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THE GREATEST GOOD FOR THE GREATEST NUMBER

An examination of early intervention strategies for trustees and sponsoring employers of 'stressed' defined benefit schemes

A Pensions Institute discussion paper for DB trustees, sponsoring employers, advisers, policy-makers and regulators

Debbie Harrison

David Blake

December 2015

The best guarantee of a pension scheme keeping its promises is to make sure that the sponsoring employer prospers. This new objective for the Pensions Regulator ['sustainable growth'] will help ensure that trustees and employers have the flexibility to come up with plans which deal with pension scheme deficits, and benefit both scheme members and firms.
Department for Work and Pensions, March 2013

The Government rightly states that a strong sponsor is the best support for an underfunded DB scheme. But what if the employer is weak and likely to fail before it has paid off the DB debt?
Pensions lawyer, October 2015

The greatest good for the greatest number: An examination of early intervention strategies for trustees and sponsoring employers of stressed defined benefit schemes

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Supporting material for this discussion paper is available here:
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The Pensions Institute (www.pensions-institute.org) is the first and only UK academic research centre focused on pensions issues. The views expressed in this discussion paper are those of the authors and not the Pensions Institute which takes no policy positions.

List of abbreviations

ABI	Association of British Insurers
ABS	Asset-backed security
ASB	Actuarial Standards Board
AUG	Actuarial User Group (of the FRC)
AUM	Assets under management
BPA	Bulk-purchase annuity
CETV	Cash equivalent transfer value
CG	Covenant grade (used by TPR)
CPI	Consumer Prices Index
DB	Defined benefit
DC	Defined contribution
FCA	Financial Conduct Authority
FRC	Financial Reporting Council
FRS	Financial Reporting Standard
FSCS	Financial Services Compensation Scheme
HMRC	Her Majesty's Revenue & Customs
HMT	HM Treasury
IORP	Institutions for Occupational Retirement Provision
LPI	Limited price indexation
MNT	Member-nominated trustee
NAPF	National Association of Pension Funds
NRA	Normal retirement age
OPRA	Occupational Pensions Regulatory Authority
PMI	Pensions Management Institute
PPF	Pension Protection Fund
PPS	Pension Protection Score
PRA	Prudential Regulation Authority
QE	Quantitative easing
RAA	Regulated Apportionment Arrangement
RP	Recovery plan
RPI	Retail Prices Index
SEDR	Single effective discount rate
SORP	Statement of recommended practice
SPA	State pension age
TP	Technical provisions
TPR	The Pensions Regulator

Overview

There is an underlying assumption on the part of UK policymakers that the legal and regulatory framework governing the relationship between a defined benefit (DB) scheme's sponsoring employer, the scheme members and the Pension Protection Fund (PPF)[1] will lead to an optimal outcome, namely that most employers' businesses will survive long enough to pay members their full benefits. In this happy scenario, the PPF plays a benign and low-key role, only stepping in if, in a small number of cases, things go badly wrong and it takes over any remaining scheme assets and pays compensation to members. Indeed, the PPF's role, as perceived from a policy perspective, is so benign and low-key that trustees are expected not to take it into account in any funding strategies – in other words, they are required to pay an insurance premium, in the form of the annual PPF levy, but to behave as though the associated insurance cover (provided by the PPF) did not exist.

The research for this discussion paper suggests that this optimistic picture does not reflect the reality that many trustees face, as they strive to manage the seemingly impossible conflicts of interests between the diverse stakeholders to the scheme. A more realistic perspective, as presented in this discussion paper, draws attention to the all too common scenario where the pension scheme is significantly underfunded relative to the value of the sponsor's business,[2] and the trustees cannot rely on the financial support they need from the sponsor because its covenant[3] is weak. In this discussion paper, we describe these schemes as 'stressed'.

The trustees might believe that in the case of their sponsor's business, insolvency is almost inevitable – a matter of 'when' rather than 'if'. Or they might believe that the business has a viable future, but that it may become insolvent unless the DB deficit is removed from the corporate balance sheet.

The discussion paper found that for political and economic reasons, the crushing reality of the situation in which trustees of stressed schemes find themselves is not publicly acknowledged and debated. This collective 'silence' serves to stifle the development of practical damage-limitation strategies – what we might call 'second-best' outcomes – where the trustees satisfy as best they can their obligations to all stakeholders to the scheme.

The overarching finding of the discussion paper, therefore, is that if the Government does not accept and act on the reality that we identify and describe, the result will be far from optimal and far from even 'second-best'. Instead the

1 The PPF, established by the Pensions Act 2004, is the insurer of last resort for private-sector DB schemes and compensates members under certain circumstances if the sponsor becomes insolvent. Qualifying schemes of failed sponsoring employers started to enter the PPF in 2007. By September 2015, the PPF had just below one-quarter of a million members from about 800 schemes transferred in. See PPF Index: http://www.pensionprotectionfund.org.uk/Pages/PPF7800.aspx

2 The market capitalisation of a quoted company or the enterprise value of a private company.

3 The 'covenant' refers to the employer's present and future financial ability to meet its legal obligations to pay the promised benefits (the liabilities) and to manage the risks to which it is exposed, e.g., inflation, investment, longevity, and underfunding. See TPR, August 2015. Assessing and monitoring the employer covenant. http://www.thepensionsregulator.gov.uk/press/pn15-39.aspx.

private sector, and the economy as a whole, will suffer a worst-case scenario, whereby about 1,000 sponsoring employers' businesses – representing one sixth of the schemes in the PPF Index – are expected to become insolvent. In some cases, insolvency might be preventable. In others, schemes will transfer to the PPF with far fewer assets than might otherwise have been the case, transferring the stress to the PPF in its role as the industry's compensation scheme.

The discussion paper argues that this worst-case scenario can be averted if the approach to managing pensions changes to one that is prepared for many more schemes to pay less than full benefits on a planned and co-ordinated basis, with all parties in agreement on how best this is achieved. Freeing an employer from the burden of its pension fund, whilst avoiding insolvency can create extra value which can be shared with the members to achieve a better outcome. Examples of how this has been done are described in the supporting materials to this discussion paper.

The current funding position

In the UK, there are more than 6,000 schemes in the PPF Index of private-sector DB schemes, which, collectively, are responsible for paying current and future pensions to about 11m members and their dependants. Most of these schemes are closed, which means that members no longer contribute and the scheme is in 'run-off' – that is, when the last beneficiaries die, the scheme dies with them.

In aggregate, DB scheme trustees, whose job it is to ensure schemes fulfil their obligations, are responsible for assets valued at about £1.2trn, as at the end of September 2015. This is in relation to about £1.5trn in 'liabilities' – that is, the cost of providing all the pensions which need to be paid out until the last member dies, based on PPF compensation alone.[4] This gives an aggregate deficit of 20% relative to the PPF valuation measure (often referred to simply as 'PPF'), which is based on the levels of compensation the PPF pays. However, aggregate figures mask a wide spectrum of situations. Of the 6,000+ schemes in the PPF Index, just under 5,000 are in deficit and just over 1,000 are in surplus. This means that the aggregate deficit for underfunded schemes is closer to 25% on a PPF basis rather than the 20% stated when schemes in surplus are included.

However, PPF compensation does not cover private DB scheme liabilities in full. The level of compensation is determined by the member's age at the assessment date, which is almost always the day after the sponsor's insolvency. The PPF pays 100% of 'headline' pensions to members who have reached their scheme's NRA. PPF compensation is capped at £36,400 pa, with a further 90% adjustment applied so that PPF compensation is effectively capped at £32,700 pa (2015 cap levels). Nor does PPF compensation increase at the full statutory rate.[5] Interviewees suggested that the aggregate liabilities of PPF Index schemes, calculated on the basis of the cost of a full insurance company bulk purchase

4 The PPF valuation measure is also known as a Section 179 valuation (after s179 of the Pensions Act 2004). This is used by TPR and the PPF in their joint annual publication, The Purple Book: http://www.pensionprotectionfund.org.uk/Pages/ThePurpleBook.aspx.

