Pensions Institute

Supporting Materials

for

The Greatest Good for the Greatest Number: An examination of early intervention strategies for trustees and sponsoring employers of stressed defined benefit schemes[1]

by

Debbie Harrison and David Blake[2]
Pensions Institute

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[1] The full version of this discussion paper is available here:
www.pensions-institute.org/reports/GreatestGood.pdf

Supporting material for this discussion paper is available here:
www.pensions-institute.org/reports/GGSuppMat.pdf

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Section 1 - Background to the findings

This research addresses the challenges faced by sponsoring employers and trustees responsible for looking after the pensions of members of UK private-sector defined benefit (DB) plans.

In the UK, there are c. 6,000 such schemes, covering around 11m members. The trustees responsible for these DB schemes have, in aggregate, access to assets valued at about £1.2trn, which compares with combined liabilities valued at about £2.0trn (i.e., the capital value of the full benefit promises which have been made to members).

In the UK, these pension obligations fall to be funded by the sponsoring employers. Any pension deficit (i.e., the value placed on the DB liabilities being larger than the asset value) is usually addressed through a combination of seeking higher investment returns on the DB plan assets and increasing employer contributions.

The success of most pension schemes depends on the strength of the sponsoring employer and this is a key focus for trustees. Where the sponsoring employer of an underfunded pension scheme is weak, it will be inappropriate for the trustees to take the risks needed to generate higher investment returns; so it becomes less likely that the scheme will be able to provide full benefits. With the recent falls in solvency levels, monitoring the strength of the employer has therefore become a key focus for trustees.

This research looks at situations where full benefits are unlikely to be provided.

1. The characteristics of a stressed scheme

Many of the c. 6,000 DB schemes are either already under stress or facing stress, in terms of being able, with a high degree of confidence, to meet the full benefit promises that have been made to members. Throughout this report, we refer to such schemes as '**stressed schemes**'. 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. Typically, this can be characterised by a mismatch between the length of the deficit recovery plan, and the potentially much shorter life expectancy 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.

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.

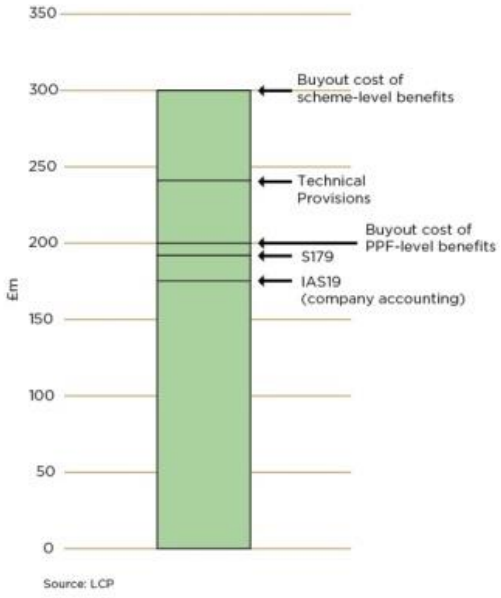
   'Weakness' in this context is defined in relation to the cost of securing the full benefits either with a bulk purchase annuity (BPA) or with a low-risk investment strategy (self-sufficiency). There are several valuation measures, with most focus usually being given to the 'technical provisions', which is the measure required by the scheme funding legislation. For very weak covenants, however, the scheme funding measure should broadly align with the cost of securing full benefits with a bulk purchase annuity.

   For stressed schemes, there is a further measure that is relevant to decision-making, and this is the cost of providing PPF compensation with a bulk purchase annuity, often referred to as the buyout cost of PPF-level benefits or the PPF measure. This is lower than the amount required to secure full benefits with a bulk purchase annuity, because PPF compensation is less than full benefits (since members lose some of their benefits).

   The PPF itself uses two different measures which are separately defined under the Pensions Act 2004, but which are broadly similar to the buyout cost of PPF-level benefits. The s143 measure is for determining whether a scheme enters the PPF or not, and the s179 measure is used to set PPF levies. The latter 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.

   The PPF measure is relevant because the scheme will escape the PPF on insolvency of the sponsoring employer only if the scheme's assets (after allowing for any recovery from the insolvent sponsor) are sufficient to secure PPF compensation with a bulk purchase annuity. The majority of schemes are funded under the PPF measure. With a high enough recovery from an insolvent sponsor, full benefits can be secured for the members, but this is very unusual in the case of weak sponsors.

The chart below shows an example of how the different funding measures might relate to each other.



2. Stakeholders to the stressed scheme

There are multiple stakeholders to a DB scheme. Some of these are obvious, such as the members, trustees and sponsoring employer; but others are less so, for example, suppliers to the sponsoring employer's business.

UK trust law gives both the trustees and the members of a DB scheme legal rights over the scheme's assets, but their positions are very different.

First and foremost, the trustees are required to look after the scheme in the interests of the members, which means doing the best they can to ensure there are sufficient funds to pay benefits promised by the scheme, now and in the future. Given that the trustees rely heavily on the sponsoring employer to fund the benefits (a closed scheme is in run-off, so there are no member contributions), trustees also have an interest in keeping the sponsor's business afloat – a role that is recognised in TPR's sustainable growth objective.

The interests of the various stakeholders to a DB scheme will vary; often, a trustee may be affected by a number of such conflicting interests, particularly if (for example) the trustee is also a member of the scheme and a director of the sponsor. To some extent such conflicts are inevitable, and manageable; but in the context of a stressed scheme these conflicts become increasingly difficult to manage.

Stakeholders include:

- **Beneficiaries** (the beneficial owners of the fund) is the generic description for scheme members – who will either be pensioners or deferred members in the case of a closed scheme – and their dependants. (An open scheme will also have active members, i.e., members who are also employees of the sponsoring employer and accruing benefits.)
- **Trustees** (the legal owners of the fund on behalf of the beneficiaries) are responsible for managing the scheme in the interests of the scheme beneficiaries. They will usually include trustees appointed by the sponsor and member-nominated trustees (MNTs), and may also include professional trustees. Trustees, at best, are pension experts. They are not experts in corporate finance and restructuring, yet, in an increasing number of cases, they are placed in a position where they are the largest creditor of the business.
- **Sponsors**, who will have a conflict between their responsibilities towards their business and its investors/lenders, and the legal requirement to support the DB scheme. In some cases, the identity of the sponsor might not be clear, for example, if the business sits within a group of companies and there are cross-company guarantees and/or notional support of the scheme by the parent company.
- **Lenders** to the sponsor (usually banks), which will be concerned about credit risk and whether this is accurately assessed and monitored, as the scheme and sponsor's fortunes wax and wane.
- **Investors** in the sponsor (shareholders, in the case of quoted companies), which will be concerned to ensure that the share price accurately reflects the actual and technical solvency position of the business, which in turn is affected by the DB deficit.
- **Suppliers to the sponsor's business**, which might terminate supplies if they think the DB deficit might be a factor in a possible insolvency.

- **HMRC**, which will be concerned to ensure that pay-as-you-go (PAYE) tax and national insurance receipts are up to date.
- **The Pension Protection Fund** (PPF), established by the Pensions Act 2004 to pay compensation to members of eligible DB schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover PPF levels of compensation. It has four sources of capital: scheme assets from schemes that enter the PPF, the investment return on its assets, the PPF levy on eligible DB schemes, and money claimed, as a creditor, from insolvent employers' assets.
- **Schemes eligible for PPF compensation**, which must pay an annual levy to the PPF. This levy is, in effect, an insurance premium to protect members' benefits if the employer becomes insolvent and the scheme has assets worth less than the cost of PPF compensation. The levy is risk-related (largely based on the Experian rating of the sponsor's insolvency risk[3]), with some schemes paying more than £200,000 in 2015/16. The levy for financially strong sponsors should reflect a strong covenant grade and credit rating, but, nevertheless, these schemes and sponsors might feel that they are subsidising their weaker counterparts. As the number of weaker schemes that enter the PPF increases, the remaining stronger schemes/sponsors might also question the potential reverse-tontine implications of the levy.[4]
- **TPR**, which has a primary objective to protect the PPF, that is, to ensure that only qualifying schemes enter, and only where PPF entry cannot realistically be avoided. It is relevant to this report to remember that TPR is a regulator of pensions, and not of directors, corporate finance or restructuring.
- **The Government**, which is seeking to strengthen the economy, and which, through TPR's sustainable growth objective, could be seen as favouring business growth over deficit funding for pension schemes.

[3] http://www.pensionprotectionfund.org.uk/levy/Pages/PensionProtectionLevy.aspx. The consultant Punter Southall explained: 'This insolvency risk is assigned by Experian which takes information from the employer's financial accounts. The switch to accounting standard FRS 102 for pension accounting this year [2015-16] could worsen the balance sheet and hence increase the PPF levy.' See http://www.puntersouthall.com/pension-insights-and-views/pages/Will-FRS-102-increase-your-PPF-levy.aspx#sthash.60XAG19T.dpuf

[4] That is, surviving schemes pay an increasing proportion of the levy. In theory this should not be a problem. As the size of the PPF grows, both the proportion of its income represented by the levy, and the size of individual claims (relative to its investments), shrinks. In its latest published valuation, the PPF stated that it remained on track to meet its objective of self-sufficiency (no longer materially reliant on risk-based levy) by 2030 and it does have the ability to reduce compensation payments. Scheme funding levels should also gradually increase as a result of recovery plans, reducing risk for the PPF. However, interviewees said that, in practice, there is a real concern, especially if all the stronger schemes buy out in full, leaving just the poorly funded schemes to fund the PPF.

