

DEFINED BENEFIT - PENSIONS REGULATOR PRACTICE UPDATE

The approach of the Pensions Regulator has always been to guide and coax and to treat its formal powers as a last resort. Its [report](#) in relation to the Docklands Light Railway Pension Scheme and the updated guidance on assessing and monitoring the employer covenant show that it is sticking to these softer strategies.

DOCKLANDS LIGHT RAILWAY PENSION SCHEME – REPORT ON PENSIONS REGULATOR'S INTERVENTION ON SCHEME FUNDING

The Pensions Regulator's recent report on its involvement with the Docklands Light Railway Pension Scheme is its first ever report under section 89 of the Pensions Act 2004 (the Act) relating to scheme funding.

The Docklands Light Railway (DLR) is the principal employer of the defined benefit pension scheme known as The Docklands Light Railway Pension Scheme (the Scheme). During the period in question, the Docklands Light Railway franchise was operated by Serco Limited (Serco), who, as franchisee, was the sole statutory employer of the Scheme for the purposes of Part 3 of the Act.

The Regulator's intervention in this case arose from the failure of the trustees and Serco to agree an actuarial valuation with an effective date of 1 April 2009 (the 2009 valuation). The parties had provisionally agreed most of the valuation assumptions but could not agree the recovery plan to clear the deficit. The deadline for agreement passed on 1 July 2010 enabling the Regulator to intervene.

Facilitation

The Regulator's initial input was to facilitate discussions between the trustees and Serco in order to help the parties reach a consensual agreement.

Initiation of formal regulatory process

When this failed, the Regulator issued a warning notice to the parties in August 2012 that it intended to ask the Determinations Panel to direct the trustees to obtain skilled persons' reports (under section 71 of the Act) on the scheme's funding position and the strength of Serco's covenant. These reports were intended to help the Determination Panel's decision in a later exercise of section 231 powers (powers to set the valuation assumptions and contribution terms). In other words, obtaining the professional opinions obtained under section 71 would frame the Determination Panel's decision on setting the valuation assumptions and the recovery plan.

Dispute over contribution powers

The Regulator took the view that the trustees had power under the Scheme's contribution rule to impose contribution obligations unilaterally outside the statutory scheme funding regime. The trustees were persuaded to exercise these powers and to seek enforcement of their contribution demand which led to High Court litigation as Serco disputed the interpretation of the Scheme contribution rule.

The Regulator suspended its regulatory proceedings pending resolution of the High Court proceedings.

Settlement

In November 2014, Serco and DLR agreed a settlement of the court proceedings with the trustees. This provided for deficit contributions of £37m by 2 January 2018.

The Regulator confirmed that it was unlikely to proceed with the section 231 process in respect of either the 2009 or the 2012 valuation if the recovery plan reflected the terms of the settlement.

The Regulator's lessons

The Regulator's approach is:

- ◆ to talk first;
- ◆ to approach its section 231 powers by first using its ancillary powers to obtain "skilled person" reports to frame and support the Determination Panel's decision; and
- ◆ to refer the trustees to any other powers they may have to find alternative solutions not requiring a decision by the Determination Panel.

Franchisee

The report contains useful comment on the Regulator's view of the statutory employer being a franchisee. Trustees would be expected to take account of the upcoming end of the franchise but need not necessarily assume that all covenant support enjoyed by the scheme will fall away at the end of the employer's franchise.

GUIDANCE ON ASSESSING AND MONITORING THE EMPLOYER COVENANT

Guidance issued by the Pensions Regulator does not have the same status as its Codes of Practice. It is not law and is essentially just a statement of the Regulator's views on a topic. It is intended to assist trustees and employers and to explain the Regulator's expectations and approach. It is a fundamental part of the Regulator's strategy of using influence rather than coercion or formal processes.

To supplement the 2014 Code of Practice on funding defined benefits, the Regulator has published updated guidance on assessing and monitoring the employer covenant. While the high level statements largely reflect the views already expressed in the Code of Practice, there is a new level of detail in this guidance, with dozens of worked examples and key points for consideration covering a wide range of practical situations.

The guidance is a powerful tool to reinforce the "integrated approach", basing investment and funding decisions on assessment of the employer covenant, i.e. "*the employer's legal obligation and financial ability to support the scheme now and in the future*". Trustees are called upon to document the assessment process and its conclusions and to monitor the covenant regularly. A requirement for records is of course key to regulation.

While the assessment may be "proportionate" to the circumstances, trustees are "*to consider obtaining independent external advice where they lack the objectivity or expertise required*". This drives trustees fairly firmly towards a professional service as trustees who are involved in the management of the business may be deemed to lack objectivity while those who are not so involved may lack expertise.

Some of the balance that was achieved in the final version of the 2014 Code of Practice has been diluted and it is worth reading the guidance alongside the Code of Practice. Statements regarding an employer's plans to invest in the sustainable growth of its business restricting scheme funding are a case in point.

Most significantly, the level of detail in the guidance drives trustees to ask for ever more specific information about the employer's business and corporate affairs (and that of any guarantor).

Trustees are called upon to monitor current and forecast affordability. Examples of monitoring triggers include changes to group structure; plans to raise external finance; dividend payments as percentage of post tax profits; key performance indicators; issues impacting brand reputation; changes to the employer's industry; key personnel changes; and even non-renewal of a key contract or a change in the price of a key commodity. Helpfully, it is acknowledged these are examples only, not of general application. Nevertheless, employers are likely to be facing more questions.

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