been reached which tPR will not "accept" (albeit that there is no statutory basis for tPR to refuse to "accept" a valuation) tPR will often not inform trustees or employers what adjustments would be required in order for the valuation to be "acceptable". This can result in a prolonged and ultimately inefficient process as the trustees and employers either try to identify and address tPR's concerns, or alternatively do not change their position, and take the risk of formal tPR action.
3.4 In appropriate cases, it may be more helpful for trustees and employers for TPR to engage more willingly in substantive dialogue around its concerns and the steps which trustees and employers can take in practice to address those concerns. We note that TPR will often suggest generic steps – e.g. the provision of a parent company guarantee – notwithstanding that they may not be appropriate or achievable in the specific circumstances. We also note that where TPR does threaten to use his powers, there is no settled practice of disclosing to the affected parties which power it intends to use and to what effect. We consider such visibility to be desirable.

3.5 Similarly, where trustees are negotiating with an employer which is not able financially to agree a schedule of contributions and recovery plan which TPR considers acceptable, absent any meaningful assistance from TPR the process can stall and be inefficient. To some extent this situation results from the fact that the current regime does not contain measures for addressing schemes in this position (the "distressed scheme"). However we nevertheless consider that TPR could provide more engaged and practical support (with realistic solutions) in these circumstances. Lack of resources seems to underline TPR’s lack of engagement with smaller schemes (as it takes a proportionate approach). But small schemes could often benefit from TPR assistance.

Potential improvements to legislation

3.6 The scheme funding legislation allows a 15 month period from the valuation effective date for the parties to agree the applicable recovery plan. TPR cannot intervene until there has been an actual breach, and so cannot intervene until after the statutory period has elapsed or the valuation has been submitted (whichever is earlier).

3.7 Given technological developments since the Act came into force, it is now more unusual for this period of time to be required in terms of preparation of actuarial calculations which could be an argument for shortening the 15 month period. That said, in many cases (particularly those for larger and/or more complex schemes where funding negotiations may be bound in with complex covenant support negotiations) it does take time to negotiate and finalise details.

3.8 One potential approach might be to enable TPR to become involved in the process at an earlier stage, for example, if the trustees advise TPR that they have concluded that agreement will not be reached. However, the Committee considers that this would be achievable in practice (without the need for legislative change) through TPR’s current early intervention processes for scheme valuations if TPR were more proactive in its engagement.

4 Prioritisation of resources

4.1 TPR has stated on different occasions that it considers the way in which it performs its regulatory functions to be appropriate, but also that it suffers from resourcing constraints. We note these points. It may be helpful to obtain TPR’s views as to how it would allocate its resources were it to have a larger team (e.g. as the FCA has).

4.2 In practice, it is difficult to understand how TPR chooses to prioritise its resources. That said, we note that once TPR has initiated regulatory activity it can become heavily engaged. TPR is structured to operate through case teams, involving specialists from each division (legal, business, actuarial etc). Given the need to engage each of these individuals on case matters, it can be difficult for TPR to move nimbly and processes can become unwieldy and time
intensive. This may impact on the extent to which tPR's approach to any situation is considered "commercial" or helpful.

4.3 As noted above, tPR's powers to obtain information by way of issuing a s72 notice are extensive. The Committee agrees that the exercise of this power can be appropriate to facilitate the performance of tPR's functions. However, in our experience such notices are drawn widely, making it unwieldy, time consuming and potentially distracting for sponsors and trustees. Further, tPR may issue multiple notices to multiple parties, resulting in material duplication of effort and information. The result of the power being exercised in this way is for large volumes of information to be disclosed which tPR's teams then appear under resourced and ill-equipped to deal with. This causes delay in circumstances where the intervention may be causing material commercial uncertainty (which is not in the best interests of any party, including the scheme). We would expect trustees and sponsors to be more willing to share specific information on a voluntary basis if forewarned that tPR would otherwise exercise this power.

