Carrot or stick?

Pensions Age **finds out which option the industry thinks may be the most effective in motivating sponsors to take their DB scheme responsibilities seriously**

BHS, Carillion, Toys R Us: Lately we've heard a number of tales of big, bad bosses ill-treating their DB scheme through abuse or neglect. But what can be done to get company executives to pay attention and treat their DB deficits with the respect they deserve?

In February, three ideas were proposed to tackle this, broadly along the lines of 'incentives', 'compulsion' and 'punishment'.

Incentives: Encouraging executives to fund DB schemes before making payouts to shareholders

Research undertaken by Sun Yat-sen University, University of Exeter Business School and Lancaster University Management School found that incentivising executives to fund their pension schemes is more likely to see defined benefit schemes survive, rather than penalising bosses once schemes have failed. Compelling bosses to pay into their staff defined benefit pension schemes before they pay out to shareholders would also help make DB more sustainable, the research claimed.

The research examined around 1,655 firms from 2003 to 2011, among which 277 made share buybacks and other windfall payouts. The authors found that companies use transitory cash to make payouts to shareholders as opposed to funding pension benefits. Therefore, it suggested encouraging companies to fund DB schemes before making payouts to shareholders as an alternative solution to penalising bosses after the DB pension scheme has collapsed.

Results of their study also show that for firms without well-funded plans, the probability of share buybacks and other windfall payouts increases by 62 per cent, which partly justifies The Pensions Regulator's concern that firms distribute cash that could be used to reduce pension deficits.

"The implication of our findings is that trustees, actuaries and The Pensions Regulator should scrutinise the existence of transitory excess cash in sponsors' accounts in light of mounting defined benefit deficits over a number of years. Forcing companies to use excess cash to fund defined benefit schemes is more likely to ensure the sustainability of the pension schemes and the welfare of employees in the long run," the researchers stated.

Compulsion: Force bosses to join the same pension plan as their staff

According to research from Warwick Business School (WBS), CEOs are 77 per cent less likely to close their company's defined benefit scheme if they themselves are a member of the scheme, while they are 62 per cent more likely to close an underfunded scheme if they are a member of a separate executive scheme.

The study, conducted by WBS, University of Exeter Business School and Queen Mary University, examined 322 publicly-listed firms that offered a DB scheme between 1999 and 2013.

WBS professor, Joanne Horton, said: "If the government wants to tackle 'reckless' executives who undermine company pension schemes, they could harness CEO self-interest. Shareholders do it all the time. They offer CEOs stock options to ensure they share their interests, including closing the firm's defined benefit pension scheme."

Horton added that it could prevent future 'Carillions' from taking place.

"If Carillion CEO Richard Howson and his executives had been members of the company's main pension plan the outcome might have been different," she said. "If they had paid more into the main pension plan alongside their employees, instead of having their own executive pension scheme, they would have stood to lose the most when the company collapsed."

Punishment: Imprisonment for allowing pension deficits to be unsustainable and £1 million fine

The Secretary of State for Work and Pensions Amber Rudd outlined plans to introduce a seven-year jail term for the "wilful or reckless behaviour" of company directors who play "fast and loose" with their pension scheme.

The new proposals, outlined in the *Government Response to the Consultation on Protecting Defined Benefit Pension Schemes – A Stronger Pensions Regulator*, will target "reckless" company bosses who have "got away scot free" through "acts of astonishing arrogance … punished only with fines that barely dent bosses' bank balances".

According to the government, the law will be aimed at company bosses who allow the pension deficit to reach unsustainable levels, "or who endanger their workers' savings through chronic mismanagement".

Furthermore, the government said it will also introduce an "unlimited fine" for those who fail to comply with a contribution notice, which is a notice issued by The Pensions Regulator that requires a specific amount of money to be paid into a pension scheme, as well as a new civil penalty of up to £1 million.

Pensions Age recently put these options to a Twitter poll: Which of the three options do you think would have the greatest impact on motivating sponsors to take their responsibilities seriously and continue running their DB scheme?

The result was overwhelmingly 'incentivise' through encouraging pension payments over dividend payments, with 71 per cent of respondents voting for this option, compared to 10 per cent for forcing bosses to join their staff's pension scheme and 19 per cent for fines and imprisonment of pension scheme neglect.

But that's not to say that respondents were overly optimistic about any of these approaches:

@pensionsdave: Most feel a bit meh. Join scheme is a bit niche (most are shut). You'll have to be pretty heinous to end up in the clink. So 1 for you 1 for me over dividends feels the most significant

@PensionsSimon: Talk of dividends over DRCs is a point of focus but there are many other ways cash can leave an employer, plus TPR currently has no power to enforce. Joining staff DB scheme won't happen unless changes to personal allowances and tax issues. Assuming punitive fines/jail can be used efficiently and without protracted challenge, they may be most effective but, as I say, the caveat is if they can be used and if TPR has the appetite to use them.

@AWarwickThomps1: Better balance between dividends and scheme funding is the only one that will deliver improved benefit security. Hence TPRs focus on dividend v deficit recovery contribution ratio in recent years. Jail for executives is just political click bait.

@pensionsdaz: Level of proof required to get a prosecution against a director makes *[imprisonment]* pure regulatory grandstanding.

Contacting *Pensions Age* regarding the poll, Barnett Waddingham partner Simon Taylor pointed out the winning poll option, prioritising pension contributions over dividends, is "likely to hasten the demise and buyout of DB schemes rather than keep them open".

"If execs are forced to pay more to the DB schemes they will want something in return, most likely settlement of benefits and reduction in quantum of the scheme," he explains. "It would almost certainly have some nasty side effects on UK equity markets as well which, would create a vicious circle with funding levels dropping."

Regarding the idea of executive compulsion into DB schemes, Taylor highlights that "most are already in the same scheme as their employees – the DC scheme". However, they may be participating in the DC scheme with a higher employer contribution rate – "but that's a different question", he adds.

As well as meeting derision on Twitter, the imprisonment and fines option was greeted with scepticism when it was announced.

For instance, commenting at the time of the announcement, Barnett Waddingham senior consultant, Malcolm McLean, said: "There are also serious doubts as to how easy it will be to establish the new criminal offence of 'wilfully' or 'recklessly' mismanaging funds.

"These are ill-defined terms that a clever defence lawyer is more than likely to successfully challenge on the 'beyond reasonable doubt' test needing to be satisfied in a criminal case."

Ashurst pensions counsel, John Gordan, argued that the lack of clarity around criminal offences will cause anxiety in the industry.

"Many directors will wonder what constitutes 'wilful or reckless behaviour in relation to a pension scheme', in the knowledge that, if they get this wrong, they could face a long prison sentence and unlimited fines," he said.

Lincoln Pensions CEO, Darren Redmayne, agreed that the proposals will be difficult to implement.

"In principle, Amber Rudd's proposals are hard to argue with and probably good politics – trying to show that the government isn't simply beholden to Brexit issues. However, establishing a clear framework over what constitutes wilful or reckless behaviour in court will be very hard in practice."

Encouraging executives to fund DB schemes before making payouts to shareholders may be the most popular suggestion out of those proposed to ensure company executives pay adequate attention to their DB scheme, but it is clearly no one would expect it be an easy fix. When it comes to increasing sponsor enthusiasm for funding their DB scheme, a mix of carrot, stick and a number of tools in between look likely to be required.

Poll: Which of the three options do you think would have the greatest impact on motivating sponsors to take their responsibilities seriously and continue running their DB scheme?