Examples of stressed schemes – the professional trustee's perspective[1]

Case 1

A complex situation that arises regularly for a professional trustee is where the sponsor group is undertaking a significant transaction that affects the security available to the scheme going forward.

The company-nominated trustees are the Chief Executive (CEO) and Finance Director (FD). The member-nominated trustee (MNT) has just reached 80 and resigned.

The CEO and FD have realised that they have a serious conflict in their ability to consider impartially the impact of the transaction. They agree that one of them will resign, to be replaced by a professional trustee.

They are also concerned about where they may be able to find a new MNT.

At the interview, we discuss the fact that we would be willing to act as a sole corporate trustee if they wish, and that the MNT legislation would not apply in that context. The existing trustees are often only too happy to take the opportunity to step back.

After the initial appointment/familiarisation, the first task (often very urgent) is to put out a tender for a covenant review. The appointed covenant advisor would work closely with the sponsor and the trustees to ensure full access to the information required. Often in parallel, the trustees will be discussing possible options, e.g., for mitigation of any reduction in security, looking for solutions which best enable the ongoing health and growth of the sponsor. If a clearance application is needed, conversations may also begin with TPR early in the process.

Sometimes it is clear from the outset, or shortly afterwards, that the financial issues of the sponsor are acute and that it may not be possible to avoid insolvency. Generally, in such a situation, a restructuring expert (usually also an insolvency practitioner) will already be involved with the sponsor.

If and when the event which has triggered the appointment is resolved, we would then move on to ordinary trustee business, looking at the overall governance and other contractual arrangements for the scheme and plans for its future.

Case 2

This is an ongoing governance role. Here the professional trustee would be appointed as a trustee primarily due to a conflict of interest or a general lack of understanding (often both). We would assume the role of ongoing trustee, either as a sole trustee or sitting alongside other trustees (our co-trustees). Our role would most likely focus on pension scheme funding and negotiation with the sponsor on how quickly the deficit could be funded, taking into account affordability, strength of employer, investment strategy, maturity of pension scheme, etc. In parallel with this work, we would provide input into investment strategy considerations, general hand-holding, member communications, guiding trustees through de-risking exercises etc.

The main issue faced by smaller schemes in this second example is general lack of affordability of contributions. This leads to proportionately higher percentage deficits for smaller schemes. Often there is a real possibility that the scheme will never be able to reach a fully-funded status. This might trigger the debate about whether the trustees should 'pull the plug', particularly if the scheme is PPF+ funded. However, it's fair to say that this type of conversation is much easier to have in theory than in practice. Once the dire prognosis for fully-funded status is recognised, this could also trigger a discussion about reducing the target level of benefits (e.g., via adopting reduced benefits/conditional indexation, etc.) rather than waiting on the never-never, as this would give such schemes a realistic target to aim for – and one potentially in excess of PPF funding.

3. Legal and regulatory developments leading to systemic deficits

Until the turn of the present century – avant le déluge, as it were – DB schemes were considered by sponsors to be a function of the human resources (HR) department, since the pension formed part of the pay and benefits package used to recruit, reward and retain employees ('the three R's'). To all intents and purposes, the DB scheme operated like a captive insurance vehicle that was treated as totally separate from the sponsor's business. However, until the 1990s, there were no specific employer funding requirements.[5]

Lay trustees were expected to be 'prudent' – i.e., broadly, to look after the scheme's affairs with the same care as they would their own. Trustees needed to understand the trust deed and rules, which generally they did, but often, the most complicated task they were asked to perform was to choose between Equity Manager A and Equity Manager B, and to judge the occasional contested case of disputed discretionary benefits.

Given the prolonged equity bull market through most of the 1980s and 1990s, everything in the DB scheme garden looked pretty rosy. At this time, the scheme's assets and liabilities did not appear on the corporate balance sheet. The involvement of the sponsoring employer's CEO and FD was minimal, except when they wanted to dip into the surplus to fund a contribution holiday or an early-retirement programme, for example. Few trustees, employers and advisers were asking the two questions, which, with hindsight, should have been asked by those responsible for a corporate debt that extended many decades into the future: 'what could possibly go wrong?' and 'when?'. The answers, respectively, were 'quite a lot' and 'very quickly'.

At the turn of the century, the perfect DB pension scheme storm included: an equity bear market that lasted from 2000 to 2003, pushing most schemes into deficit; the recognition of increasing longevity; and new accounting rules in 2001 that put that deficit on to the corporate balance sheet.

At this point, the DB chickens came home to roost in the CEO's and FD's rafters. The Financial Reporting Council's (FRC's) Financial Reporting Standard 17 (FRS 17) introduced the following rules:[6]

1. Pension scheme assets are measured using market values.
2. Pension scheme liabilities are discounted at an AA corporate bond rate.
3. The pension scheme deficit (or surplus, to the extent it can be recovered) is recognised in full on the balance sheet.
4. The movement in the scheme surplus/deficit is analysed into:
    a. The current service cost and any past service costs; these are recognised in operating profit

[5] In 1991, it came to light that the media tycoon, Robert Maxwell, had 'misappropriated' funds from his businesses' DB schemes. The Goode Committee (after the chair, Roy Goode) proposed changes, which led to the Pensions Act 1995 and the minimum funding requirement (MFR), which came into force in April 1997. The MFR was later criticised for distorting investment decisions without providing effective protection for members, and for being insufficiently flexible to respond to the circumstances of individual schemes. The Government replaced the MFR, in the Pensions Act 2004, with a long-term scheme-specific funding standard – a standard that had been proposed by Paul Myners, in the Myners Report, published in 2001.

[6] https://www.frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/Standards-in-Issue/FRS-17-Retirement-Benefits.aspx

b. The interest cost and expected return on assets; these are recognised as other finance costs

c. Actuarial gains and losses; these are recognised in the statement of total recognised gains and losses.

The turn of the century, therefore, was also the turning point when an employer's DB pension scheme morphed from a benign employee benefit to a potential corporate financial disaster. Overnight, it seemed CEOs and FDs discovered they had a big problem that would affect the way they did business. 'Does my DB deficit look big on this balance sheet?' was not a question they wanted to ask investors and lenders. They didn't have to, because investors and lenders could now see the answer for themselves.

In June 2003, the Government introduced rules that prevented solvent employers from walking away from their DB pension liabilities without paying the full buy-out cost. Deficits became legal debts. The Pensions Act 2004, which led to the introduction of TPR and the PPF, formalised this; one of TPR's early actions was to state that these debts were akin to bank loans and trustees akin to bank lenders.

Trustees are not wholly akin to bank lenders, of course, because a bank has alternative sources of income and can generally weather the storm if one significant loan becomes a bad debt. In practice, trustees often represent the largest creditor to the sponsoring employer, and, given their absolute reliance on the employer where a scheme is closed, they can be vulnerable and, at times, apparently easily manipulated. An interviewee provided the following example:

> *In one of the cases I investigated, the sponsor had arranged with the trustees to reduce its contributions in exchange for equity in the company – a debt/equity swap. By the following year, it was obvious that the shares were worth a lot less than when the deal was brokered. Then the sponsor asked for a year of zero contributions towards the DB deficit. We discovered that only the scheme had been asked to renegotiate debt-repayment terms – all of the other creditors' terms remained intact. It was only too obvious at this point that the sponsoring employer was treating the scheme as a soft touch.*

Trustees are cautioned to avoid using any powers they might have that might rock the corporate boat. However, they cannot expect a quid pro quo from the sponsor, as an interviewee explained:

> *Trustees aren't supposed to pull the plug on the employer, even if they have this power. But they can't stop employers doing this when it suits them best, e.g., when the directors have reached NRA, thereby condemning younger members to the reduced benefits under the PPF which they themselves have now escaped. So this is far more than just a pensions law issue.*

Another interviewee agreed and wondered which regulator is checking up on directors (see Appendix 5).

> *Directors' duties [under s.172 of the Companies Act 2006[7]] require them to promote the success of the business while the business is not actually insolvent, unless shareholders agree that the business should be brought to an end. In a similar way, directors' risks of personal*

[7] Section 172 (1) of the Companies Act 2006 says that a director of a company must act in the way he or she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and, in doing so, have regard (amongst other matters) to the likely consequences of any decision in the long term.

liability, as regards wrongful trading, mean that they should not keep the business trading where insolvency is clearly looming, simply to allow a few more years of PPF drift to occur. Trustees that rock the boat will have TPR banging on their door. Who is checking up on the directors to make sure they behave too?

Under the 2004 Act, TPR gained more powers than its predecessor, the Occupational Pensions Regulatory Authority (OPRA). However, it is important to appreciate that TPR's powers were, and still are, designed to provide broader disincentives to bad behaviour. As a regulator, wherever possible, it does not intervene directly in relation to trustee responsibilities; nor does it tell trustees what to do, unless it believes the evidence indicates that this is absolutely necessary and the scheme poses a risk to the PPF.

4. Features of PPF compensation and the priority order

Where a scheme sponsor becomes insolvent, the PPF provides compensation to members of the scheme if they would otherwise receive lower benefits. PPF compensation is, however, lower than the full benefits that the member had been promised.