5 PPF indexation is 0% for pre-97 service, and is CPI (Consumer Prices Index) capped at 2.5% pa for post-97 service, instead of the statutory 5% pa.

annuity buyout (BPA) of all benefits, is nearer to £2trn, suggesting an aggregate deficit of almost 40%. In effect, trustees of underfunded schemes, as an unsecured creditor of their sponsor, have made a loan equal to 40% of their liabilities to a single UK employer or employer group which might have a very weak credit rating.

Nevertheless, the PPF valuation measure is important, because it is used to assess whether, on a sponsoring employer's insolvency, the DB scheme enters the PPF. If the scheme assets – and any other business assets that can be reclaimed – amount to more than PPF-level funding, the trustees are required to buy a bulk purchase annuity (BPA) to secure these higher level of benefits for the members. If not, the PPF picks up the tab and the members receive just PPF compensation.

The journey from 2000 to 2015

The build-up of these systemic deficits started at the turn of the century. Explanations for this include volatility in the stock markets, increasing life expectancy, increasing accounting and regulatory requirements, and, importantly, quantitative easing (QE), which has led to historically low gilt yields that increase the cost of a pension promise.[6]

Clearly, the trustees' position must be seen in the context of the strength of the employer's business and its ability to support the scheme financially (its covenant). Where there is a strong employer, with a good prognosis for the future prosperity of the business, it is reasonable to assume that the deficit will be paid off in full, over time, so that the members will receive full benefits. This is not the case for stressed schemes, where trustees can have little confidence in the ability of the employer to meet the conditions of the debt-repayment schedule, as set out in the scheme's 'recovery plan'.

The risks associated with stressed schemes can be exacerbated where the trustees try and remedy the funding position by continuing to invest in riskier assets, such as equities, in the hope of receiving higher returns so that full benefits can be afforded. As unsecured creditors that already have a high exposure to a single UK company or employer group, this is counter-intuitive.

Of course, should the gamble pay off, the deficit will be reduced. But if it does not, and if it leads to returns that are lower than gilt yields, the deficit will rise, which means that the trustees will have effectively increased the amount of the loan to a sponsoring employer whose business may also have deteriorated, rather than improved, in the intervening period.

Earlier intervention might achieve one of two more positive outcomes, should the employer's business fail:

- With earlier intervention, the scheme might provide more than PPF

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6 Low gilt yields imply a low discount rate for valuing scheme liabilities. A low discount rate raises the discounted present value of future pension payments, hence increasing the reported value of the pension liabilities. So QE – a government policy designed to 'save' the banking system after the Global Financial Crisis – has compounded the woes facing trustees responsible for another set of financial institutions, namely DB pension funds.

compensation, which would be secured by a BPA with an insurance company. Without earlier intervention, the members are likely to receive just PPF compensation, which would mean that younger (pre-NRA) members, in particular, would lose out on the potential of receiving more than PPF compensation. In effect, these members will have borne an increased investment risk without their knowledge and their consent.

- With earlier intervention, the scheme might still be insufficiently funded to deliver PPF compensation, but nevertheless it might enter the PPF with more assets. Without earlier intervention, the deterioration in scheme funding, and possibly also in the business assets, would result in an increase in the financial burden and risk faced by the PPF and by the remaining levy payers.

The extent of the problem

The PPF has already accepted that about 10% of employers that sponsor schemes in its Index – that is, about 600 schemes – are unlikely 'ever' to pay off their pension scheme debts:

> *It is abundantly clear from our 7800 index[7] figures that there are many schemes out there currently in deficit. Some may not be able to meet the promises they've made. And there is perhaps 10 per cent, maybe more, where the chances of the shortfall ever being repaired, no matter what happens to interest rates, look decidedly bleak.*[7]

TPR[8] and the PPF do not publish specific data on sponsoring employer credit ratings, but we found sufficient information to make the following broad estimates,[9] which suggest the PPF's own worst-case scenario might be an underestimate. Our estimate suggests that:

- 1,000 schemes, representing more than 15% of PPF Index schemes, are subject to unmanageable stresses and are very unlikely to pay future pensions in full to members and their dependants.
- Of this number:
  - 600 sponsoring employers will never pay full pensions, i.e., we agree with the PPF's own assessment and go further to estimate that many of these employers will become insolvent in the next five to 10 years.
  - 400 sponsoring employers, with viable businesses, also face the prospect of an insolvency and this is caused largely by the pension scheme deficit.

Failure to face the facts

7 The source for this quotation was an article written by Gwyn Hacche, Head of Research at the PPF, which appeared on 8th April 2015 in Pensions Expert: http://www.pensions-expert.com/Comment-Analysis/Interest-rates-and-the-PPF.

8 TPR is the UK regulator of work-based pensions. It is a non-departmental public body established under the Pensions Act 2004. Its sponsoring body is the Department for Work and Pensions (DWP) and Parliament sets the legal framework. Prior to the 2004 Act, the system operated under the minimum funding requirement rules, which were introduced in 1991 after the Maxwell/Mirror Group Pension Fund fraud case. For a useful survey of pre- and post-the 2004 Act, see 'A 10-year scorecard', IPE, Sept. 2015.

9 See 'Estimates used in the discussion paper' on p.22 below.

The stance taken by the Government and regulator, based on what we believe is an unrealistic prognosis for the market, makes it very difficult for trustees of stressed schemes to take appropriate and prompt action, for example, to demand from the employer the required contributions to secure members' benefits in full. If they act to secure the best possible deal for all members, this might be seen as a contravention of the 2014 government-imposed objective for TPR to support 'sustainable growth'[10] in the economy.

As a result of this dilemma, trustees may feel that they have little choice other than to carry on as normal, in the hope the sponsor will survive and that interest rates will eventually rise and reduce scheme liabilities. This represents a big gamble for fiduciaries who have a responsibility to act prudently. If the employer's business fails to prosper and if interest rates remain stubbornly low, any delay in stemming the damage is likely to lead to a further deterioration in the pension scheme's funding position and, consequently, further uncertainty for the employer.

If, on the other hand, trustees do recognise that the status quo is risky and decide to approach TPR for help, the response is likely to depend on the size of the scheme. The regulator is quite open about the fact that its resources are limited, and that it focuses on the largest schemes, which would pose the most risk if the sponsor became insolvent, the scheme was significantly underfunded, and it passed into the PPF.[11]

The relationship between trustees and the PPF

Trustees have told us that they feel bewildered by the regulatory requirement to act as though the PPF does not exist. We find this bewildering too. While case history has thrown up examples where trustees have exploited or at least have tried to exploit the PPF compensation scheme, such cases are rare and involve 'selecting against' or 'gaming' the PPF.[12] Moreover, we assume that, as a modern, major and rapidly-expanding unregulated insurance provider,[13] the PPF naturally would expect to have to deal with examples of 'moral hazard', as this goes with the

10 Introduced in the Pensions Act 2014.

11 One of TPR's original objectives, as set out in the Pensions Act 2004, is to protect the PPF. In 'Defined benefit funding regulatory and enforcement policy', June 2014, TPR explains the factors it considers before engaging with what we identify as a stressed scheme. These include: 'the size of the scheme's liabilities; the potential complexity and resource intensity of our engagement compared to the impact and the value we can add through further engagement; and the overall resources we have available'. www.thepensionsregulator.gov.uk/docs/db-funding-regulatory-enforcement-policy.pdf

12 The High Court case most frequently cited is 'Independent Trustee Services (ITS) vs. Hope'. The Trustee of the Ilford Pension Scheme sought permission to buy annuities for certain scheme members before the scheme entered the PPF. The High Court concluded that the scheme was not permitted to 'select against' the PPF by buying annuities only for certain members, and therefore relying on the PPF to pick up the cost of compensation for the bulk of the members. See, for example: www.sackers.com/pension/independent-trustee-services-ltd-v-hope-high-court-10-november-2009.

