A. Introduction

1. Slaughter and May is a firm of solicitors with 112 partners. We act for a wide variety of pensions clients, including pension fund trustees, sponsoring employers and insurance companies.

2. We set out below our submissions on some of the issues on which views were requested by the Work and Pensions Committee (the “Committee”) in its call for evidence on defined benefit (“DB”) pension funds published on 8th August, 2016 (the “Call for Evidence”).

B. Executive Summary

1. We are doubtful whether the Pensions Regulator requires additional powers. We think the question is whether the Pensions Regulator currently has sufficient resources to be able to exercise its powers effectively. See further Section C below.

2. In relation to mandatory pre-clearances:

2.1 We are doubtful whether a mandatory pre-clearance regime for certain types of transaction will have any material beneficial impact for pension scheme members; in particular, we consider it quite doubtful (based on publicly available information) whether this would have had a material impact on the outturn for the BHS Pension Scheme.

2.2 However, it may be that there is scope for extending the “notifiable events regime” in a proportionate manner to catch certain types of transaction where an early warning system for the Pensions Regulator would be beneficial.

2.3 In this context, again based on publicly available information, it would seem probable that the decision to relinquish control of the employing company in relation to the BHS Pension Scheme would have been a notifiable event to the Pensions Regulator under existing legislation.

See further Section D below.

3. We think it important to avoid conflating two concepts:

3.1 the concept of a pension guarantee, and

3.2 the concept of an employer agreeing to make available a defined benefit pension scheme and to pay contributions to that pension scheme (but not to
take on the uncertainties of future economic outturns and the other uncertainties associated with providing defined benefit pensions (including longevity risk).

4. Governments have, over the years, converted what started as the second concept into the first concept. We are doubtful whether any well-advised private sector employer (at least looked at with hindsight) would have been willing to shoulder all of the risk of running a defined benefit pension scheme without having included safety valves (which have been progressively removed by legislation).

5. We also note that the Bank of England quantitative easing programme would appear to have had a material and adverse effect on many defined benefit pension schemes.¹

6. For more detail on 3, 4 and 5 above, see Section E below.

7. Consideration should be given to providing a middle ground in terms of risk sharing between employer and employees rather than the legacy private sector defined benefit pension schemes leaving all of the risk with the employer and the open defined contribution schemes leaving all of the risk with the employee. See further Section F below.

C. DB pensions regulation by the Pensions Regulator (the “Regulator”) (1): breadth of its powers

1. The Regulator already has the power to issue a contribution notice (“CN”) if it is of the opinion that the “material detriment” test is met in relation to an act or deliberate failure to act and it is of the opinion that it is “reasonable” to do so.

2. The “material detriment” test is set out in Section 38A of the Pensions Act 2004, introduced on 29th June, 2009.

3. The test is met “if the Regulator is of the opinion that the act or failure has detrimentally affected in a material way the likelihood of accrued scheme benefits being received”.

4. Section 38A is supplemented by a short Code of Practice, 12 (“Circumstances in relation to the material detriment test”), which sets out the circumstances in which the Regulator expects to issue a CN as a result of being of the opinion that the material detriment test is met.

5. According to the Code, the circumstances in which the Regulator expects to issue a CN as a result of being of the opinion that the material detriment test is met are:

5.1 the transfer of the scheme out of the jurisdiction,

¹ Leaving to one side those which had perfectly matched assets and liabilities (including, for this purpose, any hedging arrangements that had been put in place).
5.2 the transfer of the sponsoring employer out of the jurisdiction or the replacement of the sponsoring employer with an entity that does not fall within the jurisdiction,

5.3 sponsor support is removed, substantially reduced or becomes nominal,

5.4 the transfer of liabilities of the scheme to another pension scheme or arrangement which leads to a significant reduction of the:

5.4.1 sponsor support in respect of these liabilities; or

5.4.2 funding to cover these liabilities.

5.5 a business model or the operation of the scheme which creates from the scheme, or which is designed to do so, a financial benefit for:

5.5.1 the employer, or

5.5.2 some other person,

where proper account has not been taken of the interests of the members of the scheme, including where risks to members are increased.