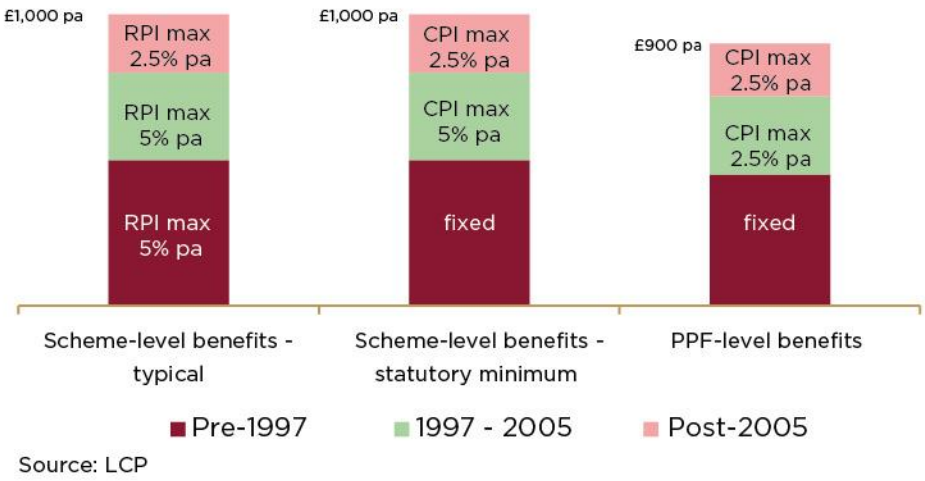
a) PPF compensation

The PPF pays 100% of the annual pension promised by the scheme to members who have reached their scheme's Normal Retirement Age (NRA) at the time of insolvency. For pre-NRA members (other than those who have retired early on grounds of ill-health), the PPF pays an annual pension that is a maximum of 90% of a cap. In 2015-16, the cap at age 65 is £36,400 pa, which means the maximum pension is £32,700 pa. As a result of the cut-back for members below NRA, there is a significant step-change on attaining NRA in the level of PPF compensation that a member would receive on insolvency.

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).[8] 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 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.

b) PPF compensation and loss of some pension increases

PPF compensation is also less than full benefits, because it does not include the full pension increases that the member had been promised. There is no pre-97 indexation and limited post-97 indexation, capped at 2.5%. The extent of losses for the members will depend on what the scheme promised, as illustrated below.



Source: LCP

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

c) Pension scheme priority orders

On the insolvency of a sponsor, the scheme usually enters wind-up. The scheme's assets, together with any recovery from the insolvent sponsor, are then spent on providing members' benefits according to the scheme's priority order. Each scheme used to have its own priority categories, but this is overlain in most cases by the statutory priority order in s73 of the Pensions Act 1995, which contains two main classes, covering benefits equal to PPF compensation and benefits in excess of PPF compensation. PPF compensation has higher priority and is provided first, with any residual assets being used to secure benefits in excess of PPF compensation.

d) PPF drift

All schemes are subject to 'PPF drift'. Broadly, 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 members who reach NRA, at which point they qualify for much higher levels of PPF compensation. This reduces the scheme's ability to cover benefits above the PPF level (unless, of course, the increase in liabilities is covered by investment returns or additional employer contributions).

The PPF drift is broadly predictable and it is usually possible to work out what investment return is necessary over the next few years to maintain the scheme's ability to cover benefits above the PPF level. In some cases, it can take a very high level of investment return to maintain the ratio.

e) Priority orders and the impact of PPF drift

Since pension scheme priority orders have PPF compensation in the top priority class, coverage ratios for lower priority benefits (disclosed in the actuary's report on the triennial valuation[9]) are affected by PPF drift. This occurs for a number of reasons:

- Members who attain NRA and qualify for higher PPF compensation.
- Ongoing pension increases at or above statutory levels.[10] This refers to any pension increases that are not part of PPF compensation, including all pre-97 increases.
- Payment of full cash-equivalent transfer values (CETVs) for members who want to transfer out of the scheme to the DC regime, for example.

In an ongoing scheme that is funded below PPF levels – i.e., the assets are insufficient to purchase PPF compensation for all members from an insurance company – the PPF itself should be the most concerned about PPF drift. This is because as PPF drift takes place, the cost to the PPF of potentially providing compensation at a future insolvency event increases, sometimes markedly so if an executive member passes through NRA; yet, there is no corresponding increase in the value of the scheme's assets, and so the PPF deficit worsens.

In an ongoing scheme that is funded above PPF levels, but below the full buy-out level – i.e., the assets are sufficient to purchase PPF compensation, but not full benefits for all members from an insurance company – the members should be the most concerned about PPF drift. This is because

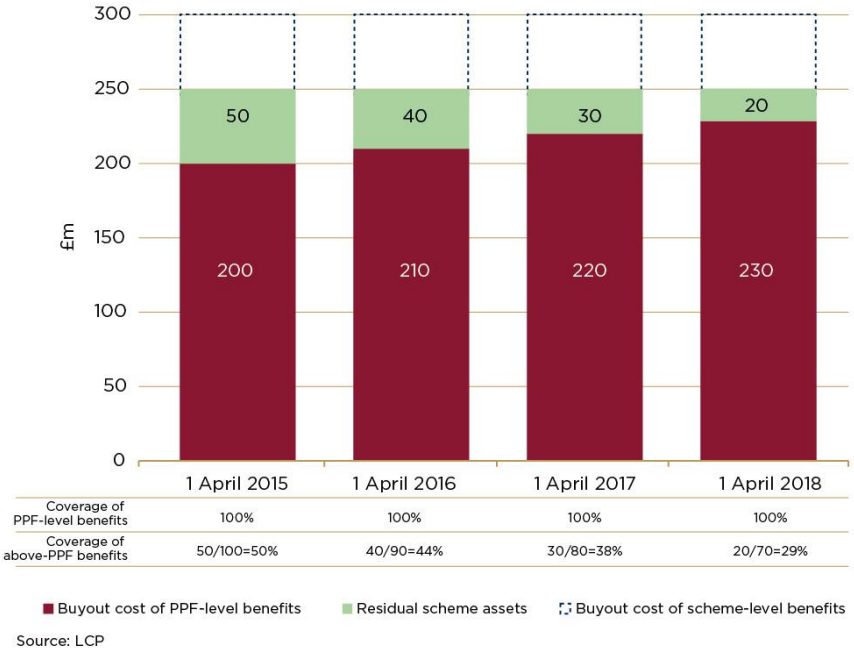
[9] Technically, the valuation report is available to members on request, but one interviewee said he had seen only one request from a member in 16 years.

[10] For DB pensions earned from 6 April 1997, pensions in payment must be increased by CPI, capped at 5% p.a. for pensions earned up to April 2005 and capped at 2.5% for pensions earned thereafter.

as PPF drift takes place, assets previously covering members' above-PPF benefits are notionally reallocated to cover higher PPF compensation levels (e.g., for an executive member who becomes uncapped), potentially to the detriment of most members. In other words, the coverage ratio of members' above-PPF benefits falls (e.g., from 30% to 10%), meaning members would then receive benefits valued at only PPF+10% on insolvency rather than say PPF+30%.

When assessing the PPF funding position of the scheme and the impact of PPF drift, it is important to remember the potential recovery from the sponsor, which would need to be taken into account in analysing the impact. Arguably, the majority of 'stressed' schemes would fall into the PPF+ category if sponsor recoveries were allowed for.

Illustration of the impact of PPF drift:



The impact of PPF drift is that fewer assets are available to provide benefits in excess of PPF compensation. For some members, the increase in PPF compensation will more than compensate for the reduction from, e.g., PPF +30% to PPF+10%. However, the younger (usually deferred) members will often not see any increase in their PPF compensation and will lose from the impact of the PPF drift.

Interviewees held very different views on whether trustees should be concerned about PPF drift. One interviewee said that PPF drift is acceptable and even beneficial:

> *In broad terms, PPF drift is beneficial because it results in more members getting 100% of the headline rate of pension, and therefore only losing out on increases and spouses' benefits. Whilst there is a certain distaste at the idea of directors keeping the business alive until they reach NRA before pulling the plug, it has to be recognised that it isn't just the directors concerned who benefit by that action: any ordinary member who also reaches NRA in the intervening period will similarly benefit, as will pensioners – because they receive increases*

which are potentially higher than PPF-level, such that they are at a higher starting-point before the PPF compensation provisions bite.

There are exceptions to this generalisation – for example, where one of the trustees was a director and shortly due to reach NPA. There might be serious conflicts of interest in this case.

Another presented a very different argument:

PPF drift is more acceptable if the scheme overall is funded below PPF levels and there is no realistic prospect of a substantial recovery from the employer on insolvency. PPF drift then benefits the relevant members, not to the detriment of the other members, but instead to the detriment of the PPF.

The situation is very different in a scheme that overall is funded above PPF levels, or in a scheme that overall is funded below PPF levels but with a realistic prospect of a substantial recovery from the employer on insolvency (but not substantial enough to take the scheme to full buy-out funding). In that case, members should be concerned about the impact of PPF drift on the coverage ratio of their above-PPF benefits. A significant PPF drift event – for example, an exec reaching NRA – could cause the coverage ratio of all members above-PPF benefits to fall from say 30% to 10%, meaning members would then receive only PPF+10% in an insolvency scenario.

