Summary

• The BHS scandal could bring greater flexibility in the way defined benefit schemes are run. The CBI has called for an end to the use of gilts as a way of measuring scheme liabilities and the power to rescind the CPI promise.

• Employers impatient for change are already testing legal boundaries. Apportionment arrangements have been discussed.

• Sponsors are showing greater flexibility for creative deals with pension funds boards as a result. Understanding how strong the covenant is, is crucial to understanding how much investment risk can be tolerated.

Employers' DB wishlist

The BHS scandal highlighted bad employer practices, but good employers could benefit as a consequence. David Rowley reports

Where the Mirror Group scandal led to the 1995 Pensions Act, which brought in a level of uniformity to the way defined benefit funds are run, the BHS scandal could bring greater flexibility. That is, if the government listens to employers.

Seizing the moment, just months after BHS and Tata hit the front pages in the summer of 2016, the CBI set out one of the boldest ever employer wish-lists of changes to pension rules.

The most radical proposal was for an end to the use of gilts as a way of measuring scheme liabilities. The CBI proposed a "new guidance or approach on discounting", arguing this had happened in other countries. It asked for the power to rescind CPI promises and concluded that if there was not change British industry risked money being diverted from research and development and into capital spending.

CBI principal policy adviser Rachel Smith says: "Businesses are committed to delivering on their pension promises, but there is a discussion to be had about how best to do this whilst also delivering growth and jobs. After all a strong and stable employer is the best security for a scheme."

Engineering Employers Federation director of employment and skill policy Tim Thomas says he knows of a couple of employers that face having to end new research to pay their pensions.

He says of one: "This is the first year they will invest nothing in the business, it is all going in the pension scheme."

He is proposing greater flexibility in how deficit repayments are made.

"If you have a sponsoring employer that says I want to pay off less of the deficit this year because I have a major investment which is going to increase the profitability of the business. It seems an odd outcome if you do not invest in order to pay into the pensions scheme."

He adds that some of his members are also facing glaring inequity in pension funding. "They continue to support their DB schemes, but it is the lion's share of their pensions support and that is increasingly for a limited number of individuals."

Legal challenges

Employers impatient for change are already testing the legal boundaries.

Hogan Lovells partner in the pensions team Claire Southern has acted for Kodak and Halcrow in apportionment arrangements where a sponsor and trustees have negotiated benefits for members that were superior to those offered by the Pension Protection Fund.

She has received enquiries from other employers interested in negotiating similar deals.

"Employers have expressed an interest in it," she says. "But once you explain that you need to be on the verge of insolvent, people understand that it is not an option which is open to everybody."

In such a test of near-insolvency, the employer needs to prove that it would be solvent if not for its pension funding liabilities.

"You would need to demonstrate that after the restructuring you would have a business capable of supporting the revised pension scheme going forward," she says.

However, she notes the government's consultation is further exploring the deals that can be struck for stressed employers and sees strong desire for an override to CPI commitments.

"You can have business where employees have not had pay increases for nearly 10 years, but pensioners are getting five per cent fixed increases," she says. "There is a frustration among businesses that in a low inflation economy we cannot address things like that."

Amid all this clamour for change it should not be forgotten that revised guidance from The Pensions Regulator that a healthy employer is crucial to the long-term health of a scheme is increasingly having an impact.

Covenant advisers Lincoln Advisory are seeing sponsors show greater flexibility for creative deals with their pension fund boards as a result. So much so that the specialist covenant firm Lincoln Pensions has never been busier and recently expanded to 35 staff.

Alex Hutton-Mills, managing director at the firm, says there is a growing recognition that a sponsor's covenant is the starting point for planning.

"You get better outcomes when the sponsor engages," he says. "But there is some way to go across the universe of 6000 schemes to get them to realise the benefits of that."

He says, that once an employer does engage a path to full funding is much more likely.

"Unless you understand how strong the covenant is you do not understand how much investment risk you can tolerate and how much prudence you need to build into your technical provision assumption." He adds: "If you say let's do the same funding deal we did last time then you are not getting it."

One of the solutions Lincoln has created is to give a pension fund protection from other parts of a corporate group to give the trustees more comfort around the covenant that is supporting the pension scheme.

Multi-employer funds

The efforts of the industry to find a better way has led to the work of the Defined Benefit Taskforce. Its finding is again a call for flexibility.

Ashok Gupta, chair of the group, says: "Employers are keen to find a way to manage better than currently exists and are frustrated by the way the legislation creates a binary set of options where you either limp on or go into the PPF."

He is keen to emphasise that with schemes set to reach peak outflows in the next 15 to 20 years, the demands for cash now are at their highest and that changes to investment returns need to happen now.

The DB Taskforce's proposals are for greater shared services between DB funds, asset pooling or for consolidating schemes entirely. All have the potential to save billions each year for the six thousand employers that sponsor DB funds. Modelling carried out by the DB Taskforce, says consolidation could reduce the risk of scheme failure from a 65 per cent chance to 10 per cent or less.

"I am sensing an appetite to consider things today to consider things that would not have been on the table two years if it had not been for BHS and Tata Steel." He adds that even consultancies that stand to lose clients from mergers of DB funds are receptive to the idea.

Gupta puts employers into three groups. Those who are distressed and who will end up in the Pension Protection Fund. The well-funded and strongly backed employers who can continue alone – (Southern says there is little appetite for consolidation in this group). And a middle group of around 50 percent of the market which could benefit from the consolidation that the DB Taskforce's proposes.

The government favours voluntary consolidation and Gupta says that it need not be as painful as it sounds, based on his experience of transfers between merged insurers over the past few years. Here people's benefits have been amended.

"There are safeguards to make sure people are not disadvantaged and it worked very well," he says. "There is potential for the pensions industry to learn from the life industry and consider what safeguards are important."

First Group group pensions director John Chilman says the idea has merit not least as it has succeeded in the Netherlands, though he says full consolidation is unlikely.

"Employers will be unlikely to accept the inherent cross-subsidy that comes with fully merged schemes, which leads me to believe that in this country the only way to proceed would be on a fully sectionalised basis, which adds to the degree of complexity," he says. "Agreement as to who will be the trustee, and how they will be appointed remains an issue, particularly in highly unionised environments."

Written by David Rowley, a freelance journalist