13 To all intents and purposes, the PPF operates as a mono-line insurer. However, it was set up by the 2004 Pensions Act as a statutory body and is governed by a board that is a statutory corporation. Unlike conventional insurers, including providers of BPAs, the PPF is not regulated by the Financial Conduct Authority (FCA) nor by the Prudential Regulation Authority (PRA). This, in turn, means that the 'insured' benefits the PPF pays to members are not protected under regulations for financial services business, e.g., by the Financial Services Compensation Scheme (FSCS).

territory.[14]

The annual PPF levy on schemes in its Index is a premium for mandatory insurance. In return, the PPF (the insurance provider) guarantees the trustees (the insured) that it will protect the benefits of members, in the event of the sponsoring employer's insolvency where the scheme is underfunded relative to PPF, i.e., it insures PPF-level compensation for members.

As we indicated in the opening paragraph to this overview, it seems illogical to expect that a 'customer' who pays an insurance premium should behave as though the insurance policy and the insurance provider did not exist. Yet this appears to be what is expected of trustees. As one interviewee said:

> *To require trustees to act as though they are uninsured is not rational; nor is it consistent with the trustee's fiduciary obligations to members.*

The lack of clarity in the relationship between trustees, as the 'insured', and the PPF, as the 'insurer', creates confusion. The dysfunctional nature of this financial relationship is exacerbated by TPR's sustainable growth objective.

Sponsoring employer funding obligations and sustainable growth

Scheme funding levels, generally, have weakened in recent years. While QE and low gilt yields have contributed to the problem, generous indexation above the statutory minimum is an additional and significant factor.

Whatever the economic, demographic, and scheme-specific reasons for the deteriorating position of most scheme funding levels, two facts are clear: in aggregate, deficits have increased and recovery periods have been extended. We believe that this is, in part, due to the relaxation of employer funding requirements under the sustainable growth objective.

Under this objective, TPR expects trustees to consider carefully a sponsoring employer's request to reduce contributions to the scheme in order to increase investment in the business. For stressed schemes, this is another gamble where the odds may be unclear. If the bet pays off, the sponsor's business will prosper (put another way, the covenant will strengthen), which means that the employer should be able to pay higher contributions to the scheme in the future. The calculation required for trustees to make an informed decision is not easy, as it requires a clear evaluation of the rate at which the sponsor covenant is expected to strengthen relative to the reduction in the scheme funding level arising from the potential loss of the employer contributions.

While we understand that TPR had moved informally towards a sustainable growth objective prior to 2014, until this date, the trustees' duty was clear and free of conflicted interests: their job was to understand the relationship between the scheme's assets and liabilities, and to agree the scheme's recovery plan in a way that would ensure benefits were paid now and in future.

The new objective stops short of a formal requirement for trustees to support

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14 See David Blake, John Cotter and Kevin Dowd (2007) Financial risks and the Pension Protection Fund: Can it survive them?, Pensions, 12(3), 109–130. Available at www.pensions-institute.org/workingpapers/wp0711.pdf.

the sponsor, that is, specifically to permit the sponsor to reduce contributions and extend the recovery period in order to invest in the business. However, it shifts the balance of power, putting the onus for evidence to refuse the sponsor's request on the trustees, which means the trustees need to present a clear case for rejecting a sponsor's request. This shift was made clear by TPR at the time of the announcement of the objective in the March 2013 Budget:

> *We regulate according to the legislative framework set by Government and Parliament…*
>
> *In today's Budget statement, the Government announced that, across the entire regulatory system, it is taking action to shift the balance of regulation in favour of private sector investment and growth. This objective applies to the regulation of defined benefit (DB) pensions as recent economic conditions have put companies sponsoring DB schemes under significant financial pressure.*[15]

The overarching question raised by this discussion paper

The Government's policy position is made clear in the quotation on the front cover of this discussion paper, which we repeat here:

> *The best guarantee of a pension scheme keeping its promises is to make sure that the sponsoring employer prospers. This new objective for the Pensions Regulator ['sustainable growth'] will help ensure that trustees and employers have the flexibility to come up with plans which deal with pension scheme deficits, and benefit both scheme members and firms.*[16]

In response, the question we raise in this discussion paper is as follows:

> *What actions should trustees take in the best interests of all the members they serve, if the employer is not strong, is unlikely to prosper, and cannot realistically be relied upon to pay member benefits in full?*

It's time to break the collective silence

In the discussion paper, we propose that all direct and indirect stakeholders to DB schemes – including the Government, TPR and the PPF – should recognise and acknowledge the clear and present danger we highlight. They should work together to produce a 'second-best' outcome, which we define as providing practical support to trustees with stressed schemes so that trustees can, first, act in the best interests of all scheme members, and, second, meet as best they can the demands of the wider group of stakeholders to the scheme.

The focus of the discussion paper's proposals is twofold:

1. To equip the trustees of stressed schemes with the know-how to have a discussion about securing less than full benefits through a PPF+ buy-out with a BPA insurer, where this is in the interests of the members overall and, in

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15 http://www.thepensionsregulator.gov.uk/press/pn13-13.aspx

16 Department for Work and Pensions, March, 2013. https://www.gov.uk/government/news/new-objective-for-regulator

particular, for younger pre-NRA members.

2. To enable trustees of stressed schemes that cannot match or beat PPF compensation benefits to maximise scheme assets before entry to the PPF, in order to reduce the burden on the industry compensation scheme and on the remaining PPF levy payers.

To achieve these objectives, the Government and the regulator would need to address four issues:

1. The need for an acceptance of the fact that stressed schemes require improved access to negotiated agreements that deliver less than full member benefits, but which are nevertheless 'for the greatest good of the greatest number'. This is a new, more realistic and more practical interpretation of the sustainable growth objective.

2. The manifest inefficiencies and inequities in the law and regulations that govern closed DB schemes.

3. The dynamics and tensions of a market in which participants – trustees, sponsors, and their various advisers – are anxious to avoid stepping out of line, resulting in herd-like institutional behaviour.

4. The need to disseminate this new interpretation of sustainable growth across the DB scheme community, particularly to the advisory community, which would need to develop an appropriate set of skills to meet the needs of trustees of schemes of all sizes. At present, it appears that the expertise and demonstrable experience in dealing with stressed schemes is concentrated in too few firms.

While the discussion paper focuses on schemes that are already stressed, or likely to become so, it is of relevance to the wider market – to the trustees and sponsoring employers whose schemes are in more favourable positions. As case history demonstrates, a strong sponsoring employer and a well-funded DB scheme today is no guarantee that this will be the case tomorrow. A scheme's position can change quickly if a sponsoring employer is bought, sold or restructured; and it can change more slowly, but relentlessly, if a sponsoring employer operates in an industry that enters long-term decline.

The methodology and structure of this discussion paper

The main research took place between January and October 2015. It included an extensive series of interviews with experts from firms of accountants, actuaries, covenant analysts, insolvency practitioners, insurance companies, investment consultants, lawyers, and professional trustees, among others, who helped us to understand the issues and to shape the proposals.

Our traditional format for practitioner reports is to set out the issues and to make firm recommendations to the Government, to the regulators, and to the industry. By contrast, what we have written here is a discussion paper. We set out a brief summary of the findings in the usual manner, but instead of making recommendations, we provide a range of proposals, which we offer as a framework for a long-overdue extensive and public debate.

There are two reasons for this more cautious approach. First, despite the excellence of The Purple Book, which is published jointly each year by TPR and the PPF, and also the excellence of their websites, we were unable to find any specific information on the number and the financial profile of the sponsoring employers in Covenant Grade 4 (CG4), which is the lowest of TPR's categories. Even trustees and sponsoring employers do not know if the employer covenant is classed as 'weak' by the regulator, and if so, just how weak relative to the others that are also in this category. This means that we did not have access to the essential data required for evidence-based recommendations. This lack of data is a significant problem in its own right.

Second, we found a surprising polarisation in the expert opinions expressed during our confidential interviews. On key issues, experts even within the same profession strongly disagreed. And while we found most experts' arguments to be valid and persuasive, on several crucial points they were also irreconcilable. This means that we cannot assume that any proposals we make in this discussion paper will necessarily have majority support across all stakeholder categories.