Logically, the final situation to consider is a scheme that overall is funded below PPF levels, with a realistic prospect of such a large recovery from the employer on insolvency that it would take the scheme up to full buy-out funding. For that scheme, arguably no-one should worry about PPF drift, because members should receive full benefits on insolvency. But a separate question is why the trustees and employer are funding the scheme at such a low level.

Several interviewees said that TPR and the PPF should request monitoring of PPF drift. They also suggested that PPF drift should be brought into the potential insolvency assessment, for example, if the scheme is funded to above PPF, and the sponsor can afford neither the s75 debt (balance sheet test) nor the contributions required to meet PPF drift (a cash-flow test), then trustees must take action. Under the guidance of a professional trustee, they might be required to arrange a PPF+ buy-out and in return receive a statutory discharge of their liabilities.

5. Sustainable growth objective

a) The impact of the sustainable growth objective

TPR's new objective, introduced in its revised Code of Practice for DB schemes, came into force in April 2014, although several interviewees said that this merely formalised an approach the regulator had already adopted. The two other most relevant objectives, originally from the 2004 Act, are to protect the benefits of DB scheme members where the sponsor becomes insolvent, and to protect the PPF from 'moral hazard'. The latter refers, for example, to a situation where a sponsor tries to 'dump'[11] its scheme into the PPF, when, in practice, it is able to support it financially, either directly or through some form of cross-company guarantee, for example.

As a policy-driven regulatory objective, sustainable growth sounds innocuous enough: it simply requires TPR to recognise 'that a strong ongoing employer alongside an appropriate funding plan provides the best support for a well-governed scheme'. [12] No-one could argue with this logic, but unfortunately our research indicates that many sponsoring employers are far from strong and, in these cases, the sustainability objective simply serves to kick the recovery can down the road for a few years; and then repeat the exercise, if the sponsor has not gone bust.

This may or may not be a good thing and interviewees were divided on this point. Our view is that the introduction of the sustainable growth objective presents a paradoxical situation. We can see that it might help companies survive (albeit, in some cases, for just a few years) and thus help trustees to secure better benefits for members. We can also see that this was an economic policy intervention taken by the Government to head off a potential corporate – and therefore political – fiasco, and that its impact may be very short-term. It papers over the cracks, but it does not address the fundamental problem, which is that many schemes and sponsors are not the survivors the Government wishes they were and that some schemes will bring down what might otherwise be viable businesses. It also assumes trustees have access to expertise that, from our research, appears to be thin on the ground and, possibly, perceived as quite expensive for smaller schemes.

In TPR's August 2015 guidance, 'Assessing and monitoring the employer covenant', the regulator clarified its view on the trustees' position.[13] Point 9, in its 'at a glance' summary, says:

> *If the employer's plans to invest in sustainable growth restrict the funding available to the scheme, trustees should understand how the scheme will benefit by supporting this investment and whether other stakeholders are contributing appropriately.*

The aim of the new guidance[14] was to provide 'practical guidance' for stakeholders to the scheme when they 'assess the employer covenant of a DB pension scheme as part of an integrated approach

[11] A comparison with the PBGC in the US might be useful here. When setting up the PPF, lessons were drawn from the PBGC to ensure UK employers could not dump their pensions obligations in the way that US employers can and do, e.g., most of the US airlines and US steel companies have dumped their pensions obligations into the PBGC, via a chapter 11 process. (The other key learning point from the US was to charge each scheme a levy relating to the risk that the scheme bore to the PPF, rather than a levy simply in proportion to the overall size of the scheme.)

[12] The actual wording is 'to minimise any adverse impact on the sustainable growth of an employer' (in relation to the exercise of the regulator's functions under Part 3 of the Pensions Act 2004 only). See http://www.thepensionsregulator.gov.uk/press/pn1418.aspx and http://www.thepensionsregulator.gov.uk/about-us/our-objectives.aspx

[13] TPR, Aug. 2015. Assessing and monitoring the employer covenant. http://www.thepensionsregulator.gov.uk/press/pn15-39.aspx

to managing scheme risks, monitor the covenant and take action to improve scheme security'. The guidance is intended to be used as a regular review tool, as well as in special situations, for example, when there is a change in the corporate group structure that affects the sponsoring employer.

The guidance explains that a covenant assessment should focus on the following three key areas:

- **The employer's legal obligations to the scheme:** the strength of the covenant depends on the nature and enforceability of the legal agreements in place to support the scheme.
- **The funding needs and investment risk of the scheme:** the strength of the employer and its ability to meet its obligations should be viewed in the context of the scheme's size, funding position, exposure to investment risk, and maturity.
- **The financial support from the employer and any other entities:** these factors materially affect the covenant by virtue of their relationship to the employer, such as a parent company. The strength of the covenant depends on the likelihood of these legal obligations being met now and in the future.

This indicates a clear shift in power from the trustees to the sponsor in situations where almost certainly the sponsor already has the upper hand based on the scheme's trust deed and rules. And while the trustees might be able to argue against a reduction in contributions or challenge a sponsor's resistance to increased contributions, the onus to fight is on the trustees. Whether they will do so, in relevant situations, is a moot point:

a. First, they would need the necessary knowledge of corporate finance and restructuring to understand the implications of supporting the employer at the expense of the scheme.

b. Second, they would need the right type of expert advice to support their actions. For some this will be perceived as an expense too far.

c. Third, the trustee board would need to be sufficiently independent of the sponsoring company's directors.

d. Fourth, the trustees would genuinely need to ignore the PPF. If they take account of the PPF and PPF drift, then they might decide that it matters very little whether or not the funding position improves, particularly if it is their belief that the employer is going to become insolvent at some point in the future.

e. Fifth, the trustees' negotiating position may be largely or entirely based upon the risk of TPR exercising its moral hazard powers. Some sponsors, especially those with overseas parents where enforcement is difficult, may be increasingly inclined to call the trustees' bluff.

One interviewee said that professional firms 'talk up' the impact of the DB deficit in relation to the sponsor's ability to raise finance:

> *They [professional advisers] would love to get the rules changed so they can get in earlier and make more money. But I question the argument that a DB deficit prevents companies from raising finance – I don't think there has been much real evidence of this. So, I would challenge the idea that a scheme brings an employer down.*

[14] TPR, August 2015: Assessing and monitoring the employer covenant http://www.thepensionsregulator.gov.uk/guidance/guidance-assessing-monitoring-employer-covenant.aspx

We put this argument to other interviewees. One said:

> *Company insolvencies, and attempts at restructuring to avoid insolvencies, can have a significant impact on the pension schemes sponsored by those companies. The pensions issues can also act as a significant obstacle to restructuring.*[15]

Certainly, companies are painfully aware of the impact of the debt, as the consultant Barnett Waddingham made clear in its August 2015 survey:

> *80% of companies with material funding shortfalls recognised their DB pension scheme as a principal business risk within their annual report and accounts.*

We asked how it is possible to identify cases where the deficit prevents the employer from raising capital. We were told:

> *It is difficult to gain direct insight into the particular circumstances, but one way to approach this issue is to track the ratio of fund size to equity market cap for a number of years – five for example. No doubt companies will all have some kind of credit facilities from their banks, but it would be interesting to see if they have publicly raised any finance over the five years, be it debt or equity.*

Another interviewee explained:

> *It might be the case that the sponsor can raise finance – or at least maintain existing arrangements. But the problem is that in stressed situations [under the sustainable growth objective] most or all of this money has to be directed to the business and little or none into the scheme. What TPR is engineering here is a short-term holding position for a zombie company.*

The sponsor's position relative to the scheme is not always clear-cut. It can be particularly complicated where the sponsor has an overseas parent:

> *Some of the trickiest cases are where the sponsoring employer is the subsidiary of an overseas company which wants to close down the UK business. This is quite a common scenario. The PPF needs to be convinced the parent will carry out its threat, i.e., it's not just rattling its sabre in order to get the scheme into the PPF. That's just financial engineering, which the PPF and TPR are understandably alert to and will do everything they can to prevent. However, evidence that the parent has closed down other overseas subsidiaries is likely to persuade the PPF that it is serious in its intentions.*

It is essential that trustees can identify clearly the sponsor and that they clarify any support that might be expected from a parent company, for example. Interviewees said that unless the commitment of a parent company was formalised, it might not be reliable:

> *The company structure is crucial and a lot of trustees don't realise how vulnerable they are. We've seen cases where a parent company decided to turn off the tap, forcing the company into insolvency. This can happen really quickly, giving the trustees little or no time to prepare.*

One thing that is clear from the new objective is that TPR's role is subject to significant Government intervention. Just as the Prudential Regulation Authority operates as a subsidiary of the Bank of

[15] Source: Hogan Lovells. http://www.hoganlovells.com/files/Publication/22d879ee-0b2b-42bc-a2a9-51932e219806/Presentation/PublicationAttachment/2435f3a5-3bc9-4105-a164-5b4ec08a423a/Insolvency_and_Restructuring_of_Employers_Issues_for_Trustees_of_Defined_Benefit_P.pdf

England, so too does TPR operate as a subsidiary of the Treasury, the DWP, and the Department for Business Innovation and Skills.

