

**By email**

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# MACFARLANES

20 February 2013

Dear Sirs

**Call for evidence: the possible introduction of a new statutory objective for the Pensions Regulator**

We refer to the DWP's call for evidence seeking views on whether a new statutory objective for the Pensions Regulator should be introduced, or whether the appropriate considerations can be delivered under the existing objectives or by other means.

**1 Introduction**

1.1 The proposal is for a new objective for the Pensions Regulator "to consider the long term affordability of deficit recovery plans to sponsoring employers".

1.2 We understand that, as referred to in the Autumn Statement, the proposal is prompted by a concern that the cost of funding defined benefit liabilities is diverting funds away from business investment and ultimately, economic growth.

1.3 Together with many of our clients, we share this concern.

1.4 The interests of defined benefit pension scheme members and the Pension Protection Fund (the "PPF") are in competition with the interests of other stakeholders, including employees and would-be employees, over the employers' resources. As the DWP rightly identifies the issue is about where the balance should lie.

**2 The Pensions Regulator's current objectives and duties**

2.1 With regard to defined benefit pension schemes, the Pensions Regulator's current objectives are:

2.1.1 To **protect** the benefits of members;

2.1.2 To **reduce** the risk of compensation being payable by the PPF;

2.1.3 To **promote** good administration of schemes.

2.2 In addition, when exercising any of its powers, it is required to have regard to the interests of the generality of the members and to other persons who are directly affected.

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2.3 Having regard to the interests of other parties does not however mean giving them equal priority, and the objectives of protecting defined benefit members and the PPF therefore trump the interests of employers and, through them, the wider class of stakeholders identified above (including employees who may not be members of a historic defined benefits scheme). Employment issues which may arise where different groups of employees have different levels of pension provision can be exacerbated where more and more of the employer's resources are perceived to be diverted to make the "haves" even more secure, at the expense of job security, wages and pension provision of the "have nots".

2.4 Given its narrow existing objectives, the Pensions Regulator cannot be expected to hold the balance between the interests of members and the PPF and the interests of other stakeholders in the economy. It is also difficult for corporates, lenders and investors to rely on any assurances from the Pensions Regulator that it will act "reasonably" suggesting some kind of balance or restraint, since its duties may require it to pursue the interests of members and the PPF to the detriment of others where it is empowered to do so. It is presumably for this reason that comfort statements by the Pensions Regulator are always qualified.

### 3 **Impact on scheme funding**

3.1 The rules on scheme funding are set out in Part 3 of the Pensions Act 2004 and related regulations and are supplemented by the Pensions Regulator's Code of Practice on Funding Defined Benefits. These largely override the governing provisions of the schemes, and together, often appear at odds with the "scheme specific" objectives of the legislation.

3.2 The Pensions Regulator does not set scheme funding unless the trustees and the employer fail to agree within the 15 month period or there is some breach of the requirements. This could include a failure to set assumptions prudently.

3.3 In practice, the Pensions Regulator has not generally made use of formal powers under s.231 of the Pensions Act 2004, although it often refers to them in correspondence with trustees. It works primarily to influence trustees and employers in agreeing valuation assumptions and funding plans, issuing general guidance and direct correspondence.

3.4 The Code states that the employer's financial strength and prospects should inform decisions on the valuation assumptions and the recovery plan and that in setting the recovery plan, "trustees should aim for any shortfall to be eliminated as quickly as the employer can reasonably afford". No distinction is made between long-term and short-term affordability. The Pensions Regulator has given prominence to the employer's financial resources and the company's covenant but there seems to be reluctance to give the same weight to a "good" covenant as is given to a "poor" one. Covenant assessment leads to a "Morton's Fork" for employers.

3.5 In practice, the Pensions Regulator's objectives of protecting members' benefits and the PPF and the absence of any wider or counter-balancing objectives has led to a growth in the value attributed to defined benefit pension liabilities and the shifting of the burden of funding them directly onto the employer and away from the investment strategy. The Pensions Regulator has also pressed trustees hard to secure additional funding or third party guarantees and other assets where cash is unavailable, often suggesting a switch in assumptions and investment strategy if additional security is not provided.

3.6 This sometimes conflicts with the trustees' duties to invest the scheme assets under trust law and UK and EU legislation in the best interests of members and employers (where not in conflict) and to ensure "the security, quality, liquidity and profitability of the portfolio as a whole" rather than purely to avoid downside risk for the members and PPF.