Acknowledgements

We would like to thank all of the organisations and individual experts who helped with this research. We would particularly like to thank the five sponsors of the discussion paper: 2020 Trustees, Eversheds, Lane Clark & Peacock, Lincoln Pensions, and Rothesay Life.

Where we quote from a published report, paper, or article in the press, for example, the source is cited. Where we quote from interviews held in confidence, the quotations are anonymised. This technique, pioneered by the Pensions Institute in 2004 for its practitioner reports, enables us to express the views of experts more candidly than might otherwise be the case. Those who were happy to be associated with the discussion paper are listed in the acknowledgements. The list does not include the individuals who agreed to be interviewed in their capacity as lay trustees and company directors. We thank them for their candour and respect their privacy.

The views expressed in this discussion paper are those of the authors and not necessarily those of the sponsors, who did not seek to influence the research. Moreover, the views are of those of the authors and not of the Pensions Institute, which takes no policy positions.

Debbie Harrison and David Blake
Pensions Institute, December 2015

Findings

1. Up to 1,000 private-sector defined benefit (DB) schemes are 'stressed' and unlikely to pay member pensions in full. In some cases – about 400 schemes – the sponsoring employers' businesses might be viable, but they will not survive if the scheme deficit remains on the corporate balance sheet. Up to 600 schemes will never, ever pay full benefits.

'Stressed' denotes a significantly underfunded scheme with a weak sponsor covenant.[17]

In aggregate, these 1,000 schemes – which include about 25 of the largest schemes in the UK, each with £1bn+ in liabilities – represent:

- Liabilities estimated at £225bn
- Assets estimated at £180bn
- Deficits estimated at £45bn

If this situation is not addressed urgently, businesses that might be saved will be lost to the UK economy. In addition, the future pensions of members and their dependants may be affected adversely, because the compensation scheme (the PPF) does not cover private DB scheme liabilities in full, especially for most pre-NRA members, but also for those with generous non-statutory indexation.

2. TPR's 2014 'sustainable growth' objective is in direct conflict with its role to support trustees in their primary duty to protect scheme members' benefits, and also to protect the PPF.

The Pensions Regulator's (TPR's) new objective, introduced by the 2014 Pensions Act, is at odds with two of its most important and original objectives in the 2004 Pensions Act, which are:

- To support trustees in their primary duty to ensure members' pensions are paid in full, and
- To protect the Pension Protection Fund (PPF) by ensuring trustees do their duty and, wherever possible, avoid the necessity for PPF compensation.

Under the new objective, TPR effectively requires trustees to allow the sponsor to retain money in the business, at the expense of the pension scheme. The likely consequences are that stressed schemes will experience worsening funding conditions, and that failing sponsors will lose money that could otherwise have supported the scheme. Where this occurs, the PPF will have to pick up the tab for this double loss.

17 For the data analysis, see 'Essential background' below.

3. The new objective also imposes conflicts of interest on the trustees of stressed schemes, which can lead them to put off taking essential actions. Schemes are already typically around 40% exposed (in terms of liabilities) to a risky borrower in the form of an implicit loan to the sponsor (equivalent to two-thirds of their assets).

Trustees told us that they are caught between a rock and a hard place. If they insist on prioritising members' interests, they will have to ask for higher sponsor contributions (assuming other forms of security are not available or are inappropriate) and this will upset the sponsor who will point to the TPR's sustainable growth objective. If they put the sponsor's business first, they could face future class actions on the part of angry scheme members whose benefits would be reduced in the event of the sponsor's insolvency.

Similar conflicts arise in relation to the trustees' investment strategy. Through no fault of their own, trustees of stressed schemes have, in effect, typically invested up to 40% of the scheme in a high-risk investment, in the form of an implicit loan to the sponsor who can give no guarantee of ever repaying it in full.

In addition to this, trustees have typically invested more than half of their available assets – equivalent to another 30% of the scheme – in risky asset classes such as equities. This might be due to institutional herding – i.e., 'this is what everybody else does' – but it is also due to the fact that some trustees believe that they have little or no choice if they want to reduce the deficit. They believe that if the strategy pays off, in the form of higher investment returns, this will offset the impact of the lower financial support from the employer. However, a low-risk investment strategy might be more prudent for the members given their perilous position as a major creditor to an unstable employer.

4. The PPF compensation structure is arbitrary and unfair for younger members. It could be 'gamed' by pre-normal retirement age (NRA) directors with large pension entitlements.

PPF compensation incorporates an inequitable cliff edge for pre-NRA members (most commonly those with deferred benefits but also some early retirees). Post-NRA members get 100% of their basic pensions; pre-NRA members' pensions are subject to an annual cap for larger entitlements and are also cut by 10%, no matter how small the annual pension. Currently the cap is £36,400 pa, which means the maximum pension is £32,700 pa.

As a direct result of this inequality of treatment, interviewees said that pre-NRA directors, with large pension promises, might be tempted to let a defunct business 'limp on' until they reach NRA, at which point they could allow the company to go into insolvency, having secured maximum compensation under the PPF and potentially much more than if they had been under NRA.

5. Lay trustees in stressed schemes are unlikely to have the level of expertise needed to deal with complex corporate issues. Corporate and debt restructuring skills were not in the job description.

Most trustees, with the exception of professional firms, are unpaid volunteers. Where the scheme is stressed, they face complex corporate issues, including company and debt restructuring, turnaround management, and insolvency issues.[18] One interviewee said: 'This corporate financial expertise wasn't in the job description and we have no learning curve and we can't afford the fees of the big professional advisers.' Another said: 'We [the trustees] have become a corporate restructuring problem – we're the biggest creditor to the company and we just happen to represent an underfunded pension scheme.'

We describe the position of lay trustees as one of 'informed bewilderment'.[19]

6. Trustees are in the dark about the rating TPR has allocated to the sponsor's covenant.

The regulator places sponsors into one of four covenant grades – based on the trustee annual scheme return and an Experian corporate credit rating (of 1-10) – which takes sponsor insolvency risk into consideration and is used to set the annual risk-based PPF levy. TPR does not report the covenant grade to trustees, even where it is 'weak' (the lowest grade) which would indicate the need for urgent trustee action. In theory, trustees could gain insight by examining the Experian rating, but few will have the quantitative skills required.[20]

7. Some directors may not be candid with trustees about planned corporate actions that would weaken the scheme's position as a creditor. They may also not be candid with shareholders and creditors about the real risks of the DB deficit for the business's prospects.

Interviewees said that, while the directors of larger companies understand the implications of the DB deficit on the corporate balance sheet and tend to deal candidly with trustees, shareholders and creditors, the directors of smaller companies may not fully understand the impact of the deficit on the business's corporate financial structure. Trustees may not be aware of planned corporate actions and as one interviewee said, 'The Pensions Regulator regulates pension schemes, not directors'. For their part, the sponsor's shareholders and creditors may not be aware of the full risks of the scheme deficit.

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18 Broadly, 'corporate restructuring' describes strategies that might help a company that is in a declining financial position to avoid insolvency and to turn around the business, so that it can continue, albeit possibly in a different guise. Typically, these strategies will involve changes in the legal structure, the ownership/management, and in operational structures, among others. 'Turnaround management' forms part of this restructuring process and describes the expert corporate analysis that identifies the causes of financial stress and determines the steps necessary for the business to recover.'

19 A phrased coined by the Spanish-American philosopher/social-scientist Manuel Castells in relation to the overwhelming and often contradictory information available on the Internet.

20 See https://www.ppfscore.co.uk/Content/Documents/Scorecard_Examples_Oct%202014.pdf.

Proposals

1. Change TPR's remit for trustees of stressed schemes from 'protection of member benefits' to 'protection of member interests'.