We can see this relationship in action if we examine the genesis of the new objective. In its response to the 2014 Budget, TPR made its position very clear:

> *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 [sustainable growth] applies to the regulation of defined benefit (DB) pensions as recent economic conditions have put companies sponsoring DB schemes under significant financial pressure.*[16]

An interviewee, who appeared to have been involved in the discussions that led to the Government's action, made the following observation:

> *This is the first time in a long while that I've seen the unions get into bed with the CBI, but that's what happened. I guess it's understandable. What's good for business longevity is good for jobs and good for deferred pensioners – but only if the company has a genuine chance of survival.*

And we can see the fruits of this relationship in the insolvency figures for sponsors of closed DB schemes:

> *It looks like TPR is under pressure from the Government to avoid insolvencies at all costs – there have been about 10 or 20 over the past 12 months. This does not reflect reality.*

Several interviewees questioned how rational it was to extend recovery periods beyond 10 or 15 years. For example:

> *We know that TPR had already started to extend recovery periods, but the sustainable growth objective formalised this and made it easier for sponsors to push hard for much longer periods, even though this is risky from a trustee perspective.*

TPR itself recognised the additional risk of lengthy recovery plans in its 'Annual defined benefit funding statement 2015', which says:

> *When considering an appropriate recovery plan period, trustees should be mindful that longer plans can result in an increase in scheme risks as the certainty with which the employer's covenant and expected investment returns can be relied upon reduces over time.*

One interviewee said that there was a clear contradiction between sustainability and 'excessive' recovery periods:

> *So TPR is now extending recovery periods from an average of about 10 to 15 years to well over 30 years in some cases – and with back-end loaded contributions. I've seen one case where TPR accepted an extension to almost 40 years and with a back-end loaded schedule of contributions. This means that a sponsor with a weak covenant pays a few thousand quid in 2015 and promises to pay a million quid at some point in the 2050s – if it's still around. Which it won't be, of course.*

[16] http://www.thepensionsregulator.gov.uk/press/pn13-13.aspx

b) Can trustees invest the fund in ways that compensate for lower employer contributions?

Interviewees were divided on this point – as they were on so many. Some argued that an allocation of 50% to equities represents a serious misalignment with the covenant, because the sponsor is unable to tolerate this risk if it backfires. A weak covenant intuitively suggests a conservative investment strategy, they said. Others said that given the current low yields on bonds and gilts, there is an argument for taking investment risk, because if it pays off it could help reduce the deficit 'and if it doesn't the PPF will pick up the pieces'. Hence, 50% in equities could be seen as rational and reasonable, although the PPF would not appreciate it if trustees invested on the basis of the presence of the compensation scheme, which they are supposed to ignore in their decision-making. One interviewee said:

> *If the covenant is weak, trustees need to guard against acting instinctively. The simple gut reaction to these cases – let's call it Plan A – is to lock down investment strategy and hedge as much as possible. But the consequence is that the recovery period will be way too long and the chances of ever getting there are probably zero. So this type of approach is very short-sighted and sub-optimal.*
>
> *Plan B is to take on some investment risk with the aim of shortening the recovery plan period. The chances of reaching full recovery are still not great, but better than in Plan A. TPR might disagree, but the alternative – Plan A – would reduce the investment assumption and increase the need for employer contributions. It's hard to square that with TPR's sustainable growth objective.*

Another problem for trustees of stressed schemes is that the investment and de-risking strategy might have included a buy-in or buy-out for the pensioner section at a time when the scheme funding position had been more positive:

> *It might have looked like the right thing to do at the time, but in effect they have sold off the crown jewels and are left with the stuff no insurer wants. Left with the most difficult sections of the membership, trustees often respond by adopting a more aggressive investment strategy. Unless this is genuinely appropriate and expertly implemented, it will all end in tears.*

The level of risk might not be fully appreciated. Regulation permits trustees (and their actuarial adviser) to discount future cashflows using the expected rate of return on their assets. This allows them to take credit for the extra return on risky assets – a return they may or may not achieve.

6. Life in 2015-16 under the Pensions Act 2004

Over the ten years since the main provisions of the Pensions Act 2004 came into force in 2005, the liabilities of about 1,750 schemes have been removed from UK plc's corporate balance sheet. In most cases the liabilities have been transferred to the PPF or to an insurance company. This has reduced the PPF's original universe of eligible schemes from about 7800 to just over 6,000.[17] The PPF is the underwriter of last resort for the benefits of members of these schemes. There are about 11m members of closed schemes.

Table 1: The PPF Index reduction 2006-2014[18]

Schemes/cases transferred into the PPF	713
Schemes in assessment at March 2014, i.e., going through take-on processes (these schemes were not excluded in 2006)	198
Schemes/cases rescued, i.e., continued in existence, e.g., with another group employer not in insolvency supporting it or going through a company voluntary arrangement (CVA)	57
Schemes/cases overfunded and able to secure benefits in the market above PPF levels	102
Schemes/cases rejected	75
'Unaccounted for'	585

We were told that the surprisingly large number of 'unaccounted for' schemes – almost 600 – reflects a range of factors, including scheme mergers and transfers, and also buyouts. Also, the early universe estimate of 7800 may have included ineligible schemes, e.g., defined contribution (DC). We understand that TPR and the PPF have not carried out a formal analysis of the 'unaccounted for' schemes and that doing so would be a major exercise.

It is possible to keep a monthly track of activity via the websites of TPR and PPF and we suggest that experts and market commentators might undertake this exercise. Certainly, at the time of writing, the PPF was experiencing an unprecedentedly low level of activity. The PPF Index is published monthly and, at the time of writing, showed that 4,943 schemes were in deficit and 1,114 schemes in surplus on a PPF measure. Total assets were £1.2trn and total liabilities were £1.5trn.[19] However, interviewees estimated the s75 debt, or full buy-out cost, at about £2trn.

Allowing for quite significant monthly fluctuations, overall the funding position worsened rather than improved over the year to May 2015, when TPR published its annual defined benefit funding statement.[20] In this statement, TPR noted:

[17] Despite the drop in numbers, the PPF still refers to the '7800' Index.
[18] Source: PPF
[19] http://www.pensionprotectionfund.org.uk/Pages/PPF7800.aspx
[20] TPR, May 2015. Annual funding statement 2015. http://www.thepensionsregulator.gov.uk/pn15-23.aspx

Yields on long-dated gilts have fallen significantly in the last 12 months. Long-term real gilt yields are now significantly negative and considerably lower than they were three years ago. Low interest rates can have the effect of driving up current measures of pension scheme liabilities but also the value of gilts and other assets.

There is continued uncertainty about future economic and financial conditions and the outlook for gilt yields in the short, medium and long term. Compared to previous years, market expectations are for interest rates to remain lower for longer and to revert to lower long-term levels than previously thought, which has significant implications for scheme funding strategies.

Despite all major asset classes having performed well and sponsors having paid £44bn in deficit repair contributions over the last three years, our analysis suggests that many schemes with 2015 valuations will have larger funding deficits due to the impact of falling interest rates and schemes not being fully hedged against this risk.

In August 2015, the *Financial Times* reported that UK companies were paying less towards meeting their pension shortfalls than at any point since 2009, even as aggregate pension deficits reached their highest level in five years.[21]

A survey published in the same month by the consultant Barnett Waddingham[22] found that FTSE 350 companies paid £7bn towards their DB pension deficits in 2014 – 20% less than the previous year and 40% below the amount each year between 2009 and 2012. At the same time, the aggregate deficits for FTSE 350 companies increased from £53.3bn to £64.7bn during the year, as falls in corporate bond yields pushed down the discount rates used to calculate the present value of payments the scheme expects to make. Another survey, from the consultant Lane Clark & Peacock, found that over the past decade, since January 2005, the total pension liability of FTSE 100 companies had almost doubled.[23]

The numbers might vary from survey to survey, just as liabilities vary month by month, but the underlying message is clear. As a snapshot of 'recovery' this is as pretty as the picture in Dorian Gray's attic. As the impact of TPR's sustainable growth objective is felt – which we anticipate will lead to longer recovery periods and the greater use of back-end loaded contributions – the worrying lack of correlation between funding levels and employer contributions is likely to be exacerbated.

Trustee objectives for schemes under the 2004 Act

The natural objective of the trustees of DB schemes is to provide full benefits, often (ultimately) via a BPA with an insurance company.[24] Arguably, for stressed schemes, this is an unachievable objective – it is far more likely that the sponsor will fail before anything close to full benefits can be secured.

Where the sponsor of an eligible[25] scheme becomes insolvent, and where the regulatory conditions are met (a qualifying insolvency), and where there are insufficient assets in the pension scheme or

[21] http://www.ft.com/cms/s/0/7f284e26-3e9b-11e5-9abe-5b335da3a90e.html#axzz3jFHmj9w6

[22] Barnet Waddingham, August 2015. Impact of Pension Schemes on UK Business. https://www.barnett-waddingham.co.uk/comment-insight/research/2015/08/04/impact-pensions-uk-business/

[23] LCP, 2015. Accounting for pensions 2015. http://www.lcp.uk.com/news-publications/thought-leadership-reports/accounting-for-pensions-2015/

[24] The BPA market might be affected by Solvency II, which comes into force in January 2016. In August 2015, the consultant PwC warned that the cost of BPAs may increase by as much as 10% after this: http://pwc.blogs.com/press_room/2015/08/cost-of-pension-buyouts-set-to-rise-by-10-according-to-pwc.html

recoverable from the insolvent sponsor to cover at least PPF levels of compensation, the scheme enters the PPF, taking its assets with it.