6. Given the breadth of the test, and the extensive list of circumstances in which the Regulator expects the test may be met, it is difficult to conclude, assuming that the Regulator’s powers are properly analysed and exercised, that the powers are inadequate to cover each of the situations where it has been suggested that deficits have been “dumped”.²

7. We disagree with some of the conclusions of the Pensions Institute paper, particularly in relation to the use of service companies. The Regulator's power to issue Financial Support Directions (“FSDs”) is specifically targeted at service companies.

8. Whether the Regulator currently has sufficient resources to be able to exercise its powers effectively is a separate question.

D. DB pensions regulation by the Pensions Regulator (2): pre-clearances

1. In reality the main issue is whether clearance is achievable in the time available. Although the time between a formal application for clearance being submitted and clearance being issued is, in our experience, short, in practice a draft application needs to be submitted up to 6 weeks ahead of the transaction to enable the necessary negotiations with the Regulator concerning mitigation to take place.

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² See, for example, page 25 of the Pensions Institute’s paper “Milking and Dumping: the devices businesses use to exploit surpluses and shed deficit in their pension schemes”, published in August, 2016 (the “Pensions Institute paper”), which lists what the author sees as transactions that have resulted in deficits being shed or side-stepped http://www.pensions-institute.org/reports/MilkingAndDumping.pdf
Particularly in a scenario involving a distressed employer, this is unlikely to be practical.

2. In relation to the **BHS Pension Scheme**, based on the publicly available information, it is doubtful that there would have been any material change in the outturn had there been a clearance application.

3. Even where no clearance application is made, the Regulator has used its powers to issue CNs and FSDs effectively on a number of occasions.

4. An example is in relation to the **Lehman Brothers Pension Scheme**; the Regulator’s determination panel issued FSDs to 6 companies in the Lehman Brothers Group in September 2010; a settlement was eventually reached on 14th August, 2014 under which companies in the Lehman Brothers Group paid to the scheme an amount expected to be sufficient to buy out in full the scheme’s DB liabilities.3

5. Rather than requiring pre-clearance in certain circumstances, consideration should be given to extending the notifiable events regime under **Section 69 of the Pensions Act 2004**. In this context, a decision to relinquish control of a participating employer in a defined benefit scheme is already a notifiable event.4

6. It is not possible to discern from publically available information whether the Regulator was notified under the notifiable events regime of the decision to relinquish control of BHS.

7. If a decision is taken to extend the scope of the notifiable events regime, then it should be extended in a proportionate manner to avoid the Regulator being overwhelmed with information which does not provide an early warning for real risks.

**E. The balance between meeting pension obligations and ensuring the ongoing viability of the sponsoring employers**

1. Until 6th April, 1975, there was no obligation on schemes to pay benefits to members who left before normal retirement date; from then, the Social Security Act 1973 required schemes to allow members to retain “short service benefits” in the scheme. From 1986, schemes were required to revalue deferred pensions in line with inflation up to a statutory limit.

2. The report of the Pensions Law Review Committee (chaired by Professor Roy Goode) (the “**Goode Report**”), published in 1993,5 concluded that:

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3 See the Regulator’s Section 89 report dated August, 2014 [http://www.thepensionsregulator.gov.uk/docs/section-89-lehman-brothers.pdf](http://www.thepensionsregulator.gov.uk/docs/section-89-lehman-brothers.pdf)

4 Regulation 2(f) of the Pensions Regulator (Notifiable Events) Regulations 2005.

5 CM2342.
2.1 the security for members’ entitlements should be strengthened by minimum solvency requirements and monitoring by the Pensions Regulator, but

2.2 on setting up a scheme, the employer should be free to reserve the right to close, freeze or wind-up the scheme, to approve or refuse increases in benefit and to reduce or stop contributions, subject to the minimum solvency requirements referred to above.

3. The Pensions Act 1995, responding to the Goode Report, introduced, with effect from 6th April, 1997 a minimum funding requirement, restrictions on scheme amendments that affect accrued rights, and a requirement to index pensions in payment. The employer debt legislation was also brought into force from that date.

4. The main legislative changes that have increased employer obligations in respect of the “pension promise” are set out in the Appendix.

5. No well advised private sector employer establishing a scheme prior to 6th April, 1975 is likely to have conceived of guaranteeing a pension (promised, say at age 20) where the last payment under the commitment might be 60+ years hence unless there were adequate safety valves, given the inability to predict:

5.1 the future for the sponsoring employer, and

5.2 the future generally (for example interest rates, longevity, investment returns) over that period.

