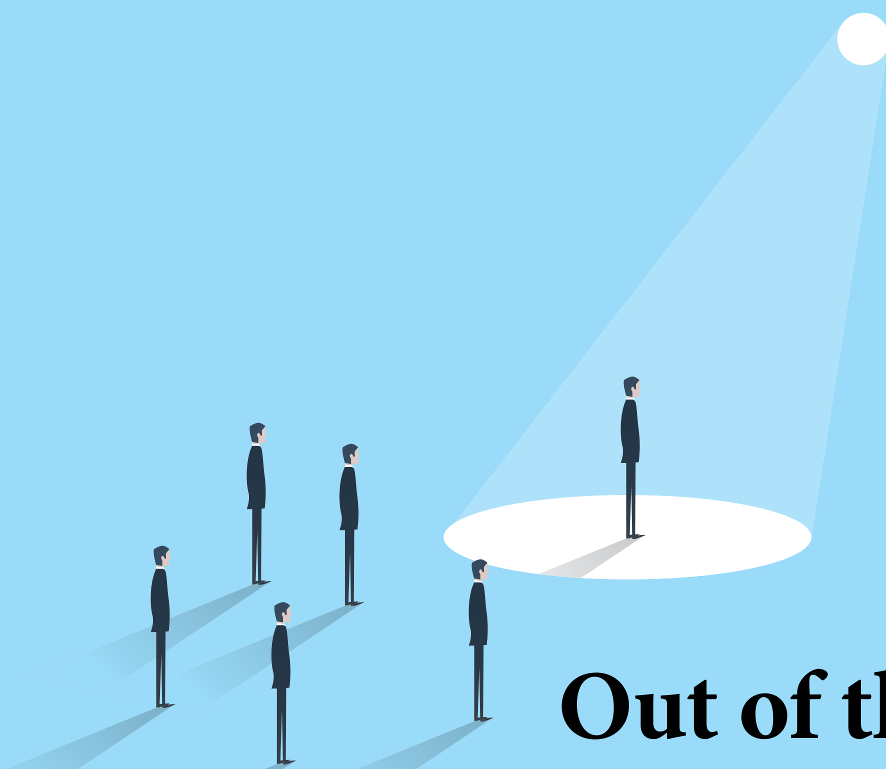

Summary
- In keeping with proposals to beef up the powers of The Pensions Regulator (TPR), the mantra 'clearer, quicker, tougher' runs through the regulator's latest annual funding statement.
- For scheme trustees, the notifiable events framework is possibly the proposal that has the biggest impact on their duties and responsibilities.
- Reports suggest that the regulator is already making more initial enquiries and intervening on certain occasions where it has been contacted by the scheme's trustees.

Out of the spotlight

Reports that employers who endanger their company pension schemes through reckless behaviour have meant that other proposed powers for the regulator attracted less attention, reports Graham Buck

The demise of British Home Stores (BHS) and Carillion were symptomatic of a wider malaise across their respective industries, the retail and construction services sectors. The vulnerability of other high street names and the recent administration of Interserve further underline the potential for further corporate casualties and the jeopardising of their pension schemes.

A year ago, the government white paper *Protecting Defined Benefit Pension Schemes* proposed beefing-up the powers of The Pensions Regulator (TPR) to intervene when employers recklessly contravene their obligations to DB schemes. In February, the Department for Work and Pensions' (DWP) response confirmed jail sentences as the ultimate sanction for company directors endangering the pension scheme through wilful or reckless behaviour. The move was welcomed by Frank Field, chairman of the work and pensions select committee, despite criticisms that it smacked overly of "gesture legislation".

Indeed, for Aon Hewitt partner, Lynda Whitney, the more interesting part of the additional powers proposed is the notifiable events framework, which requires trustees and employers to notify TPR if certain events occur that could potentially give rise to problems impacting on the scheme. "When corporate merger and acquisition (M&A) deals are agreed, the trustees will need to become more involved and the company will be required to detail just how the deal will affect the scheme," says Whitney.

Clearer, quicker, tougher

Not surprisingly the TPR's just-published latest annual funding statement is widely seen as adopting a more prescriptive approach to DB scheme funding; for example confirming that companies should pay greater attention to paying down their DB deficits over fattening up shareholder dividends. It comes ahead of TPR's revised funding code of practice, scheduled for later this year.

"TPR would no doubt argue that its tougher approach has been in the making for several years," says former minister of state for pensions and now Royal London director of policy, Steve Webb.

"But there can be no doubt that the high-profile pressure from Frank Field and the committee has given additional impetus to the need to be seen to be intervening earlier and more effectively where employers are not doing right by their pension scheme."