Law and regulation, therefore, are clear on these two potential outcomes for a closed DB scheme: a full buy-out with an insurance company, or, in the case of the insolvency of the sponsor with a scheme funded to less than the PPF level, a transfer to the compensation scheme.[26]

What is less clear is the range of options trustees might consider – and which might be available, which is not the same thing – if the scheme is funded to PPF or PPF+, but the sponsor is unlikely to be in the position to fund a full buy-out.

[25] For the definition of 'eligible' see http://www.pensionprotectionfund.org.uk/About-Us/eligibility/Pages/Eligibility.aspx

[26] There are other possible outcomes, for example, where the business is taken over and the scheme is supported by the new owner.

7. Alternatives to conventional entry to the PPF

a) What actions should trustees take where the covenant is weak and insolvency 'likely'?

Interviewees told us that at times – some said most of the time – predicting impending insolvency is as much an art as it is a science. This is what they had to say:

> *Covenant Grade 3 and particularly Grade 4 are likely to cover a very wide range of cases. Let's say the top 50% of these two are stable enough and that with a long recovery period they'll have a decent chance of doing a full buyout – although it might take 30 years to get there. So we just have to hope these companies outlive their pension schemes' recovery periods, which somehow I doubt will be the case.*
>
> *There will be a significant number – let's say about 1,000 companies – that are just going to die, irrespective of how long TPR extends their recovery period under its sustainable growth objective. This bunch should have declared insolvency already because there is no viable business to save, even if you could get the DB deficit off the corporate balance sheet. Where the scheme is funded to well under PPF, there's not a lot you can do – although the PPF might be glad to get the scheme before the liabilities grow [due to PPF drift] and the sponsor's financial position weakens any further.*

We were told that the sustainable growth objective will not help failing companies to survive:

> *Despite the regulator's new sustainable growth objective, about 1,000 employers are going to disappear over the next five to 10 years. All the sustainable growth objective does for a lot of schemes and businesses is to delay the inevitable. We predict the delay might be for up to five years, which by strange coincidence is the lifetime of a Government. So we have to ask if pension policy is being run by 5-year Government expedients, i.e., insolvencies due to DB deficits don't cause insolvencies 'on my watch' – or if there is a real long-term sustainability objective, under which sponsors and trustees would need more and better options than they have right now.*
>
> *But that still leaves perhaps another 1,000 – and this is very much a back-of-the-envelope estimate – where something could be done to get a better deal for the members as a whole and possibly save the business. If that 'something' isn't done it's likely that the scheme will take the business down with it eventually. In these situations a few members might benefit if they reach NRA before the insolvency – but they benefit at the expense of all the rest of the members, which doesn't seem fair to me.*

We asked what that 'something' might be:

> *The short answer – because each case is going to be very different – is that there are several options. The choice will depend on a whole range of factors, but the key questions are these. First, what's the funding position relative to PPF? To do that 'something' you need at least PPF funding and preferably above. Second, does the sponsor's business have a future? If it's a business with a future you might be able to do a PPF+ and save the business via restructuring. If there's no business, then you need to judge when to call time and go into voluntary insolvency. That way, if you can do a PPF+, there might be better benefits for the members because there might be some value to extract from the business. Having said all of that, TPR isn't keen on PPF+ cases and you can understand why because of the moral hazard.*

b) What is available from the sponsor?

The key question to resolve is what might be available from the sponsor to supplement the scheme's assets. Judging the value of future contributions from the sponsor is very difficult in particular for weak sponsors. An alternative is to consider what might be available as a final payment from the sponsor that releases it from all further obligations to make pension contributions.

On insolvency, the sponsor is liable for what is called the s75 debt, which is an estimate of the shortfall against the cost of securing full benefits with an insurance company via a buy-out. Repayment of the full s75 debt is very unlikely to be available from a weak sponsor, but it might be possible for the trustees to collect a significant proportion of the full s75 debt.

Being released from the full s75 debt is likely to have significant value for the sponsor, as it will be able to operate going forward without the burden and risks associated with the pension scheme. It also means that the costs of an insolvency can be avoided.

Releasing the sponsor from its pension obligations in return for a proportion of the full s75 debt is known as a 'compromise' of the s75 debt. There will be a negotiation with respect to what proportion of the debt is paid to reach a compromise and this becomes a commercial negotiation for both sides, an area in which trustees need support.

c) What is a 'compromise'?

A compromise always involves loss of support from the plan sponsor and often involves the loss of eligibility for PPF compensation. The word compromise is used because it involves the trustees compromising on receipt of the full s75 debt and instead receiving a lower amount. In return the trustees release the sponsor from any further commitment to the scheme.

d) Form of the final payment from the sponsor

What can be offered will reflect the circumstances of the sponsor. The economic balance sheet of the sponsor will, however, be transformed once it has been released from the pension burden and it may then have much more financial flexibility, e.g., to raise financing. As a result, the final contribution to the pension scheme can take a variety of forms:

- cash
- equity in the sponsor or related company
- debt in the sponsor or related company
- physical assets (e.g ., property)

The final contribution can then be combined with the existing scheme assets, so the trustees can determine the best way forward.

e) Available assets less than PPF funding

If the final contribution or potential recovery from the sponsor is not enough to provide more than PPF compensation to the members when combined with the scheme assets, then there may be little or no incentive for the trustees to do anything unless required to by TPR. A subsequent turnaround in the sponsor's fortunes or in the investment returns may, of course, take the scheme's funding over PPF. The question, however, remains to what extent the PPF/TPR are aware of these schemes and are content to allow this risk (and the associated PPF drift) to run its course.

f) Available assets more than PPF funding

If the scheme assets when combined with the final contribution/potential recovery are sufficient for the trustees to secure more than PPF compensation, then the trustees will need to weigh up the options. Do they:

- take the final contribution and secure benefits in excess of PPF compensation (commonly called a 'PPF+' buy-out) or
- carry on running the scheme as normal in the hope that the situation will improve whilst risking an outcome that results in worse benefits for the members?

In the latter case, it is the members who are bearing all the risks of the sponsor's business. Some trustees decide that this is inappropriate and decide to crystallise the value of the sponsor covenant.

What the trustees do next depends on the form of the final contribution. We consider four possible cases:

i) The compromise is supported with a cash contribution

If the trustees are offered cash and they hold liquid assets in the scheme, then they are able to work out what they can secure from the bulk annuity market. A compromise always involves loss of support from the sponsor and can result in the loss of eligibility for PPF compensation.

Loss of PPF protection will mean that the trustees want to ensure that a bulk annuity of at least the PPF level of benefits is a condition of completion of the compromise. This is to provide certainty for the benefits that can be provided and certainty that members are at least as well off financially as they would have been in the PPF. In this way, they can avoid the risk that market buy-out prices move against them and the members end up with less than PPF compensation.

To provide this certainty the trustees usually engage with the insurance market in the months running up to a compromise in order to be ready to transact a bulk annuity with an insurer in parallel with preparing the compromise documentation. From a legal perspective this is relatively straightforward to put into place and the scheme goes into to wind-up with the sponsoring employer's s75 debt paid upfront, albeit at the compromised, reduced level.

To complete the wind-up, the trustees will need to use the available assets to secure benefits in line with the priority order in a scheme's rules. Benefits equal to PPF compensation will usually be secured first as a higher priority benefit. To allocate the residual assets across the members is not a simple or quick process. So at the point of securing a BPA, the trustees will typically secure an estimate or an approximation of what will be the final benefits. As a result, the bulk annuity will normally need to have provisions that enable the benefits insured under the bulk annuity to be reorganised in line with the priority orders, once the trustees have finalised what this means.

The MIRA compromise is an example of this. MIRA,[27] the global advanced vehicle engineering, research and product testing company, was the sponsoring employer of the MIRA Retirement Benefits Scheme (MIRARBS) and also participated in the Universities Superannuation Scheme (USS). The size of the pension obligations relative to the business was such that the trustee and MIRA both concluded that a restructuring transaction was necessary in order to allow a new investor to invest

[27] http://www.lcp.uk.com/media/1143750/derisking-report-case-studies_mira.pdf and http://www.lcp.uk.com/news-publications/news/2015/pa/2015-07-28-mira-trustees-use-business-sale-to-secure-benefits-above-ppf-levels/

in the business and to optimise the outcome for scheme members. The trustee of the MIRARBS used its share of the proceeds of the business sale of MIRA Ltd to secure PPF+ benefits for members.

ii) The compromise is supported by an illiquid asset that can be sold

Unlike in the case of MIRA, for Uniq,[28] the compromise contribution was not just cash but also a 90% equity holding in the scheme's sponsor, which could be sold, although it had uncertain value. In these cases, the trustees are unlikely to be able to use the equity stake as part payment for a bulk annuity. This is because annuity providers are unlikely to want to take ownership.

As a result, the trustees may not be able to secure a bulk annuity with benefits above the PPF compensation level at the point of compromise. A simple compromise, however, means that the scheme loses PPF eligibility, and the trustees will be concerned that market movements could result in the members receiving less than the 'do nothing' option of PPF compensation.

Where a PPF+ buy-out cannot be secured at the point of compromise due to illiquidity in the compromise/final contribution, then there is an additional step that can be taken to preserve PPF eligibility. This is known as a regulated apportionment arrangement (RAA).

