

Up to 1,000 Defined Benefit Schemes at ‘serious’ risk of falling into the Pension Protection Fund

- **Of this, members of 600 schemes may only receive PPF compensation; many sponsors are expected to become insolvent in the next five-to-10 years**
- **The remaining 400 sponsoring employers might initially survive, but may eventually fail if they are not able to off-load their pension obligations**
- **Report challenges the ‘flawed assumption’ that, in time, the majority of these sponsors will meet their pension promises in full.**
- **Planned and coordinated action now could secure better outcomes for members than the PPF compensation floor while securing jobs and freeing up businesses to create growth**

LONDON 14 December 2015: A new report from the Pensions Institute, part of Cass Business School, highlights the acute pressure faced by many private-sector defined benefit (DB) schemes and their trustees as they strive to meet their long-term liabilities. The report, *“The Greatest Good for the Greatest Number”*, predicts that the businesses of hundreds of employers will become insolvent well before the end of their recovery plans, under which the trustees and sponsor agree contributions to make good the deficit over an agreed number of years. On insolvency, these schemes may have insufficient funds to pay members’ pensions in full.

The report 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.

Professor David Blake, Director of the Pensions Institute, and one of the authors of the report, said: “Government policy is predicated on the assumption that employers with DB schemes, over time, will be strong and prosperous enough to pay benefits in full. The report challenges this rose-tinted view and seeks answers to the following question: What actions should trustees take, to secure the best possible

outcomes for the members they serve, if the employer is not strong, is unlikely to prosper, and, the prospect of the Pension Protection Fund ‘lifeboat’ looms?”

The research found that of the approximate 6,000 DB schemes in the PPF Index, most of which are closed, as many as 1,000 schemes are highly vulnerable to the risk of significant underfunding and the sponsor’s insolvency as scheme funding levels continue to weaken. Around 600 schemes – 10% of the total – are unlikely to ‘ever’ pay off their pension scheme debts. The businesses of up to a further 10% are at risk of failure due to the DB deficit. Quantitative Easing (QE), low interest rates, and low gilt yields are all considered to add significantly to the problem, especially as gilt yields are a key factor in the assumptions used for valuations.

Nigel Jones & Naomi L’Estrange of 2020 Trustees Ltd said: “On behalf of the five sponsors, we are delighted to be supporting this Pensions Institute report which discusses the challenges faced by trustees of private-sector defined benefit schemes who are faced with extremely difficult decisions. The report discusses an uncomfortable topic but is an important document for everyone working in the industry. 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 Pension Institute should be commended for starting a debate on this important issue and we look forward to continuing that debate with Government, regulators and the wider pensions industry.”

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The Pensions Institute at Cass Business School is the first and only independent academic pensions research organisation in the UK (<http://www.pensions-institute.org/>).

The Greatest Good for the Greatest Number: Early intervention strategies for trustees and sponsoring employers, regulators, policy makers, advisers, lenders and investors

Available at: www.pensions-institute.org/reports/GreatestGood.pdf

Notes to Editors

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. 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.

- 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.

- 3. The new objective also imposes conflicts of interest on 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 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 PPF’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.

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.

Pre-NRA directors, with large pension promises, might be tempted to let a defunct business 'limp on' until they reach NRA, to secure maximum compensation under the PPF.

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. 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.'*

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) and, hence, would indicate the need for urgent trustee action.

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.

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.

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.

- 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.

- 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.

- 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.

- 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.

- 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.

- 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.

About the sponsors

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