"The pressure and criticism faced by TPR in recent years are definitely key factors in the ongoing evolution of its regulatory approach," agrees Allen & Overy partner, Jane Higgins. "But this isn't a step-change.

"The new mantra is 'clearer, quicker, tougher' – the latest statement is clearer, rather than necessarily tougher. It sets out TPR's expectations in more detail than before, with a greater focus on scheme maturity and covenant strength."

In its latest statement, the regulator stipulates that "as the pension scheme

is a key financial stakeholder, we expect to see it treated equitably with other stakeholders."

So where the employer is "tending to weak, or weak", the scheme's deficit reduction contributions (DRCs) should be larger than dividend payments and other shareholder distributions, unless there is a strong funding target and short recovery plan. If the employer is weak and unable support the scheme, TPR expects shareholder distributions to cease entirely.

"TPR has published statistics that show there are many DB schemes in deficit where the amount the employer was paying out in dividends was a multiple of the deficit recovery payments," says Webb. "With BHS, huge dividends – larger than the profits of the company – were paid out in the early years and some took the view that this starved the business of investment, jeopardising its longer-term future. With Carillion, large and increasing dividends were being paid out right up to the brink of insolvency."

Many employers have negotiated longer recovery plans with trustees to pay off funding deficits on the basis that paying them off any quicker would damage the business, adds Capita Employee Benefits head of bulk annuities, Colin Parnell. However, TPR's 2018 scheme funding analysis found that median deficit recovery contributions across FTSE 350 companies were just 7 per cent of dividends paid – part of a downward trend in DRCs when compared to company dividends.

"In most cases, pension schemes are unsecured creditors that rank above holders of equity," says Parnell. "Therefore, trustees appear to have the power to push employers harder to speed up recovery payments."

At the same time, the onus is placed on them to determine when – and if – an employer should be regarded as 'weak'.

"Understanding the employer's 'covenant strength' can be difficult if the employer is not transparent," notes Webb. "An important part of the trustee's role is to stay close to what is happening in the business and also, where appropriate, to use professional advisers to provide an independent perspective on that covenant strength."

Parnell agrees that trustees are placed in a difficult position. "Obtaining appropriate advice and taking meaningful action can be expensive and is more difficult if delayed until a moment when the scheme and employer can least afford it. It is best to develop integrated risk management – usually with specialist covenant advice – while the covenant is still reasonable."

Long-term funding targets

The regulator's latest annual funding statement also places much emphasis on long-term funding targets (LTFTs), although, as Higgins notes, most schemes already have a long-term plan in place as part of their de-risking strategy and the comments may simply be there to help formalise good practice.

"LTFTs have already seen a lot of work between trustees and employers as in many cases a reasonable target needs to be agreed," agrees Whitney. "Consequently there can be considerable variation in the timescale. Integrated risk management is needed to determine the balance between the desired return, risk and security."

"The main new requirement is for schemes to have a clear statement of their destination – for example, are they heading for buyout and if so, over what period," says Webb. "This makes sense and will often have been implicit in the scheme's planning."

Parnell reports that "anecdotally, bulk annuity insurers have told us that larger schemes are better prepared to get to their ultimate destination than smaller ones. It is important that journey plans are sufficiently wide in their scope, also covering actions associated with data and benefit definitions, as well funding and investments."

Also still attracting attention is the issue of covenant leakage, particularly when the sponsoring employer is part of a larger group of companies. As two main examples, Parnell cites loans from the sponsoring employer to another member of the group and the sale of fixed assets where the sale proceeds are moved out of the sponsoring employer.

"However, it's hard to identify what actions are deliberate attempts to divert money from the statutory employer and, consequently, further away from the pension scheme," he adds.

"For example, many corporate group structures have cash sharing arrangements within the group, which help to reduce borrowing costs – ultimately improving the health of the sponsoring employer and scheme."

Higgins adds that instances of deliberate action to the detriment of a scheme without the offer of some mitigation remain relatively rare, since there is always the risk of TPR opening an anti-avoidance investigation.

The regulator also reveals that last year there were occasions when it made interventions ahead of a scheme conducting its latest valuation. Could this become a more regular occurrence?

"TPR is moving to a system of one-to-one supervision of the major schemes, rather than a three yearly reactive process," says Webb. "This will enable it to pick up issues earlier rather than simply wait for a valuation and then potentially spend months – if not years – disputing it.

"It is far better to be proactive and prevent these problems arising in the first place. Schemes are likely to see a more interventionist TPR than they have done in the past."

Whitney admits to feeling some sympathy for TPR, which "only a few years ago was being encouraged to be friendlier to plcs and focus on sustainable growth".

However, as she concludes: "The political climate has obviously changed; hence the new mantra and we've seen the regulator deliver a stronger message."

Written by Graham Buck

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