If a compromise is being done via an RAA (e.g., as it was for Uniq) then eligibility for the PPF continues and the trustees may feel like they have more time to arrange a bulk annuity contract as they have the protection of the PPF. However, the amount of benefits that can be secured might still be fluctuating by a significant amount on a daily basis, due to the potential for movements between the scheme's assets and an annuity provider's premium.

So trustees are likely to want to secure the members' benefits at the earliest practical opportunity. In the case of Uniq, the final contribution was not paid just in cash, but was also delivered via a ground-breaking deficit-for-equity swap: the trustees agreed to forgive Uniq its pension deficit in exchange for an immediate cash contribution and a 90% equity stake in the ongoing business. Over the next 6 months, this equity stake was sold, providing c£100m of additional cash for the scheme, and the members' benefits were then secured with a PPF+ bulk annuity around 8 months after compromising.

Where securing a bulk annuity is to occur before the end of the PPF assessment period, then the trustees will need to obtain the consent of the PPF.[29]

Some experts argue that Uniq set a precedent:

> *There are a lot of companies in Uniq's position. What happened with Uniq provides a roadmap for a lot of other cases.*
>
> *Once Uniq happened, it was clear to me that it set a precedent.*

Others say that Uniq did not set a precedent and that it is dangerous to assume this is the case:

> *Uniq is being used by consultants and others to drum up business – wrongly in my opinion. 'We can do a Uniq' is being used as a sure-fire way to sell services to trustees and employers.*
>
> *When the PPF says each case is different, this is precisely what it means – it's very dangerous to assume you can do a Uniq.*

[28] http://www.thepensionsregulator.gov.uk/docs/section-89-uniq.pdf

[29] A buy-in during assessment is an investment decision, so requires the PPF's consent under PA04.

iii) The compromise is supported by an illiquid asset that can't be sold easily

Where the final contribution is in the form of an illiquid asset and likely to be undervalued on sale, there is a second approach which involves a member choice between PPF compensation and a new benefit structure. This was the approach adopted by Kodak following its compromise.

Members were offered the chance to transfer their accrued rights to a new pension scheme. The new scheme offered benefits better than PPF compensation and was to hold assets which included a subsidiary of Kodak. Through discussions with the PPF and TPR, the new scheme was offered the protection of PPF eligibility and most of the members took the option of transferring. The benefits in the new scheme were equivalent to those in the Kodak scheme, apart from certain elements of benefit which were reduced. However, these reductions were structured so that the level of PPF compensation that members would receive if the new scheme subsequently fell into the PPF would not be affected (i.e., members would not be worse off than if they had stayed in the Kodak scheme and transferred to the PPF).

Success of the Kodak subsidiary could mean that these new benefits can be paid in full. Failure will mean that the members receive PPF compensation (at no worse a level than if the entire Kodak scheme had gone into the PPF). Members who did not elect to transfer remained in the existing scheme which has now been accepted into the PPF; they will now receive just PPF compensation.

iv) The compromise with entry to the PPF

There are circumstances where the sponsoring employer is permitted to survive but where the scheme still enters the PPF. A common factor in these otherwise very diverse cases is that the regulator and the PPF believe that the sponsor's business has a viable future, but that it would inevitably fail unless the DB deficit can be transferred off the sponsor's balance sheet. The overall 'deal' must secure a better return for the PPF than the subsequent insolvency would have done.

> *The PPF doesn't want the employer to go bust – and it doesn't want the DB deficit to get bigger. This is why it's prepared to negotiate restructuring deals, where it takes in the scheme in return for a stake in the employer.*

All such cases require detailed discussions with TPR and the approach is usually made by the trustees, but with the sponsor's support.

While each case is different, the outcome follows a particular pattern in that the sponsor restructures and the scheme either transfers to the PPF or the trustees arrange a PPF+ buy-out with an insurance company – depending on the funding outcome. Where the scheme enters the compensation scheme, the PPF is likely to take a stake in the restructured company in the form of equity and/or other assets, such as cash, debt, and physical assets, for example.

g) Have there been many cases?

TPR and the PPF emphasise the fact that each case is quite different and cannot be used as a blueprint. Moreover, we understand that the examples published by TPR, as a Section 89 report,[30] represent only a fraction of the number of restructuring cases, many of which are settled in private. The reasons for privacy vary. It might be the cases that the trustees request privacy in order to have

[30] http://www.thepensionsregulator.gov.uk/regulate-and-enforce/section-89-reports.aspx

the time to explain the deal to members. It might also be the case that the ongoing business might be concerned that it would suffer if it was the subject of negative publicity about the members, who usually will receive less than full benefits. So, the details of a case might be:

- Published by TPR as a section 89 report, where the parties are named. In these cases the advisers to the trustees and the sponsor have the right to publish their own press releases, which can explain their role in the negotiations that led to a successful outcome.
- Published by TPR as an anonymous case study (identified by the pseudonym 'project', as in 'project golf', for example). In these cases the advisers are not permitted to publish a press release. The trustees may be required not to discuss the subject (e.g. there is a non-disclosure agreement).
- Not published, in which case there will be no information in the public domain.

A list of Section 89 reports is provided below for some key cases

- UK Coal - http://www.thepensionsregulator.gov.uk/docs/section-89-report-uk-coal.pdf ; http://www.thepensionsregulator.gov.uk/docs/section-89-ukcml.pdf
- Kodak - http://www.thepensionsregulator.gov.uk/docs/section-89-report-kodak.pdf
- British Midland Airways - http://www.thepensionsregulator.gov.uk/docs/section-89-bma.pdf
- Uniq - http://www.thepensionsregulator.gov.uk/docs/statement-section-89-uniq.pdf [original revised = http://www.thepensionsregulator.gov.uk/docs/section-89-uniq.pdf]
- Polestar - http://www.thepensionsregulator.gov.uk/docs/section-89-polestar.pdf

8. How TPR looks at these situations

a) Key triggers for trustee investigation

In TPR's August 2015 covenant monitoring guidance,[31] the regulator highlighted the following trigger points for trustee investigation and possible action:

- Payment of a dividend in excess of 50% of post-tax profit.
- A 10% fall in the employer's revenue relative to the time of the last valuation.
- A change in credit rating.
- Loss of a customer which represents more than 5% of the business.
- A change in ownership of the employer or its group.
- A change in the price of a key commodity for the sponsor (e.g., oil).
- Non-renewal of a key contract.
- Inability to refinance debt twelve months before scheduled maturity (for significant debt obligations).

These cases are sensitive because the regulator needs to avoid moral hazard: for example, a sponsor that wishes to 'dump' the scheme to be rid of the debt, but which, on examination, might be found to have the ability to meet the recovery plan in full over time.

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- Not published, in which case there will be no information in the public domain.

[31] http://www.thepensionsregulator.gov.uk/press/pn15-39.aspx
[32] http://www.thepensionsregulator.gov.uk/regulate-and-enforce/section-89-reports.aspx

b) TPR's approach to regulated apportionment arrangements (RAAs)

TPR says it expects an RAA application to be accompanied by a clearance application,[33] though the regulator should have already been involved in earlier discussions around the possible options. Relevant information should be submitted to the regulator in a draft clearance application and draft RAA, including the level of mitigation proposed.

Any proposal should have been discussed in detail with the trustees. Trustees and their advisers should consider all relevant factors, including any possible alternatives to the RAA, and whether insolvency is inevitable. It is very important that trustees address any possible conflicts of interest or duty and seek advice where appropriate.

TPR will need sufficient information from the applicants and trustees to allow an initial assessment. It will undertake a certain level of due diligence to decide whether an RAA may be appropriate. This due diligence may take some time to complete, as the facts and the legal issues may be complex, and specialist advice is likely to be required. It should also be borne in mind that an approval notice cannot be issued until 28 days after TPR determines to approve an RAA.

TPR will consider the relevant circumstances, which may include:

- Whether insolvency of the sponsor would be otherwise inevitable or whether there could be other solutions (including funding options for the scheme) which would avoid insolvency;
- Whether the scheme might receive more from an insolvency;
- Whether a better outcome might otherwise be attained for the scheme by other means (including through the use of the regulator's powers where relevant);
- The position of the rest of the employer group; and
- The outcome of the proposals for other creditors.

The advice the trustees have received from independent financial advisers will be a fundamental and integral part of what TPR will consider. TPR will conclude this due diligence and form an initial view about whether a RAA might be appropriate and reasonable in the circumstances. If so, TPR and the PPF will then work closely together to form a common view of whether the proposed level of mitigation is appropriate.

TPR stresses that approval of an RAA will be considered only in circumstances where the scheme will enter a PPF assessment period in any case (i.e., where insolvency of the sponsor is otherwise inevitable), irrespective of whether or not TPR approves the RAA.

Typically, a sacrificial subsidiary of the sponsoring employer is set up and the liability for the scheme deficit is transferred. Then this subsidiary is allowed to become insolvent (so outstanding debt after any s75 recovery is effectively written off) and the scheme enters a PPF assessment period.

[33] 'Clearance' is the term used to describe the voluntary process of obtaining a clearance statement from the regulator. A clearance statement gives assurance that, based on the information provided, the regulator will not use its anti-avoidance powers to issue to the applicants either contribution notices or financial support directions in relation to a defined benefit occupational pension scheme and a particular event. 'Events' include transactions, agreements, decisions, other acts and failures to act.