5 Clearance

5.1 The clearance process was intended as a means of ensuring that the threat of tPR moral hazard sanction did not become an impediment to corporate activity. Whilst there are circumstances in which the process works well, overall our view is that the manner in which tPR has decided to operate the clearance process is not fit for purpose or meeting that objective.

5.2 TPR has issued guidance which documents the way in which it expects the clearance process to work. As part of this guidance, tPR has defined the types of circumstance in which it would expect clearance to be appropriate – referred to as "Type A events". Whilst these can be helpful examples for commercial parties, they are not a statutory concept and consequently should be no more than illustrative. In practice, however, tPR's policy is to stick very rigidly to the terms of the guidance – effectively telling parties that they cannot apply for clearance if tPR does not consider that they have provided sufficient evidence that there is a “Type A event” or that, if they do apply for clearance in such circumstances that application will be refused on policy grounds regardless of the merits of the application.

5.3 This means that it is not always possible for parties who wish to seek clearance to obtain it, even though the clearance process was intended to give parties an opportunity to obtain legal certainty that no sanction would be imposed. TPR's rigid adherence to their policy can deny parties that opportunity for legal certainty. Further, as clearance is only available for specific transactions/events, which tPR insists must be separately mitigated, the clearance process does not allow for parties to achieve a “clean break” even where clearance is available because of the very wide range of circumstances in which tPR can impose liability (particularly for an FSD).

5.4 This can be particularly problematic in circumstances where a transaction is intended to result in a "clean break" for a seller or purchaser. If clearance is not granted (because tPR does not consider it to be necessary) or if its efficacy is contingent upon the purchaser taking certain actions in the future, this does not provide the requisite level of commercial certainty for the relevant party. This often means that clearance is not considered to be a useful option, even if it is theoretically available.
5.5 For some transactions, this may not be particularly problematic because tPR risk can be allocated amongst the parties by means of indemnity protection. However, this only works where the indemnifier has deep pockets. Where the indemnifier is insolvent or a man of straw, indemnities will offer no commercial protection for the relevant party – which may mean that the transaction cannot go ahead. This is contrary to the statutory framework which envisages a clearance regime in order to provide precisely this protection.

5.6 Illustrating this by reference to a specific example may be helpful. Members of the Committee were involved in a case where a corporate group had three divisions (all of which were separate legal entities), one of which was employer to a defined benefit pension scheme. That corporate group was in significant financial distress and proposed selling two of its divisions to maximise returns for the group’s creditors (including the scheme). Because the sale companies were associated with the employer, potential purchasers were aware that tPR could use its moral hazard powers (in particular the “no fault” FSD) against them for up to two years after the purchase, even though purchaser would have paid full value for those companies. An indemnity from the distressed seller was worthless and tPR did not consider there was a Type A event and so indicated that clearance would be refused on policy grounds, making it incredibly difficult for purchasers to get comfortable in going ahead resulting in considerable time and cost being wasted on agreeing an alternative regulated apportionment agreement structure.

5.7 The upshot of the fact that it is largely not possible for corporates to obtain legal certainty that they will not receive a moral hazard sanction, coupled with tPR generally expecting to extract a "price" for granting clearance (even where mitigation has otherwise been agreed between the trustees and sponsor) is that in many cases (outside of distressed situations) corporates will often decide that there is no merit in seeking clearance at all and will instead rely on having had appropriate regard to the impact of any activity on the scheme and having engaged properly with the trustees. It was plainly not the intention for there to be a clearance process that corporates were disincentivised to use.

5.8 In contrast to the foregoing comments we note that, where tPR does consider clearance to be within its policy, it can act quickly and respond to commercial timescales. This is helpful and recognised and appreciated by stakeholders as a commercial application of resource.

5.9 Our view is that the legislation should not be changed to introduce mandatory clearance. The purpose of clearance when it was first introduced was not to provide information to tPR (this is done through the notification requirements) or to provide protection to pension schemes (this is done through the moral hazard powers) but rather as a response to concerns from stakeholders that the existence of moral hazard powers would significantly hamper commercial activity. Clearance was therefore intended to benefit stakeholders who wished to take advantage of it.