Protection of members' benefits means doing everything possible to ensure members receive full benefits. This makes it difficult for trustees to acknowledge that, in reality, full benefits may never be delivered by the scheme. Protection of members' interests is more practical and could be defined as 'doing the right thing in the financial and economic circumstances', which might mean reducing indexation and/or capping benefits, for example. To make such actions available would require statutory change. If adopted, this would:

a. Enable trustees, sponsors, TPR, and the PPF to take a more realistic view of their options and facilitate 'second-best' outcome negotiations that could result in better pensions for pre-NRA members in particular than would be paid by the PPF.

b. Enable trustees to be more candid with their members about the true state of the scheme.

c. Reduce trustees' incentive to take excessive investment risks in order to increase the chances – however small – of paying full benefits, even when this gamble may not be in the interests of the employer, the members, and PPF levy payers in general.

2. Make non-statutory pension increases contingent on the scheme's funding level, i.e., introduce conditional indexation.

Following on from proposal 1 above, non-statutory pension increases should be made contingent on the scheme's funding level. There are two possible ways of doing this: either trustees are given the ability to apply to TPR for such a power (as in Ireland), or TPR should have the power to direct trustees to restrict pension increases to the statutory minima where the scheme is significantly underfunded – for example, where it is lower than a specified percentage of the PPF funding level. Some interviewees suggested the trigger should be 100% of the PPF funding level, as at the last levy assessment reporting date. Others suggested percentages lower than this, for example, 80%.

If adopted, the restriction on pension increases to the statutory minima should apply to pensions in payment as well as to deferred pensions, as is the case with PPF compensation increases.

The ability to restrict increases already applies in Ireland[21] and in the Netherlands (where it is known as conditional indexation).

21 Section 50 of Ireland's Pensions Act 1990 enables the regulator (the Pensions Authority) to take action where a scheme is experiencing significant funding difficulties, after receiving an application from the trustees. In these cases, the regulator can direct trustees to reduce the benefits of active and deferred members, including preserved benefits. It also enables the Authority to direct trustees to reduce future increases in benefits payable to pensioners.

3. Introduce a PPF 'pre-assessment' period to facilitate early intervention.

Where the covenant strength does not improve and the funding position continues to deteriorate, TPR could intervene and require trustees to take appropriate advice and action. This might be denoted as a 'PPF pre-assessment'.

In fact, TPR already has the power and obligation to intervene and has a formal appeals process, which is necessary for regulators to have such powers in the first place. The PPF does not have intervention powers, but its influence in cases that present a risk to the PPF compensation scheme could be enhanced if it had the right to formally request TPR intervention in particular cases.

4. Change the PPF's cliff-edge compensation rules for pre- and post-NRA to a phased approach, based on age and/or length of service.

This would introduce greater equity between member cohorts. It might also eliminate concerns about the potential gaming of the compensation rules by high-liability directors in failing businesses, who are holding on in order to reach NRA. The Government has already considered changing the rules to soften the effect of the cliff-edge for pre-NRA members with long service, but the provision in the Pensions Act 2014 had not come into force at the time of writing.[22] Moreover, experts said that even when it is introduced, it will have a very limited effect on the impact of the cliff-edge.

5. Provide specific guidance for trustees of stressed schemes on the appointment criteria for specialist advice, and provide a rapid fee-check calculator to reassure trustees that they will not contravene the regulator's guidance on 'proportionality'.

Telling trustees of stressed schemes to appoint an adviser is of little use if they don't know how to identify the right firm from among the many that practise in each relevant field. Moreover, it's not just about identifying the right firm: interviewees said that trustees need to find the right individual or team within a firm.

We propose that the PPF sets out the criteria trustees of stressed schemes might apply to the selection process, based on its own criteria for appointments to its Trustee Advisory Panel (members of which are commonly appointed to guide schemes through the PPF assessment period).[23] We would expect the guidance to emphasise the importance of demonstrable experience and the need to request references based on relevant previous case work. The PPF and TPR should also clarify the order of priority of appointments. Certain appointments, such as the scheme actuary, are statutory requirements, but many are not.

Interviewees from across the professions said that trustees and/or sponsoring employers of stressed schemes should start with the appointment of a professional trustee with experience in corporate debt restructuring, turnaround management, and insolvency. The individual or team should have a proven track record

22 DWP, June 2013. https://www.gov.uk/government/news/government-to-increase-pension-compensation-for-long-servers

23 All schemes go through an assessment period before entering the PPF. Among other processes, this includes a data check to ensure that members receive the right compensation payments. http://www.pensionprotectionfund.org.uk/AssessmentPeriod/Pages/AssessmentPeriod.aspx

in managing conflicted and fraught trustee-employer negotiations, and in negotiating successful outcomes with TPR and the PPF.

Trustee training is also important, of course, but interviewees said that standard trustee training programmes can be ineffective, because the training is often just too generic.[24] We suggest the PPF is best-placed to run or to facilitate online training. It already offers seminars on contingent assets, for example.[25] Of course, one of the most pressing problems for trustees is time. Trustees of large schemes typically spend more time on their duties than those in medium and small schemes (a mean of 16, 12 and 9 days per year respectively).[26]

Professional fees are a big concern for trustees of stressed schemes, as resources are limited. TPR stresses the importance of professional advice, but says the cost should be 'proportionate', an ambiguous term that trustees do not know how to interpret in relation to the financial resources of the scheme and the employer. We propose that TPR provides some form of quick and simple fee-check service to enable trustees and sponsors to secure the help of a specialist professional trustee which has the necessary expertise in restructuring and turnaround management.

6. Introduce a requirement for TPR to alert trustees and sponsors when it identifies that a sponsor's covenant is 'weak' (its lowest ranking), or is on a rapid downward trajectory towards this ranking.

Trustees and sponsors could be made aware if the regulator has categorised the sponsor covenant as weak. We appreciate that TPR might be reluctant to issue such information, as, if leaked, it could have a negative impact on the confidence of shareholders and creditors. That said, we believe that the regulator, in conjunction with industry experts, could develop an effective process.

In return for providing regular details about the covenant rating, TPR could require trustees to demonstrate over time a positive overall net improvement in the sponsor's covenant strength. This could be in relation to TPR and Experian's ratings, the length and terms of the recovery period, and the scheme's funding position.

Initially, the covenant strength might improve and the scheme's funding position might deteriorate, but the requirement should be that the net effect is expected to be positive for the members or on a trajectory that will become positive over a relatively short period. TPR and the PPF should consult with the industry to develop a metric that facilitates an evaluation against this expected improvement. In particular, interviewees stressed that the measure of an improvement in the business prospects relies on much more than an increase in the company's short-term trading performance, since the risks in the scheme may have outpaced any apparent trading upturn during this period.

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24 'Research and analysis,' published by TPR in October 2015, found that only a minority of trustees had used formal training offered by the Pensions Management Institute (8%) or the National Association of Pension Funds (13%). http://www.thepensionsregulator.gov.uk/doc-library/research-analysis.aspx

25 http://www.pensionprotectionfund.org.uk/levy/Documents/ca_seminar_flyer_sep15.pdf.

26 TPR, Oct. 2015. Research and analysis. http://www.thepensionsregulator.gov.uk/doc-library/research-analysis.aspx

An alternative to TPR providing covenant grades would be to facilitate trustees' use of the Experian rating, which is a key factor in setting the PPF levy. However, sample Experian rating reports on the PPF website[27] suggest that at present this information is directed largely at professional advisers. Trustees would need a plain-English guide to the data and a clear explanation of the correlations between TPR's four covenant grades and Experian's 10 risk categories.

Trustees should be required to monitor potential levels of future PPF drift and report it to TPR via the annual scheme return.

7. As part of each funding review, employers should be required to provide an annual statement to the trustees about the prognosis for the business over the next three to five years, including any plans for corporate actions. This would align the regulation and governance of sponsoring employers with the concerns of trustees.

At present, TPR tends to take a fairly short-term view (e.g., 12 months) of impending insolvency, as one of the triggers for regulatory engagement or intervention. Trustees need a longer period over which to assess the sponsoring company's prognosis. The Financial Reporting Council's (FRC's) new governance code for quoted companies applies to directors' disclosure of the business's prognosis in the corporate annual report and accounts and requires a medium-term outlook, which is taken to mean three to five years.