3.7 The Pensions Regulator's approach could be summarised as follows:

- 3.7.1 If the employer can afford to pay off the deficit, it should do so as quickly as possible (even if its covenant is such that there is little risk in a longer term horizon, and where the result might be to frustrate business expansion);
- 3.7.2 If it can't afford to pay, a third party should be found to provide a guarantee, additional funding or other security should be provided (diverting resources to the pension scheme);
- 3.7.3 If it can't afford to pay and no third parties or other security is available, more prudent assumptions and fewer return-seeking investments should be used. This inflates the deficit and increases the proportion of funding to be met from contributions rather than investment returns (again diverting more resources to the pension scheme);
- 3.7.4 If, on this conservative funding and investment basis, it can't be expected to clear the deficit even in the long term (we understand such schemes are nicknamed 'zombie schemes'), the trustees may be encouraged to wind-up the pension scheme to procure its transfer to the PPF sooner rather than later to avoid any risk of an increase in the PPF deficit. This will generally involve an insolvency process for the employer although restructuring options may be available to save some jobs.
- 4 **Consultation Q6 – what would be the advantages of a new statutory objective for the Pensions Regulator to consider the long term affordability of deficit recovery plans to sponsoring employers?**
- 4.1 Providing an objective for the Pensions Regulator “to protect or *facilitate* the long term affordability of deficit recovery plans to sponsoring employers” would assist in providing some level of balance and implying some duty to the sponsoring employer to ensure deficit recovery plans are affordable, at least in the long term. Although it has been suggested that giving the Pensions Regulator an additional objective of this nature would make the Regulator’s task more difficult, we see no reason why a regulatory body should not be as capable of balancing a number of different interests as, say, company directors.
- 4.2 It might also enable the Pensions Regulator to be more supportive of balanced funding, and investment strategies that assume some of the funding is to come from investment return and which provides for the “security, quality, liquidity and profitability of the portfolio as a whole” in accordance with UK and EU legislation, even where the employer is weak. This may be preferable both in the interests of the members and the employers and the wider economy.
- 4.3 However, what is proposed in the consultation falls far short of this kind of provision.
- 4.4 An objective “to **consider** the long term affordability of deficit recovery plans to sponsoring employers” would not require any balancing or any duty to have regard to the interests of the employer, of employees or the need for investment in the business. It is not really an objective at all. It is merely a duty to consider and would not provide an appropriate counterweight to the Regulator’s existing objectives. Such a duty already exists in the Pensions Regulator’s general duty to have regard to the interests of directly affected persons (s.100 of the Pensions Act 2004).
- 4.5 In any event, the Pensions Regulator already considers the long term affordability of deficit recovery plans to sponsoring employers. The Pensions Regulator asks trustees to satisfy themselves as to the employer ‘covenant’ (its financial position and prospects) for the duration of the recovery period and the affordability of the contributions throughout the period.

- 4.6 However, it considers the long term affordability only from the perspective of its objectives of protecting members and the PPF. It is concerned only with whether the employer could pay the contributions, rather than whether adequate security is afforded by the company's long-term covenant and whether paying more contributions in the short term than are needed is the best use of the employer's resources in the continuing business. As such, it leads to a policy of seeking more funding sooner than is necessary and more risk reduction and more diversion of funds into the pension scheme and into low risk investments. It is not clear that the new objective as proposed would change the current approach as described above.
- 5 **Consultation Q7 – what would be the disadvantages in creating this further statutory objective for the Pensions Regulator?**
- 5.1 The disadvantages of a statutory objective “to *consider* the long term affordability of deficit recovery plans to sponsoring employers” are that:
- 5.1.1 it does not provide an adequate counterweight to the Regulator's existing objectives. To do so it would need to be changed as suggested in paragraph 4.1 above; and
- 5.1.2 it is ambiguous and could be misleading, encouraging some to think that there is some improvement for employers and business investment, while potentially being relied on by the Pensions Regulator to justify a more risk-averse approach by reference to the long-term risk of a recovery plan being unaffordable, leading to more pressure to wind-up schemes and crystallise deficits early.
- 6 **Consultation Q8 - is the consideration of the long term affordability of deficit recovery plans to sponsoring employers already implicit in the existing objectives and requirements for the Pensions Regulator? If so, is this sufficient?**
- 6.1 Affordability is mentioned in the Code of Practice on Defined Benefit Funding without any distinction made between short term and long term affordability. In practice, the Regulator has been known to dismiss affordability as a relevant concern.
- 6.2 Consideration of the interests of sponsoring employers as “directly affected persons” and through them, other stakeholders such as employees, is a duty of the Pensions Regulator under s.100 of the Pensions Act 2004.
- 6.3 These provisions are wholly inadequate to enable the Pensions Regulator to balance the interests of members and the PPF with those of other parties.
- 6.4 The duty to have regard to the interests of directly affected persons has not carried significant weight when in conflict with a potential risk to the PPF. If downside risk on investments is identified and not matched by covenant strength or security, the Pensions Regulator may encourage trustees to change investment strategy even though this will make the scheme unaffordable. If a possible increase in PPF liabilities might arise from continued trading and deferment of winding up of a scheme with a weak employer, albeit one which is able to continue trading (known as “PPF liability drift”), the Pensions Regulator may encourage the trustees to wind up the scheme. The result is likely to trigger an insolvency process for the employer.
- 6.5 In other words the “considerations” to which the Pensions Regulator is to have regard are often disregarded in pursuing its fundamental “objectives” of protecting the members and the PPF.

- 6.6 Simply put, the Pensions Regulator has a duty to prioritise members and the PPF and can do no more than acknowledge the interests of other parties or the damage that may be done to them in the pursuit of those statutory objectives.
- 7 **Consultation Q9 – are there other options (including legislation) which would ensure that the Pensions Regulator carries out its functions in a way which appropriately balances protection of members, the Pension Protection Fund and sponsoring employers?**
- 7.1 Yes, as an alternative to the proposed ‘objective’, the Pensions Regulator could be given one of the following as a new objective:
- 7.1.1 To “**protect or facilitate** the long term affordability of deficit recovery plans to sponsoring employers”; or
- 7.1.2 To “balance the interests of members, the PPF and the sponsoring employers”;
- 7.2 The first option is preferred.
- 7.3 In any event, the objective must create a clear aim rather than merely a duty to consider.
- 7.4 The second option would not define the balance or what is appropriate but would at least require the Pensions Regulator to demonstrate that its policies and the manner in which it exercises its functions are aimed at achieving a balance.
- 7.5 It would also realign the Pensions Regulator’s duties with trustees’ current duties to invest the assets of the scheme for the purposes of the scheme and in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole, rather than purely to avoid downside risk for the members and PPF.

Yours faithfully

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Macfarlanes LLP