5.10 In addition, we think it would be very difficult to create a mandatory clearance regime which was clear enough to create certainty and covered all scenarios where a potential risk to a pension scheme could arise. It would need to be very clear when clearance was required – if this was narrowly drafted (eg only covered sales of companies with DB schemes) it would inevitably not cover many relevant situations such as refinancing or payment of dividends; on the contrary if it was widely drafted to cover all possible scenarios, tPR would need significantly more resourcing. If it were subjective (such as the current "Type A definition), tPR would also need significantly increased resourcing as it would be required to confirm whether clearance was applicable in cases where it was not clear whether or not clearance
was required. It would also need to have a formulaic approach towards mitigation as it would not be appropriate for tPR to have wide discretion where clearance was compulsory.

6 Supervision and Proactive Regulation

6.1 We have commented above on the difficulties which can arise when tPR acts as "referee not player". We consider that funding processes could be significantly more efficient in distressed situations if tPR played a more open and pro-active role: on the one hand informing the relevant parties why or to what extent it does not "accept" certain matters, and at the same time clarifying what steps they expect trustees to take (within the scope of their powers and realistic in the circumstances e.g. a parent company with no moral hazard exposure is unlikely to be persuaded to give a parent company guarantee).

6.2 We are also aware of employers raising questions of proportionality and commerciality. Whilst it is accepted that tPR is a public body for the purposes of exercising its powers, its stated position that it cannot "fetter its discretion" can lead to circumstances in which it is not possible for the relevant parties to address an issue commercially and as a result of which matters become elongated and potentially negate the possibility of reaching a commercial settlement. We also query whether there are circumstances in which the concept of fettering discretion is confused by tPR with the power to make and implement a decision. For example, we are aware of circumstances in which tPR has stated that a party should take comfort as to tPR's future behaviour from the fact that the party has the ability to make an application for judicial review of tPR's actions. This does not provide commercial certainty.

7 Employer Debt powers

7.1 We comment specifically on the Regulated Apportionment Arrangement regime, which is used for corporate groups in distress to enable a defined benefit pension scheme to enter the PPF (and be detached from the corporate group) without an insolvency event occurring in relation to the scheme's employers. This enables restructurings to take place in a manner most likely to maximise returns for all stakeholders (e.g. an alternative approach of an insolvency event followed by a business sale can be followed, but that can result in significant erosion of value if particular assets are negatively impacted by the insolvency event and/or business sale).

7.2 TPR has powers under the Employer Debt Regulations which mean that its approval is required for Regulated Apportionment Arrangements (RAAs). RAAs are a critical tool in rescuing companies with DB pension schemes in distressed situations and tPR's power to approve RAAs enables companies to be rescued and the recovery to the scheme/PPF to be maximised. However, there are a number of key failings in the RAA legislation, the most important of which is that, once a compromise deal has been reached with tPR, PPF and trustees, there is a statutory 28 day period that is required to elapse between the Regulator issuing a warning notice indicating that it is minded approve an RAA and the final approval notice. This is in contrast to clearance, where there is no minimum period and the Regulator can and does helpfully condense the process where appropriate so that the warning notice and final determination notice can be issued very close together (sometimes within hours).

7.3 This delay for an RAA serves no useful purpose. The purported aim is to enable directly affected parties to make representations to tPR about whether or not the RAA approval power should be exercised, but the only directly affected parties (and hence the only parties who receive the warning notice) are parties who will already have agreed to the RAA. Further, the delay can positively endanger the ability to rescue distressed companies, particularly where
(as is often the case) the pensions negotiations are being conducted in conjunction with complex compromise negotiations with other stakeholders (such as banks, employees, landlords etc.). In those circumstances, each day counts: the company in distress might not be able to continue trading for a further 28 days (i.e. in effect, the legislation requires the parties to reach a pensions deal 28 days in advance of the final crunch point). Further, even if a pensions deal is reached, setting the 28 day period running, if the situation of the company changes materially (e.g. because of what happens in continuing negotiations with other stakeholders) during that 28 days then there is a risk that the RAA will not be effective unless the warning notice is reissued (restarting the 28 day period and compounding the timing problem).