We propose that TPR and the FRC jointly introduce an equivalent requirement for directors' disclosure to trustees who, as we have mentioned, are often the biggest unsecured creditors by far.

27 http://www.pensionprotectionfund.org.uk/levy/Pages/PensionProtectionLevy.aspx and https://www.ppfscore.co.uk/

Conclusion

This discussion paper indicates a bleak prognosis for members of c. 1,000 stressed DB pension schemes sponsored by UK private sector employers, especially for the younger members – if, that is, nothing is done to change a status quo characterised by systemic conflicts of interest.

Our hope is that the paper will stimulate an open debate and unflinching scrutiny of the problems we identify. We hope also that changes may be made, which will lead to the survival of many of the sponsoring employers, to improved benefit prospects for scheme members, and, where insolvency proves inevitable, to the mitigation of risk to the PPF and to PPF levy payers.

We conclude with a few observations that struck us as fundamental to understanding the present difficulties faced by closed stressed DB schemes in particular, and by stakeholders to DB schemes as a whole.

The Pensions Act 2004 was designed to protect and sustain the DB pension system in the private sector. It was not designed to deal with corporate and debt restructuring. TPR and the PPF were set up under the Act to ensure fair play and to compensate members where a sponsoring employer became insolvent. They were not designed to arbitrate in cases of corporate damage-limitation exercises. The job of lay trustees under the Act was to manage the scheme in line with its trust deed and rules and to look after the members' interests, not to own, run, and, if necessary, restructure the sponsoring employer's business.

What TPR is being asked to deal with is a corporate crisis in relation to major creditors that just happen to be the trustees of closed pension schemes. In the past, it has told trustees to act as though they are bank lenders. But in many ways, trustees are not like bank lenders. A bank can call in the debt and push the business into insolvency; if the debt turns bad, the loss can be offset against profits elsewhere in the bank's business. Trustees do not have an 'elsewhere' to which they may turn for funding.

Essential background to the findings and proposals

1. The characteristics of a stressed scheme

'Stressed' very broadly translates as 'a weak sponsor, whose business is likely to fail before it has repaired the deficit in an underfunded closed DB scheme'. More precisely, it denotes a specific combination of features, of which the strength of the sponsor covenant is just one, albeit the most important. In particular, stressed denotes:

a. **The sponsoring employer's 'covenant' is weak.** This means the trustees are not able to rely on the sponsor to fund the members' full benefits over time, due to the mis-match between the length of the recovery plan, and the potentially much shorter lifespan of the sponsor's business. Moreover, a weak covenant is not synonymous with 'smaller employer'. More than 50 of the UK's largest closed private-sector DB schemes (defined by TPR as those with liabilities in excess of £1.2bn) are already stressed or likely to become so, due to the weakness of the covenant. These schemes account for more than £170bn of liabilities, which is more than 10% of the total for all schemes.

b. **The scheme's funding position is weak.** This means the scheme needs more support from the employer, in the form of contributions and guarantees, at a time when the employer's support is being significantly reduced, for reasons we explain below.

'Weakness', in relation to scheme funding, is a relative term because there are several funding and valuation measures. For stressed schemes, we use the most relevant measure, which is the Section 179 valuation (s179 of the Pensions Act 2004). This is the main measure used by the TPR and the PPF in their joint annual publication, The Purple Book, which examines the risks that schemes in the PPF Index face. Broadly, s179 represents the cost of providing PPF compensation, if a qualifying scheme were to enter the PPF in the event of a sponsor's insolvency. S179 is also known as the PPF level of funding, or just 'PPF'.

S179, or 'PPF', is much lower than the amount required to secure full benefits because PPF compensation is less than full benefits and some increases are removed. The PPF pays 100% of the annual pension promised by the scheme, but with no pre-97 indexation and only with limited post-97 indexation, capped at 2.5% – to members who have reached their scheme's NRA. To pre-NRA members it pays a maximum of 90% of a cap. In 2015-16 the cap is £36,400 pa, which means the maximum pension is £32,700 pa.

The Government is aware of the unequal treatment of pre- and post-NRA members. A provision in the Pensions Act 2014 would give a fairer deal to pre-NRA members with long service (of more than 20 years).[28] However, at the time of writing, the DWP said that this provision had not been introduced, due to its complexity, which might require secondary legislation. Interviewees said that when it comes into force, the provision will address only a fraction

28 DWP, June 2013. https://www.gov.uk/government/news/government-to-increase-pension-compensation-for-long-servers

of cases of inequality for pre-NRA members and will provide a tiered level of compensation, depending on service, rather than the full headline rate.

c. **The scheme is subject to 'PPF drift'.** PPF drift describes a month-by-month increase in the cost of providing PPF compensation. The most common causes of PPF drift for stressed schemes are the impact of non-statutory pension increases and the increasing number of members who reach NRA, at which point they qualify for much higher levels of PPF compensation. This reduces the scheme's ability to cover above-PPF level benefits (unless, of course, it is offset by investment returns or additional employer contributions).

2. Estimates used in the discussion paper

In the Findings, we set out our estimates of the number of stressed schemes, aggregate AUM, and aggregate memberships, based on the PPF Index of about 6,000 schemes. We said that:

- About 1,000 private-sector defined benefit (DB) schemes are 'stressed' and unlikely to pay member pensions in full. In more than half of these cases – about 600 schemes – the scheme will never, ever pay full benefits.
- In aggregate, these 1,000 schemes – which include about 25 of the largest schemes in the UK, each with £1bn+ in liabilities – represent:
    - Liabilities estimated at £225bn
    - Assets estimated at £180bn
    - Deficits estimated at £45bn
- If this situation is not addressed urgently, the future pensions of members and their dependants may be reduced over the next five to 10 years, during which time we anticipate the sponsoring employers may become insolvent. A 10% reduction applies to all pre-NRA members; a cap on the headline pension applies to those with larger benefits.

We also said that while, for some sponsoring employers, insolvency is likely to be inevitable, due to the nature of their business, for others, the business may have a viable future, but it will sink under the weight of the pension scheme burden.

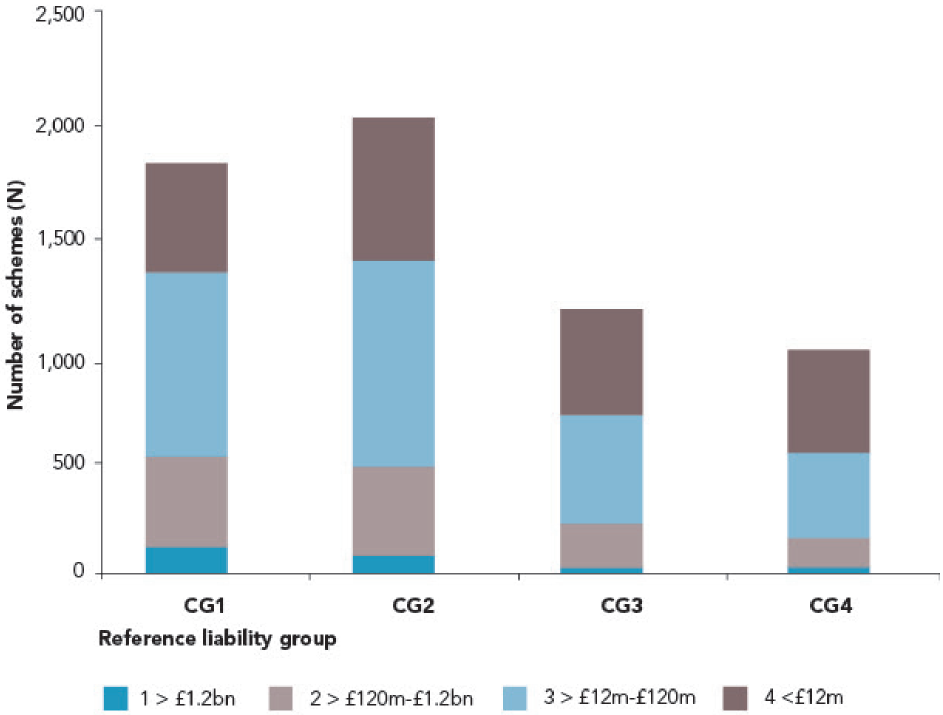
We have based these figures on the research – several interviewees with considerable expertise in these matters gave us their own best estimates, based on similar investigations to our own – and in particular on a chart and its accompanying notes published by TPR. The chart was included in an appendix of a 50-page draft consultation document published by TPR in December 2013, 'Draft: Our defined benefit funding policy'.[29] Chart 4.2, reproduced below with the permission of TPR, appears in Appendix G on page 43 of this draft consultation document.[30] We have included the accompanying notes.

