Pensions in the 21st century

One of the unintended consequences of a prolonged period of low interest rates has been a growing crisis in the pensions industry. Low interest rates have brought down annuity returns and in turn left Defined Benefit pensions with significant short falls in their funds.

So long as either people remain in work, so as to be able to continue contributing to their personal pension funds, or companies remain solvent, and so able to maintain their promised pension payments despite any funding shortfall, this is a theoretical problem. Where, however, an imminent retirement or corporate crisis is faced, the challenges can be considerable.

As scandals go, the demise of BHS is one of the more extraordinary, and most tragic. The decline of this famed British brand, founded in 1928, has cost 11,000 jobs and will be felt in the order books of hundreds if not thousands of suppliers across the country.

BHS’s demise cannot be put down to just one factor. A damaging lack of investment, the rise of internet shopping, changing consumer tastes, the arrival of new competitors all contributed. Indeed in the longer term, the viability of pensions which are highly dependent upon the ongoing health of a parent firm, must be questioned. For those dependent on a future BHS pension, it was a perfect storm; much as was the case when the venerable Reader’s Digest fell to the same fate.

A quick reminder of the circumstances leading to the crisis: In 2000 BHS was purchased by Sir Philip Green and the Arcadia Group for £200m, with a pension fund surplus of £5m. While increasingly large dividends were taken out of the firm, the pension deficit spiralled to £140m by 2009. In 2014, losses at BHS topped £21m, before Sir Philip sold BHS to Dominic Chappell’s Retail Acquisitions
Group (RAG) for a £1. Despite voluntary arrangements designed to cut costs, the firm went into receivership in April 2016 with a £571m deficit in the pension fund. There are now ongoing discussions between the Pension Protection Fund, the Pensions Regulator, and various members of Arcadia and Retail Acquisitions Group management regarding the degree to which pension promises can be kept.

A recent report from pensions experts LCP estimated the deficit of FTSE 100 firms alone at an estimated £46 billion. This is likely to be a very conservative estimate as it does not account for the pensions promises made by thousands of smaller listed and unlisted firms.

The problem arises from pension promises made in times past. The kind of generous pension schemes which are the source of much of this deficit are long gone. The assumptions made at the time these schemes were entered into have not proven robust. No one foresaw an era of virtually zero interest rates with bond and annuity yields consequently diminished.

Businesses, however, can and do fail. In those circumstances, there will of course be times when the taxpayer-backed Pensions Protection Fund (PPF) will step in and guarantee a certain amount of their pension fund deficit. It goes without saying that minimising the number of times this happens should be a priority.

In the medium- to long-term, there needs to be serious discussion about the future of how a viable pension fund will be structured, where the risks will lie, and how unforeseen circumstances can be ameliorated. In the shorter-term, however, it is important that we tease out quicker wins where we can, before addressing more structural issues.

**The role of the regulator**

Pension regulation is by its very nature, complex, long term and where it fails, acutely painful to those affected. In the light of the BHS scandal, significant gaps in the UK’s regulatory regime became apparent. The acquisition of BHS by RAG – and the clear warning signs that the pension fund could not be sustained – is a case in point.

The initial reaction of many was to point fingers at The Pensions Regulator, the non-departmental public body created in 1997. The statutory objectives of the Pensions Regulator are to:

- Protect the benefits of members of occupational pension schemes
- Protect the benefits of members of personal pension schemes
- Promote and improve understanding of good administration of work-based pension schemes
- Reduce the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund
- Maximise employer compliance with employer duties and the employment safeguards introduced by the Pensions Act 2008

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1 Lane, Clark and Peacock; “LCP: Accounting for Pensions 2016”; 16 Aug 2016
• Minimise any adverse impact on the sustainable growth of an employer.

During the investigation into the sale of BHS by the joint Parliamentary Committee, the Chief Executive of the Pensions Regulator – Lesley Titcomb – stated that she found out about the sale of BHS in the newspapers. At this point, the Pensions Regulator launched an ‘Anti-Avoidance investigation’ which remains ongoing.

The IoD also inquired of the Financial Reporting Council whether, as the de facto overseers of corporate governance in the UK, they felt the BHS debacle was worth investigating. They responded by saying they have the power only to “investigate accounts, auditors, and actuaries who are members of a professional body in the UK.” This clearly demonstrates a fundamental breakdown in the UK’s regulatory regime.

A time to learn lessons

Numerous media outlets and the public at large have been keen to lay the blame for the BHS scandal at the feet of Sir Philip Green and Dominic Chappell. They are certainly the ones who bear most responsibility, but they are by no means the only individuals who should be asked searching questions. The host of advisory firms involved in the sale, from Goldman Sachs to Grant Thornton to Olswang LLP, all must account for their advice and roles.

The focus must now be on distilling those lessons that can be learned; from the short term regulatory failures to the longer term structural issues which allowed a regulatory failure to become so catastrophic.

In particular, it is important to address three areas.