7.4 See below for further comments on RAAs in the context of the interrelation between tPR and the PPF.

8 Guidance and Risk of Precedent

8.1 tPR has published extensive guidance. Whilst intended to provide insight into the way in which tPR expects parties to behave and would expect to exercise its powers, it is lengthy, requires interpretation and ultimately does not (and perhaps cannot) provide clear answers.

8.2 Whilst there are certainly instances of tPR (and the PPF) being flexible and responsive to particular commercial situations (e.g. Kodak and Uniq), our predominant experience is that tPR is concerned not to set precedent and to stick very closely to its guidance (which is necessarily generic). This means that it can struggle sometimes to adapt to particularly challenging situations where bespoke/novel solutions are necessary unless significant political or other pressure is put on them – i.e. they tend not to look to the commercial reality of the best solution for a particular scheme. It is not clear to us the reason for this approach, but we do suggest that it merits scrutiny if tPR is to be an effective regulatory body.

C The Pension Protection Fund

1 The questions pertaining to the sustainability of the PPF and the fairness of the PPF levy systems are matters on which other organisations are better placed to comments. Clearly there must be a balance between a system like the current one which may be fairer but the complexity is difficult for employers to understand and no doubt expensive for the PPF to operate and a system where the levy paid is not a fair representation of the risk of the particular employer/scheme.

2 The level of PPF compensation is a matter for Government, subject to meeting (at present) EU minimum requirements.

3 However, PPF Compensation is funded through levies paid by ongoing schemes and so, in effect, by schemes’ sponsoring employers; it is therefore important that the PPF compensation structure (as funded by PPF levy payers) does no more than provide compensation for pension benefits that would otherwise be lost on employer insolvency; PPF levy payers should not have to pay levies to fund windfall benefits for individuals (so benefits in excess of what would have been provided to a member under the pension scheme).

4 The BSPS consultation has highlighted an anomaly in the PPF compensation structure where significant windfall benefits can be provided to members.
This is where a scheme provides temporary bridging pensions to members (normally in the period before state pension benefits become payable) such that the rate of pension payable to a member is higher for an initial period, following which the pension reduces at the agreed step-down age (typically state pension age).

Under current PPF compensation rules, the PPF assesses compensation by reference to the rate of pension in payment at a particular point (the assessment date). This rate of compensation is then payable for life (increased in accordance with PPF increase provisions). PPF compensation does not take account of any step down that is due to be made to that pension at a future date when assessing the starting compensation, nor does the PPF compensation payable reduce at that step down age to reflect the reduced pension that would then have been payable to the member under the scheme’s rules.

This gives individuals in receipt of temporary bridging pensions at the date of PPF assessment a windfall benefit if the pension scheme enters the PPF. This anomaly can result in the member receiving significantly greater benefits under PPF compensation than he/she would have done from the pension scheme.

In all cases, it results in this cohort of members receiving a more generous PPF compensation (relative to actual benefits) than that provided to other cohorts of members under the standard PPF compensation principles.

This is an anomaly which has previously been identified and statutory powers enacted to address it. However these powers have not yet been exercised.

The additional cost of providing such windfall benefits is significant – as indicated by the BSPS consultation.

As it is PPF levy payers who ultimately bear the financial burden of this, this anomaly should be addressed.

The role and powers of pension scheme trustees

Introduction

Occupational pension schemes are required to be set up under trust. This means that trust law applies to the scheme. Trust law developed over many centuries in the context of family settlements. It is important to note however, that an occupational pension scheme is a unique type of trust where the settlor (the employer) remains involved in the scheme. Occupational pension schemes are also subject to extensive Department for Work and Pensions (DWP) legislation as well as HMRC legislation. The role and power of pension scheme trustees is, therefore, determined by trust law, legislation and also the governing documentation of the pension scheme.