6. For example, in 1990, the yield on a long dated (10 year) reference gilt was 10.81% and inflation was 7.1%. The yield on the same reference gilt is currently in the region of 1.3%, with inflation in the region of 0.5%.

7. The safety valves referred to in 5. above included that:

7.1 any revaluation in deferment prior to 1986, and

7.2 any increase in pensions in payment prior to 1997

was discretionary, enabling schemes, during periods of financial stress, to manage the pension promise i.e. to balance the need to preserve the purchasing power of the pension as against the financial health of the scheme.

7. This is the model for Dutch pension schemes where, if the funding requirement cannot be met, indexation of pensions in payment and deferred pensions can be restricted in the first instance and, if necessary, the pension itself reduced.

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6 Source: Bloomberg UK Government 10 Year Yield Index. Office for National Statistics.
8. The cumulative effect of the legislative changes in the UK since 1975 has converted these discretionary rights into guarantees and removed the safety valves for the employer.

9. The introduction of the minimum funding requirement and the employer debt legislation on 6th April, 1997, and subsequent changes in the bases for scheme funding (in particular the basis on which the Section 75 debt is calculated that took effect on 6th April, 2008) have in effect turned the pension promise into an inflation-proofed pension guarantee.

10. The key point is to distinguish between 2 concepts:

10.1 **Concept 1 - a pension guarantee**: where the employer undertakes to the employee to pay directly or indirectly to the employee a pension for the life of the employee in respect of that employee’s employment with the employer.

10.2 **Concept 2 – an agreement with its employees by the employer to make available a pension scheme and to pay contributions to the pension scheme trust from which pensions are payable as defined in the trust deed and rules of the scheme.**

11. Concept 1 is a guarantee by the employer to pay the employee a pension for life.

12. Concept 2 is the promise by an employer to establish a pension scheme to pay contributions as required by the actuary with the aim of providing defined benefit pensions. So long as the scheme assets are sufficient, the defined benefit pensions would be paid in full. If the assets were insufficient, and the employer were unwilling or unable to pay the shortfall, the scheme was wound up. This was the ultimate safety valve for the employer against trying to forecast 10, 20, 40 and even 60 years into the future.

13. What has happened over time is that legislation has converted Concept 2 into Concept 1.

14. In contrast, over the years, successive Governments have made reductions to the costs of providing the basic and second state pensions, in particular to reflect increased costs due to improvements in longevity.

**Note**: In other words, the value of the basic and second state pensions has been reduced.

15. The DWP concluded that postponing state pension age (“SPA”) to 67 would save an estimated £76 billion. The Government has a reserved right, through the Parliamentary process, to amend, as is prudent, state pension benefits to reflect affordability. In contrast, successive Governments have removed the ability of private sector employers to adjust pension benefits to reflect stresses on scheme funding.

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16. Following the 2008 financial crisis, a consequence of the Bank of England’s programme of quantitative easing is the material and detrimental effect it has had on DB scheme funding, leading to a sharp increase in the value of pension liabilities.

17. Analysis by the Bank of England showed that long dated gilt yields fell by up to 1.2% as a result of the first round of quantitative easing in 2009. “Overall…[the programme] had a significant and persistent impact on gilt yields.”

18. The Pensions Regulator has estimated that a 0.1% cut in gilt yields increases DB pension liabilities by around 2%. Ignoring subsequent decreases in gilt yields following the 23rd June, 2016 referendum, this would translate into an overall, on average, increase in pension liabilities of 24%.

19. To put it another way, if the value of a DB scheme’s pension liabilities based on a gilt yield pre quantitative easing, was £100m, as noted in 18. above, the effect of the first round of quantitative easing in 2009 would have increased the today amount of those liabilities to around £124 million. Unless fully hedged, this would leave the employer with the need, potentially, to have to find another £24 million to make good the deficit.

F. Conclusion

1. We hope the comments in this submission will help to inform the debate and recognise the wider context within which private sector defined benefit schemes operate.

2. One issue for consideration by the Committee is whether it is possible to create a middle ground for employers in terms of risk sharing with employees between the two extremes of DB (where 100% of the risk is with the employer) and DC (where 100% of the risk is with the individual employee).