29 http://www.thepensionsregulator.gov.uk/doc-library/regulating-defined-benefit-pension-schemes.aspx

30 The chart was kindly provided to us by TPR.

We are not aware of the reasons why this chart was omitted from the final version of the updated code of practice on funding DB schemes,[31] which was published in June 2014 and which came into force for scheme valuations with effective dates from 29 July 2015 onwards. To the best of our knowledge, there are no other similar data in the public domain.

Chart 4.2 – Distribution of number of schemes by covenant and scheme reference liability size



Source: The Pensions Regulator's data

[Pensions Institute note: the chart legend is potentially confusing. The '>' symbol is used to mean 'greater than' in block 1 (after the dark blue square), but is used simply as a separator in blocks 2 and 3 (after the light grey and light blue squares).]

TPR's notes to the chart

1. Most of the members and liabilities are in the stronger covenant groups with a large concentration of liabilities in a small number of very large schemes. Around £900bn of liabilities – more than half of the total for all schemes – are accounted for by 182 schemes with reference liabilities in excess of £1.2bn and in Covenant Groups (CG) 1 and 2. These schemes account for approximately 55% of the aggregate deficit on a common valuation basis.

2. It does not, however, follow that the largest schemes and those that pose the biggest risks necessarily have the strongest support. For example, 54 schemes with reference liabilities in excess of £1.2bn are in the two weakest covenant groups which account for a further £172bn of liabilities in aggregate (11% of the total for all schemes). These schemes account for approximately 10% of the aggregate deficit on a common valuation basis.

31 http://www.thepensionsregulator.gov.uk/codes/code-funding-defined-benefits.aspx

Interpreting the chart

The chart shows:

- The distribution of the c. 6,000 schemes in the PPF Index across TPR's four covenant grades: strong, tending to strong, tending to weak, and weak.
- Within each covenant grade, the 'reference liability group' that TPR uses to divide schemes into four groups according the size of the liabilities is: 1) Above £1.2bn; 2) Between £120m and £1.2bn; 3) Between £12m and £120m; and 4) Below £12m.

It is useful to appreciate, as stated in TPR's Note 2 to the chart (see above), that 'large', in terms of the size of scheme liabilities, is not synonymous with 'strong', in relation to the employer's covenant. More than 50 sponsoring employers of schemes with the largest liabilities (above £1.2bn) have a 'weak' (CG4) or 'tending to weak' (CG3) covenant.

Our estimates, based on the chart, come with two caveats: first, we do not have the data set TPR used to construct the chart; and second, the chart is two years out of date. Bearing in mind these important provisos, our interpretation of the chart indicates that the number schemes in the four covenant categories, together with the percentage they represent in respect of the PPF Index, are approximately as follows:

- CG1: 1,800 schemes or 30% of the Index
- CG2: 2,000 or 33%
- CG3: 1,200 or 20%
- CG4: 1,000 or 17%

On the basis of this chart, we estimate that about 1,000 schemes, representing, on a conservative estimate, at least 15% (and possibly up to17%) of the total PPF Index, are in serious risk of default.

3. Examples of potential 'second-best' outcomes

In the outline, we referred to the need for 'second-best' outcomes, where the optimal outcome – that the employer, over time, funds full member benefits – is not feasible. Here we suggest two possible scenarios:

a. Where the scheme funding and sponsor's assets permit, the trustees could arrange a PPF+ bulk-purchase annuity (BPA) buy-out of the liabilities with an insurance company. Member benefits would need to be reduced to below the full level of benefits currently promised in the trust deeds, but they would still be higher than the levels of compensation provided by the PPF, in particular, for pre-NRA members whose pensions would be cut back – in some cases significantly – under the PPF. This type of arrangement has already been used and is known as a 'PPF+' buy-out.

b. Where the assets available from the scheme and the sponsor do not permit the above scenario – that is, where there are insufficient assets to match or improve on the cost of PPF compensation – and where it is evident that the sponsor is very unlikely to meet the recovery plan to pay off the deficit over time, the trustees would arrange for the scheme to enter the PPF, on a planned and co-ordinated basis, rather than wait for what may be an inevitable and possibly rather fraught and complex insolvency. This approach should result in a lower deficit for the PPF and the PPF levy payers to fund.

TPR has a duty to protect the PPF from ‘moral hazard’, which can arise, for example, where sponsors that might be able to fund better benefits, over time, attempt to ‘dump’ the scheme on to the PPF and re-launch the business in a different corporate guise. To avoid this and other types of moral hazard, we propose that the regulator and the PPF develop a methodology to identify genuine cases.

Statements from the sponsors

2020 TRUSTEES

2020 Trustees Ltd is delighted to be a main sponsor of the Pensions Institute report: *The Greatest Good of the Greatest Number* The Report discusses the challenges faced by trustees of private-sector defined benefit (DB) schemes who are faced with extremely difficult decisions and is an important document for everyone working in the industry.

2020 Trustees is an independent trustee company with offices in Manchester and Nottingham. The company is one of the largest professional independent trustee companies in the UK with a portfolio of over one hundred pension schemes benefitting from our high quality, cost-effective, pragmatic and commercial approach to trusteeship.

2020 Trustees provides independent trusteeship to the full spectrum of pension schemes. Services offered include establishing effective governance frameworks, developing funding strategies and leading discussions with sponsors. 2020 Trustees is renowned for its management of complex and distressed situations, regularly working with sponsors undertaking M&A exercises and finding bespoke funding solutions for those sponsors in financial distress.

Indeed, it is this latter cohort which has lent much of the inspiration to the report here and there are clearly situations where all major stakeholders (members, trustees and sponsoring employers) can benefit from recognising the inability to provide full benefits from the scheme, and in turn looking to provide an alternative solution based on some form of compromise arrangement. The Authors of the Report should be commended for pushing this firmly up the agenda of the pensions industry and we look forward to industry developments from here.

2020 Trustees is pleased to have been able to share its knowledge with the Authors of the Report in bringing the issue of schemes that are in deficit back on to the table and how the pensions industry can work to broker a better deal for pension scheme members whilst also helping keep UK businesses solvent.

Doing nothing is not an option and 2020 Trustees is proud to be part of a Report that has asked difficult yet essential questions.

2020 Trustees Ltd - Independent Trustees with a different outlook

www.2020trustees.co.uk

EVERSHEDS

Eversheds has sponsored the Pension Institute report *The Greatest Good for the Greatest Number* because we hope that it will provide a catalyst for genuine discussion in the industry on a key question: what should be done with schemes which are – in the absence of intervention – likely to go into the PPF, meaning that members will not receive the full benefits originally promised to them?

In particular, the report asks whether there might be a better way of structuring pensions law so as to enable members of these schemes to receive a higher level of benefits from the available assets, rather than just receiving PPF-level compensation.

This issue is, of course, politically difficult, since engaging with it involves acknowledging the unpalatable truth that some schemes have no realistic hope of delivering the promised level of benefits. It would be easy to ignore the issue and just hope that (somehow) these schemes do not end up transferring into the PPF.

It is also an issue on which there are a number of widely divergent views within the pensions field, and this report does not shy away from acknowledging the practical difficulties involved in building a consensus to address this issue.

Notwithstanding such difficulties, the authors are to be applauded for raising the issue for discussion. By bringing the question into the open in this way, the report facilitates the development by the pensions industry and by policymakers of new and practical options, to enable the trustees and sponsors of stressed schemes to provide the best benefits realistically achievable for their members.