Identity and involvement of trustees

Trustees come from a very wide range of backgrounds. An increasing number are professional trustees (usually referred to as independent trustees), paid for carrying out their role although not centrally regulated, but most trustees are either members of the scheme nominated by other members, or employees nominated by the Company.
2.2 Legally speaking, the duties of all trustees are generally the same – trustees nominated by the employer are not "representatives" of the employer any more than member-nominated trustees "represent" the members. They must usually all make decisions as trustees, balancing the different interests involved, and disregarding any other role that they may have.

2.3 Trustees’ practical approach to trusteeship is equally varied – some schemes have a trustee chair who has more day to day involvement, and other trustees who take more of a back seat outside trustee meetings; in other schemes, there is more engagement from all of the trustees. Some trustees are heavily reliant on their advisers, while others are more proactive in their own right. More recently some schemes have appointed a single professional trustee to run the scheme often as a result of the difficulty in members to put themselves forward as trustees.

2.4 In addition, it is important to note that the trustees of an occupational pension scheme may be individuals, a corporate trustee (or a trust corporation) or a combination of individuals and corporate trustees. The role and powers of the trustee are the same whether or not the trustee is a number of individuals, a corporate trustee or a combination of both. In practice where there is a sole corporate trustee, it is the directors of the company who are in effect the trustees of the scheme.

3 The role of trustees

3.1 The key role for occupational pension scheme trustees is to act in good faith, honestly and loyally in the administration of the scheme for the benefit of the scheme's beneficiaries. The scope of this role is set out in both trust law, DWP legislation and Pensions Regulator guidance. Trustees are also subject to penalties for breaching their duties.

3.2 It is often said that a key part of the trustees’ role is to "act in members' best interests" (the phrase appears in some Pensions Regulator and Government guidance). While that can be a useful shorthand, it is over-simplistic for several reasons including:

(a) it is now generally recognised as clear that trustees are not exclusively there to protect members – in some circumstances they can (and should) balance member interests with those of the employer(s);

(b) trustees have no duty to "act" in any particular way – they generally have a duty to consider how their decisions affect beneficiaries, but then have a wide margin of discretion as to what action to take as a result; and

(c) the trustees' duties only operate within the powers that they have. If they do not have discretion to make a particular decision (by law or under their trust deed) they cannot make it (even if it is perceived to be in member interests).

3.3 As a result, trustees of different scheme in similar circumstances can and do react very differently. The very different decisions they make are generally equally valid in law and, provided they have gone about the decision-making process in the correct way, (other than in very extreme circumstances) that decision cannot be overturned by the Courts. There is no overriding requirement for trustees to act reasonably.

3.4 Similarly, it is sometimes suggested that trustees are under a duty to act "impartially". This is not correct in law – trustees must generally consider how their decisions affect different
groups, but how much weight to place on the interests of each group is up to them. In any event a duty to act impartially, if it existed, would be impossible for trustees to comply with.

3.5 In addition, trustees often have certain roles that are not formally set out in legislation or in their trust deed. A good example is Regulator clearance – the Pensions Regulator has various powers under the Pensions Act 2004 to extend pension liabilities beyond employing companies, to their "associates" and "connected persons", and operates a statutory clearance facility under which it can agree (on a binding basis) not to use those powers. Where a clearance application is made, the Regulator will typically attach great weight to the views of trustees (although they have no particular role under the legislation).

4 What powers do trustees have?

4.1 The first point to make is that the powers of trustees vary hugely from scheme to scheme – there is no "standard" set of trustee powers. The initial starting point for understanding trustees' powers is the trust deed and rules. The trust deed and rules is the pension scheme's governing documentation which sets out the benefits to be provided by the scheme as well as details as to how the scheme is to be run.

4.2 It is not only the trustees who have powers under the trust deed and rules, the sponsoring employer(s) usually also have powers. The extent to which the trustees or the employer has power to act either on their own or with the consent of the other is referred to as the "balance of power". The balance of power is scheme specific, that is, it depends on the particular terms of a scheme's trust deed and rules.

4.3 Once a scheme has been established it may be difficult to alter the balance of power by using the scheme's amendment power. Trustees and employer tend to be reluctant to agree to any amendment which will alter the balance of power put in place when the scheme was established.