1) The failure to proactively assess BHS’ significant pension deficit

During the Parliamentary evidence session, Ms. Titcomb suggested that due to resource issues, it is difficult for the Pensions Regulator to monitor all those files which come across their desk and that they therefore use a ‘calibration process’ to decide which schemes should be considered as worthy of proactive concern.

It is inconceivable to us that BHS should not have been considered a high-risk scheme even prior to the sale of BHS to Retail Acquisitions Group. From the sheer scale of the deficit, the cash being drained from the firm and lack of reinvestment, and challenges being faced by most high-street firms at the time, it is clear that the Pensions Regulator needs to significantly improve the quality of their ‘calibration process.’ Ms. Titcomb stated in her evidence that their model is “not a perfect science.” She is correct.

It is crucial that the Pensions Regulator addresses the failings in their model, so that the highest-risk schemes are more prevalent on their radar.

2) The failure to inform the Pensions Regulator of the forthcoming sale of BHS to Retail Acquisitions Group, and the lack of teeth that the Pensions Regulator has to pressure Trustees

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The Pensions Regulator reviews a wide range of situations where firms and pensioners are facing significant pensions deficits. The Regulator, however, should be particularly vigilant when a firm is to be sold. It is clear than in many cases incumbent management will have, or should have, greater concern for long term pensions promises that have been made, than will the management of an acquiring company.

At the time BHS was sold to Retail Acquisitions Group for £1, its pension fund deficit was already of significant size. We have already made clear that we feel the Pensions Regulator should have monitored BHS more closely.

The moment of sale, however, provided a second opportunity for the Pensions Regulator to register concerns; the Regulators’ current powers, however, do not offer that possibility.

The IoD therefore proposes that in the light of the BHS scandal, it is time to give the Pensions Regulator a binding veto over merger and acquisition activity, in firms of a certain size, where a sale does not come complete with a clear and obvious statement of how any pension fund deficit will be met in the future. In this sense, it would be given similar powers to the Competition and Markets Authority, which is responsible for ‘investigating mergers and acquisitions which could restrict competition.’ The language would be for consultation, but essentially we would give the Pensions Regulator the responsibility for ‘investigating mergers and acquisitions which could imperil the long-term sustainability of private pension funds.’

This is an important change to current proceedings and would require careful legislation and consultation. There should be a minimum threshold – perhaps that the turnover of the to-be-acquired company is £200 million annually, or where the pension fund covers more than 2000 employees, for example. This would ensure that M&A activity in the UK remains vibrant. The actual use of a veto would be the last step in a long, and collaborative process.

In the first instance, if an M&A transaction that triggered the threshold was agreed in principle, it would then be subject to regulatory approval, with the purchasing firm filing a plan with the Pensions Regulator detailing the current state of the accompanying pension fund, and stating how any liabilities will be met in the future. The Pensions Regulator would then assess this filing.

If the filing does not assuage any concerns the Pensions Regulator has, the purchasing firm would be invited to discuss with the Regulator, in a collaborative fashion, how it might meet the Regulators’ concerns. Only if this process fails would a veto be used with respect to the M&A transaction. In this situation, the deal would not be able to go ahead until appropriate provision is made.

This ‘comply or explain’ style of regulatory oversight has been successful in Britain for decades. Recognising the possibility of another BHS failure dictates that we extend the principle to M&A and pension fund deficits.

It is important, of course, that we balance any new powers for the Regulator with an acknowledgment of the speed of merger and acquisition activity, and the fact that M&A is a crucial part of the dynamic British economy. The Pensions Regulator would therefore need to be given strict instructions regarding the use of any new powers, and a strict timeline on delivery. Further, the size of any deficit is not in and of itself a sign for a regulator to step in; British Airways may well have collapsed if it had not been able to merge with Iberia and form IAG, and we would want the
Pensions Regulator to make an extremely long-term judgment on the viability of an existing fund. The cost to the PPF of such a failure would have been significant.

3) The need for specific board responsibility for a pension fund deficit

The role of a Pension Fund Trustee is a significant one, and has shown to be only more so in the wake of the BHS scandal.

Still, we cannot rely just on Trustees to ensure the sustainability of Britain’s private pension funds. Corporate Governance, in the form of high-quality board leadership, has been shown yet again to be crucial to the sustainability of businesses and the security of associated jobs. In the case of BHS, it is apparent that there was a fundamental failure of corporate governance on the board of Arcadia. The Chairman, Lord Grabiner QC, told the Parliamentary Committee investigating the sale that he had not been aware of the sale until five days after it had been agreed.

That is an individual case, and should not lead to rash judgements or legislation. We would, however, propose that good corporate governance should now include an individual, named non-executive board member (perhaps a member of the Audit Committee) who would be given responsibility for monitoring and reporting on the pension fund deficit at a particular number of board meetings every year, and in detail in the Annual Report.

Government should explore ways to ensure that this occurs as quickly as possible.

Conclusion

The sad demise of BHS reflects well on nobody. Accordingly, it is now clear that the time has come to move on from the media firestorm, and to look at constructive and useful ways in which we can apply the lessons learned in the aftermath.

December 2016