3. It is interesting to note the difference in investment strategies adopted by:

3.1 the default arrangement for a defined contribution pension scheme where members’ retirement accounts are, until between five and fifteen years before their target retirement date, often invested 100% in equities (to seek to benefit from the expected higher return on equities), and

3.2 the investment strategy for defined benefit schemes where, increasingly, the strategy is to aim for the scheme assets to be wholly or substantially invested in government and other high quality long-term bonds with a much lower

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8 Except for pension schemes which had perfectly matched assets and liabilities (including, for this purpose, any hedging arrangements that had been put in place).


10 Pensions Regulator’s Purple Book 2010.

11 Numbers will be sensitive, among other things, to the exact demographic profile of the pension scheme in question but serve to illustrate the point.
expected investment return (which provides greater certainty of outturn but is more likely than not to increase the costs of providing the DB pension).

Note 1: This investment strategy raises questions as to whether defined benefit pension funds should be investing in what could be viewed as a market which, for quantitative easing purposes, the Bank of England is on public record as seeking to manage (in terms of purchasing long-dated bonds with a view to reducing long-term interest rates).

Note 2: From a pure investment perspective (as distinct from a liability matching perspective), there is a question of when will the Bank of England allow interest rates to normalise and how big will the investment loss be for those who have purchased, for investment reasons, bonds in a “managed market”.

4. The Pension Schemes Act 2015 contains the legislative framework for collective benefit schemes (sometimes called “collective defined contribution” or “CDC schemes”). That legislation has not yet been brought into force.

5. These pool risk between members and potentially provide for greater stability around pension outcomes but with the employer not having any obligation to make up any shortfall in the scheme. We consider that innovation in this “third space” is potentially crucial for employers from a workforce planning perspective: an employee who cannot afford to retire will not retire (which, in turn, will lead to the risk of age discrimination claims for the employer). More information on CDC schemes is on our website.  

September 2016

### Appendix: Timeline of legislative requirements for DB schemes

<table>
<thead>
<tr>
<th>No.</th>
<th>When</th>
<th>What happened</th>
<th>Impact/Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>6th April, 1975</td>
<td>Right to short service benefit for early leavers</td>
<td>Initially for members aged over 25 with minimum 5 years’ service but now all members with 2 years’ service</td>
</tr>
<tr>
<td>2.</td>
<td>6th April, 1986</td>
<td>LPI revaluation of deferred pension</td>
<td>Initially capped at 5% and applied to pensionable service from 1st January, 1985 but extended to all pensionable service from 1st January, 1991. LPI for pensionable service from 6th April, 2005 capped at 2.5%.</td>
</tr>
<tr>
<td>3.</td>
<td>6th April, 1997</td>
<td>Introduction of Minimum Funding Requirement</td>
<td>Scheme assets required, for first time, to cover liabilities, assessed on a prescribed set of actuarial assumptions. Substantially amended with effect from 19th March, 2002 and replaced with effect from 30th December, 2005 by scheme specific funding provisions. Schemes can no longer make changes (including rule amendments) that could detrimentally affect accrued rights unless certain conditions satisfied or members agree to the changes. Provisions modified with effect from 6th April, 2006. Applies to pensions attributable to service between 6th April, 1997 and 5th April, 2005. LPI for pensions attributable to service on or after 6th April, 2005 is capped at 2.5%. Since 1st January, 2011, the reference index is CPI not RPI. Difference between a scheme’s assets and liabilities is treated as a statutory debt (a “Section 75 debt”) on the employer, which it must pay in certain circumstances. Legislation (including basis on which employer debts are calculated) has been changed on numerous occasions</td>
</tr>
<tr>
<td>4.</td>
<td>27th April, 2004</td>
<td>Pensions Regulator’s “moral hazard” powers apply</td>
<td>Regulator may issue contribution notice or financial support direction. Powers extended with effect from 14th April, 2008</td>
</tr>
<tr>
<td>5.</td>
<td>6th April, 2005</td>
<td>Notifiable events regime introduced</td>
<td>Duties apply to trustees (to report scheme-related events) and employers (to report employer-related events).</td>
</tr>
<tr>
<td>6.</td>
<td>30th December, 2005</td>
<td>New scheme specific funding requirements</td>
<td>Regulator’s powers in relation to scheme funding extended with effect from 26th January, 2009.</td>
</tr>
<tr>
<td>7.</td>
<td>6th April, 2007</td>
<td>Restrictions on repayment of surplus</td>
<td>Surplus may only be repaid where scheme is funded to full buy-out level. 6.</td>
</tr>
</tbody>
</table>