Eversheds was first established in 1988, and has since grown to become a leading global law firm, with 55 offices in 28 countries. Our team of over 70 pensions lawyers is the largest of its kind in the UK, and is supported by a network of pensions specialists in other jurisdictions around the world. Our pensions lawyers work closely with our corporate, employment, financial services, banking, tax and insurance teams to deliver a full service to clients.

Our client base includes multi-national employers and some of the world's largest pension plans. We also advise national governments, public authorities, insurance companies, banks and fund managers.

Our approach is always to provide practical, commercial advice and to find solutions that work for our clients. We strive to find innovative approaches and sensible answers to difficult questions.

Our ethos is therefore very much in keeping with the key drivers behind the Pension Institute's report, and we are pleased to have been able to contribute to the ongoing debate on this particularly difficult question through sponsorship of this research project.

Lane Clark & Peacock (LCP) has sponsored the Pensions Institute report *The Greatest Good for the Greatest Number* because we want to encourage a debate within the pensions industry on the challenging questions facing stressed pension schemes.

Case studies such as Uniq and MIRA show that trustees and sponsoring employers of stressed pension schemes can achieve a positive solution both for members and for the business, by working with experienced advisers and taking a collaborative approach.

Often, however, the challenges are put into the "too difficult" box. Perhaps that is not surprising, as the regulatory environment is focused on perpetually targeting full benefits – however unlikely that outcome might be. Currently, left unchecked, a stressed pension scheme and its members can face a slow descent into the PPF. Together, we can do better.

The authors of this report have been both diligent and bold. They have sought views from a large number of stakeholders across the industry and have asked challenging questions that are rarely posed.

A consensus emerges, even at this early stage: a need for regulatory change towards a broader focus on members' overall best interests; a need for a wider recognition of the "value" of sponsor covenant and a better appreciation of PPF drift; and, above all, a need for debate.

LCP is a leading firm of financial, actuarial and business consultants, specialising in the areas of pensions, investment, insurance and business analytics. Our pensions de-risking team has a wealth of experience in helping trustees and sponsoring employers to deliver bespoke solutions to challenging pensions issues, and is widely recognised as the leader in the field. LCP has advised on many high-profile PPF+ cases and we pride ourselves on taking a creative and innovative approach. www.lcp.uk.com

Lincoln Pensions Limited ("Lincoln Pensions") is delighted to have sponsored this report from the Pension Institute.

We hope that this important report will initiate a forum for genuine discussion among not just those who work in the complex world of occupational defined benefit ("DB") pensions but also among government bodies, regulators, employers, unions and those who ultimately benefit from such schemes – the DB scheme members themselves.

Much has been achieved in the UK over the last 10 years or so to bolster the protections given to DB member benefits, including the setting up of the Pension Regulator and the creation of the PPF safety-net to deal with the unfortunate cases when sponsoring employers become insolvent, leaving behind underfunded DB schemes.

The Pension Regulator's current funding code places employer covenant at the heart of DB pension risk-management as it is the employer's strength or "covenant" that enables the trustees to take investment risk on the scheme assets in anticipation of favourable investment returns, which in turn informs the level of funding required to deliver member benefits in the future. If things do not go as planned, it is the employer who is required to increase cash funding support to the scheme. Therefore, the concept of employer covenant is fundamental and we have seen more trustees and sponsors seeking proper independent covenant advice in recent years.

For a variety of reasons, well-articulated by the authors, considerable challenges remain for those responsible for running or sponsoring DB pension schemes in the coming years. The authors suggest that a high proportion of DB schemes may find themselves simply unable to deliver on the DB benefits promised in the years ahead unless trustees take unjustified levels of investment risks with the scheme assets.

We commend the authors for throwing light on this issue, especially when they involve very technical points. However, at their heart, they do need tackling if the UK DB pensions framework is to remain fit for purpose, transparent and fair for "the greater good".

Founded in 2008, Lincoln Pensions is the UK's leading independent covenant advisor for DB pension schemes of all sizes. Lincoln Pensions is the specialist pensions advisory division of Lincoln International, the leading, global mid-market investment bank with 16 offices across the world.

We have grown over recent years with professionals from backgrounds in credit risk analysis, corporate finance, corporate banking, actuarial, legal and regulatory advice. This diversity enables our team to focus on client issues from different angles.

Lincoln Pensions helps our clients by delivering a full range of covenant advisory services including covenant reviews, affordability analysis, scheme funding advice, corporate transactions, regulatory issues and counterparty assessments.

Rothesay Life is delighted to be a sponsor of the Pension Institute report *The Greatest Good of the Greatest Number* which we believe will be relevant and helpful to many pension schemes going forward.

The topic of not being able to pay full benefits is a difficult one that trustees and other stakeholders have generally been very wary of discussing in any detail whilst there remains a possibility, however slim, of providing full benefits. The findings of this report illustrate this reticence very well.

There are circumstances in which both employers and pension fund members can benefit from acknowledging the inability to provide full benefits and achieve a better outcome for the members through a separation between the employer and the fund. Whilst this has been achieved by some pension funds already through compromise arrangements, they remain unusual with the most significant one being the Uniq scheme, a client of Rothesay Life. This report provides a useful toolkit for trustees who want to explore this area.

We very much hope that this report will stimulate further discussion across the pension and corporate finance industries on the resolution of stressed schemes. We believe that the proposals outlined in this report are examples of changes that could be put in place to facilitate a more focused and useful dialogue on each stressed scheme.

Rothesay Life was established in 2007 and has become one of the leading providers of regulated insurance solutions in the UK market for pensions de-risking, making payments of around £700m a year from over £19 billion of insurance contracts. In 2015, Rothesay Life has received over £2.2 billion of bulk annuity premiums from pension funds to date (2014: £1.7bn). Our strong growth has been achieved through the steady accumulation of pension scheme clients and significant strategic acquisitions.

Existing Rothesay Life clients include the pension schemes and members associated with such names as RSA, British Airways, Lehman Brothers, Rank, Uniq, General Motors, the MNOPF (Merchant Navy Officers Pension Fund), InterContinental Hotels, Philips, GKN and the Civil Aviation Authority.

Rothesay Life is a secure long-term provider of pensions, focused on

- a flexible and committed approach to execution;
- ongoing risk management to maintain balance sheet strength; and
- robust operational processes.

Rothesay Life is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

www.rothesaylife.com

About the Pensions Institute

The objectives of the Pensions Institute are:

- to undertake high quality research in all fields related to pensions
- to communicate the results of that research to the academic and practitioner communities
- to establish an international network of pensions researchers from a variety of disciplines
- to provide expert independent advice to the pensions industry and government.

We take a fully multidisciplinary approach. For the first time disciplines such as economics, finance, insurance and actuarial science through to accounting, corporate governance, law and regulation have been brought together in order to enhance strategic thinking, research and teaching in pensions. As the first and only UK academic research centre focused entirely on pensions, the Pensions Institute unites some of the world's leading experts in these fields in order to offer an integrated approach to solving the complex problems that arise in this field.

The Pensions Institute undertakes research in a wide range of fields, including:

Pension microeconomics
The economics of individual and corporate pension planning, long-term savings and retirement decisions.

Pension fund management and performance
The investment management and investment performance of occupational and personal pension schemes.

Pension funding and valuations
The actuarial and insurance issues related to pension schemes, including risk management, asset liability management, funding, scheme design, annuities and guarantees.

Pension law and regulation
The legal aspects of pension schemes and pension fund management.

Pension accounting, taxation and administration
The operational aspects of running pension schemes.

Marketing
The practice and ethics of selling group and individual pension products.

Macroeconomics of pensions
The implications of aggregate pension savings and the impact of the size and maturity of pension funds on other sectors of the economy (e.g., corporate, public and international sectors).

Public policy
Domestic and EU social policy towards pension provision and other employee benefits in the light of factors such as the Social Chapter of the Maastricht Treaty and the demographic developments in Europe and other countries.

Research disseminated by the Pensions Institute may include views on policy but the Pensions Institute itself takes no institutional policy positions. For more details, see: pensions-institute.org

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