4.4 In relation to scheme benefits, for example, it is rare for trustees to have a wide unilateral ability to alter benefit structures (more commonly it is a joint employer/trustee power). However, often trustees may have powers over certain aspects of benefit provision, such as (a) the basis on which pensions are exchanged for lump sums (b) the factors used for reducing pensions for early payment (c) the index used for increasing pensions in payment and/or revaluing pensions in deferment (e.g. changing from RPI to CPI). In some schemes these will be unilateral employer decisions, in others trustee decisions, and in others joint decisions.

4.5 There are also a number of instances where statutory requirements override the balance of power in the scheme. Examples of these include:

(a) investment of defined benefit scheme assets – trustees of defined benefit schemes have overall responsibility for setting high level investment strategy for their schemes;

(b) advisers – the scheme actuary, auditor, legal adviser, investment adviser, investment manager etc. must be appointed by the trustees; and

(c) funding – the Pensions Act 2004 sets out the requirements of the defined benefit scheme funding regime and, in particular, the balance of power between the trustees and the employer. There are only very limited exceptions where the scheme's rules
may continue to apply, for example, where the trustees have the unilateral power to set contributions without employer agreement.

4.6 A good example of a power granted to trustees by legislation is in relation to the statutory debt on the employer regime (set out in the Pensions Act 1995 and regulations) which applies to defined benefit pension schemes.

4.7 In summary, the debt on the employer regime applies when an employer exits a scheme at a time when the scheme is underfunded on the buy-out basis. The exiting employer is required to pay a debt equal (broadly speaking) to its share of the debt. Legislation sets out a number of ways in which all or part of the exiting employer’s debt may be apportioned to another employer. The legislation requires the trustees, in most cases, to consent to the proposed arrangement.

E Relationship between TPR, PPF, trustees and sponsoring employers

1 Again this is an area on which other organisations can probably provide more useful comment.

2 One point that we would mention is in relation to what role the PPF is supposed to play in respect of RAAs (being one of the main areas it has specific powers in addition to PPF levy/compensation payments).

3 There is a lack of clarity for stakeholders in relation to the role played by the PPF (and how this relates to the role played by tPR) in relation to RAAs. An RAA must be agreed to by tPR. It will not take effect unless it is also approved by the PPF (or, rather, the PPF confirms it does not object to the RAA). This suggests that the primary responsibility for approving an RAA is with tPR. However, as the effect of the RAA is that a scheme will enter the PPF, then the PPF could veto an RAA by objecting to its terms.

4 In reality, it is the PPF which often takes the primary role in determining whether an RAA can proceed and in negotiating its terms. It is often perceived to be acting as a commercial player in this role (so acting to obtain a benefit or contingent benefit for the PPF). The consideration required by the PPF before confirming it will not object to an RAA (so called anti-embarrassment) will often be held for the benefit of the PPF, and not the scheme members to which the RAA in question relates.

5 The position taken by the PPF to an RAA will often determine whether a restructuring/continuation of a business/pension scheme can take place or not, and the cost of this. The way in which the PPF exercises these powers can therefore have significant commercial consequences. However, there is not a clear statutory framework for how PPF should exercise those powers. It would be helpful to clarify what exactly the PPF’s role should be in connection with an RAA and how this differs from/fit with the role played by tPR.

6 TPR has defined statutory objectives against which it exercises its powers including that of protecting against claims against the PPF and/or minimising claims made. If tPR is happy with the commercial terms of a RAA restructuring, then should PPF have a separate role in the substantive approval of whether an RAA should/should not take place and/or imposing terms on which it should? If so, should there by clearer guidelines as to how the PPF, as a statutory body, should act in these circumstances?
F The balance between meeting pension obligations and ensuring the ongoing viability of sponsoring employers.

1 Introduction

1.1 This issue needs to be considered bearing in mind that the obligations of employers have in many cases been significantly increased by statutory requirements which have increased the required level of benefits, introduced funding requirements which have radically altered the balance of power in schemes, and prohibited any amendment which could be detrimental to accrued rights.

1.2 Ratcheting up of the pensions promises over time (e.g., preservation/indexation) has increased liabilities during good times which employers are now struggling to fund in economically challenging times. This is often at the expense of making adequate provision for current younger employees who typically have only DC provision.

Required level of benefits

1.3 Government has forced ever greater benefit obligations on schemes, thereby increasing scheme liabilities. For instance, schemes must now offer preserved benefits or the choice of a transfer value after 3 months (previously entitlement to preserved benefit arose only after 2 years pensionable service and before that only after 5 years), and all DB schemes have had to increase pensions in payment by at least statutory indexation in relation to pension accruing from 6 April 1997.

Required funding levels

1.4 The pendulum has swung dramatically over the years: from virtually no statutory minimum level of funding pre 1997, to the "weak" minimum funding requirement ("MFR") under Pensions Act 1995, to the statutory funding objective ("SFO") under Pensions Act 2004.

1.5 The debt legislation under section 75 Pensions Act 1995 has been repeatedly amended over the years and is highly complex. Initial changes increased the debt from one calculated by reference to the minimum funding requirement to one calculated by reference to the buy-out deficit. Many subsequent changes have moderated the impact of section 75 where an employer exists a multi-employer scheme e.g. by enabling the debt to be transferred to another participating employer where conditions are satisfied. However, the debt is still there and steps must be taken to address it. The DWP Consultation on possible relaxations in the context of multi-employer schemes closed earlier this year but the Government has yet to issue its Consultation response.

1.6 The amount of prospective section 75 debts is now often very significant and, since the decline in gilt yields particularly over the last 12 months, has reached record levels.

1.7 In many cases a scheme's deficit (both ongoing and discontinuance) is now so great that finding an acceptable solution is often very difficult. More substantive help from tPR in the more challenging situations and more flexibility from tPR could assist.

Prohibition against detrimental changes

1.8 Prohibition against adverse amendments to accrued rights in all circumstances prevents some prudent changes which might reduce benefits marginally but which could help significantly
with deficits and administration – the circumstances of the Halcrow scheme are not an uncommon scenario and the difficulty of resolving means that situations which are not viable are allowed to float on until ultimate insolvency occurs.

1.9 Sacrosanct position of accrued pensions, particularly those in payment causes inflexibility and leads to unnecessary complexity and arguably intergenerational unfairness.

2 TPRs objective to "minimise any adverse impact on the sustainable growth of an employer"

2.1 In practice TPR new objective is not a key issue in cases where the employer's viability is a concern. Some employers have seen trustees be a bit more flexible as a result but our overall impression is that the impact has not been material.

3 Whether the current framework is generating any inter-generationally unfair outcomes

3.1 As we say above, the sacrosanct position of accrued pensions, particularly those in payment causes inflexibility and leads to unnecessary complexity and arguably intergenerational unfairness.

3.2 The protection of accrued DB benefits inevitably creates intergenerational unfairness, particularly in difficult economic times during which employers are forced to fund historic DB benefits. While this will not always lead directly to lower wages/ pension contributions for current employees this will often be at least an indirect result.

4 Whether the current wider environment, including very low interest rates, warrants an exceptional approach

4.1 We consider the current funding framework is already flexible enough to deal with exceptional economic circumstances. TPR could be more supportive of, say, less prudent assumptions/ longer recovery plans to reflect current economic.

4.2 Consideration could perhaps be given to the way member liabilities and scheme assets are valued, both for scheme and corporate accounting policies to build in more flexibility.

4.3 Other suggestions for action are contained in the Pensions Institute's report "Milking and Dumping". This is a Pension Institute discussion paper. See in particular the Institute's suggestion for "amelioration" in paragraph 52 of the report. We have referred above to the difficulties caused by the Ratcheting up of liabilities through legislative change and the restrictions on making past service changes under section 67. A relaxation of section 67 may open the door to the amelioration options put forward by the Pensions Institute.

Yours faithfully

Rosalind Connor
For and on behalf of the Association of Pension Lawyers

September 2016