The price for clearance is that the PPF gets more out of the insolvency than would have been the case if the employer went bust and there was no restructuring. In other words, the PPF has to be in a 'significantly better' position financially.

c) Dealing with moral hazard and anti-avoidance in non-standard solutions

The danger to the PPF of considering a PPF+ case is the moral hazard that a sponsor might seek to dump its pension scheme – either in the PPF or via a buy-out – when, in practice, it might have been able to pay full benefits over time; for example, where it could get support from a parent company.

One way to help resolve this potential problem is to equip the trustees with the information and tools they need, so that they can make informed decisions. Interviewees said that many trustees are bewildered by the anti-moral hazard requirement to act as though the PPF is not there. They said that this is not necessarily rational; nor is it consistent with their fiduciary obligations to members.

For trustees, the use of the scheme funding/sponsor covenant metric would help them to understand when it is appropriate to support the sponsor's request to invest more in the business than in the scheme. At present, they may feel obliged to do so, even when they are aware of the potential negative impact on the PPF funding level. The support and oversight of a regulator-approved professional trustee should also reduce the potential for moral hazard. [34]

Having said this, we would point out that moral hazard is systemic in the insurance market. One interviewee observed:

> *Dealing with moral hazard is the name of the game in the insurance market – and the PPF is a type of insurance arrangement. Insurers deal with potential moral hazard from policyholders, who may change their behaviour as a result of insurance. I see no reason why the PPF should be any different.*

Moreover, TPR already has robust powers to deal with moral hazard if it believes that an employer is deliberately attempting to avoid its pension obligations, with the intention of leaving the PPF to pick up its pension liabilities.[35] It has a wide toolkit:

- **Contribution notices**, where there is a deliberate attempt to avoid a statutory debt, or where acts or omissions by the employer or parties connected to the employer have a materially detrimental effect on the likelihood of scheme benefits being paid in full (a 'Type A event'). The notice requires those involved to pay an amount up to the full statutory debt either to the scheme or to the Board of the PPF.
- **Financial support directions**, which require the employer or parties connected to the employer to put in place financial support for an underfunded scheme. These are used where TPR decides that the sponsoring employer is either a service company or is insufficiently resourced.
- **Multi-employer Rules:** A s75 debt may be crystallised (often inadvertently) if an employer stops participating in a multi-employer scheme. This debt can be modified or removed in certain circumstances by following TPR prescribed processes.

[34] There are two panels of trustees. TPR lists about 14 firms on its panel; the PPF had five at the time of writing. The choice might depend on the scheme funding level relative to PPF.

[35] These are known as 'moral hazard' and 'anti-avoidance' powers. See http://www.thepensionsregulator.gov.uk/search.aspx?client=my_frontend&proxystylesheet=my_frontend&output=xml_no_dtd&oe=UTF-8&ie=UTF-8&site=default_collection&q=moral+hazard

- **Restoration orders:** This is where TPR believes that a transaction involving scheme assets has taken place at an 'undervalue'. These orders allow it to require that the assets – or their equivalent value – are restored to the scheme.
- **Scheme funding powers:** TPR has power to intervene where the trustees and the sponsor cannot agree the recovery plan for a scheme.
- **Wind-up:** TPR has the powers to force a wind-up, but there needs to be a trigger for these powers to come into play.

In order to use these powers, TPR has to prepare a legal case – to High Court standards, we were told – which is time-intensive and costly.

Section 2 - Background to the proposals

In this section, we explore the proposals in more detail.

1. Summary so far

To summarise thus far:

- The research highlights the complex and potentially unviable position of about 1,000 closed DB schemes, where it seems unlikely that the trustees and their sponsor will be able to provide full DB scheme benefits to members, due to a combination of factors that include a weak sponsor covenant.

- In these situations, the position of younger, deferred scheme members is of particular concern, as their prospective scheme benefits are expected to worsen over time. Older deferred members could also similarly see benefit erosion, albeit to a lesser extent. This is because, where sponsor weakness might lead to insolvency in the future, the potential scope for a pension in excess of PPF compensation is eroded by future PPF drift. That is, there is a difference between what the scheme might currently be able to afford above the PPF compensation levels, and what pre-normal retirement age (NRA[36]) members (and, in particular, younger, deferred members) will receive if the sponsor becomes insolvent in the future with the scheme entering the PPF.

- As a result of the above concerns, one question the report raises is whether, in certain cases, it would make sense for the trustees and the sponsor to compromise the s75 debt – which is the shortfall against the amount necessary to insure members' benefits with a regulated insurer[37] – and agree a final payment that is sufficient for the trustees to secure more than PPF compensation for all of their members. Examples of a compromise of the s75 debt include Uniq and MIRA.

From a public policy standpoint, there are two key issues:

- The consumer protection perspective, which relates to transparency and greater certainty of the level of benefits that may be provided from stressed schemes. Put simply, how can 55-year-olds sensibly plan for retirement in these circumstances? They do not know if they will get the full benefits under their employer's scheme, or if they will get PPF compensation. PPF compensation will have lower pension increases and, for all pre-NRA members, starts at a lower level than full benefits, due to the 90% rule. Moreover, they may be significantly lower for some members due to the PPF compensation cap.

- The corporate perspective, which relates to the economy as a whole. Our research seeks to identify an open and transparent process, which, in the given circumstances, treats all members fairly – to borrow a fundamental principle from financial services regulation. This would enable employers and trustees of stressed schemes to resolve the pension legacy issue by removing it from the corporate balance sheet. The effect would be to stimulate economic growth – an aim that is aligned with TPR's sustainable growth objective – among

[36] NRA is scheme-specific and we use the term in this report to indicate the age at which a member is entitled to take their full pension from the scheme. Broadly, for the purpose of determining PPF compensation, a member's NRA is whatever the scheme's rules specify for that member. Common examples are 65, 62 and 60.
[37] See http://www.thepensionsregulator.gov.uk/guidance/guidance-abandonment.aspx

companies that currently facing near inevitable insolvency under the unsupportable weight of the DB burden. While restructuring may be unpopular with the shareholders of specific employers, it may still be the right way forward for the business and its workforce – and for the economy as a whole.

When we examined the key findings in relation to the way the market for stressed DB schemes operates, we recognised that these were interconnected and interdependent to a greater or lesser extent. Taken together, the findings boil down to two fundamental problems: first, stressed schemes are a major economic risk that is understated by the Government and the regulator; and second, trustees don't know what represents the best outcome for their own scheme in relation to the greatest good for the greatest number. This is often as a result of either a lack of information or a lack of professional competency, or indeed both. It is, however, a risk that needs to be tackled for good of members as a whole.

We stress that the research does not make firm recommendations on these points, but instead aims to stimulate an open debate between the Government, the regulators and stakeholders to DB schemes.

2. What we learned from candid discussions with interviewees

Interviewees said that trustees do not know what is expected of them because they don't know what 'good' looks like, given the many conflicts of interest they face:

> *For a lot of trustees, it's blindingly obviously that the long-term recovery plan is not going to work. In extreme cases the banks might be refusing to renew lending arrangements and suppliers to the business are getting cold feet. So it's only a matter of time. But under the new sustainable growth objective, TPR expects trustees to manage somehow – to avoid taking decisions that might lead to a better outcome for members, such as a PPF+, and to do whatever they can to help the sponsor. What they are being asked, in practice, is to watch while the sponsor's business experiences a slow and painful death. Instead of being prompted to accelerate inevitable insolvency, they are being asked to make the company linger on for another five years, but without the sponsor's ability to raise additional external capital.*

Unless there is a clear recognition of this fact, and unless better ways are found to deal with this significant minority of cases, many of these schemes will not deliver the greater good for the greatest number. They cannot be 'fixed' by extending and softening the terms of the recovery plan. Such an approach might defer the problem for a few years ('kicking the deficit can down the road', as one interviewee put it), but it will not eradicate it. Instead it is likely to exacerbate the weak funding position of the scheme relative to the PPF measure and the weak financial condition of the sponsor's business. The idea that somehow, at some future point, these schemes will be able to pay full member benefits is not realistic; it is wishful thinking, as an interviewee observed:

> *The situation is stark. DB schemes have something like £1.5trn of liabilities and £1trn of assets. So in aggregate schemes are short of half a trillion quid. You can't sort that out by a combination of minor liability management exercises and waiting for gilt yields to rise. For many schemes, reducing benefits and crystallising them through a buy-out is the only way to deal with a problem of this magnitude.*

Interviewees also said that many trustees of stressed schemes are out of their depth. As we have already pointed out, this is not their fault – their role has changed over the years from 'prudent person' to 'expert in corporate and debt restructuring'. There is unlikely to be anything helpful – in relation to their current predicament – in their scheme's original trust deed and rules.

Pensions law and regulation strive to keep abreast of developments, but they were not designed to deal with schemes that are the biggest creditors to sponsoring employers that are likely to go bust.

Interviewees said that in many cases, trustees of stressed schemes are not getting the help they need. Rudderless, the tendency is not to take actions that might steer the scheme towards a definitive outcome.

One interviewee described this phenomenon as 'enforced inertia':

> *Under Government pressure, the regulator has to assume that all DB schemes are survivors. It takes no action, until it's usually too late. Unless this changes, hundreds of businesses that might otherwise survive will go bust because they can't afford to service the deficit; and the trustees have to keep paying benefits in full as though the sponsor is a survivor, even when they know it's not. There is no mechanism to scale back benefits, which is what trustees and sponsors really need.*

Another described it as 'analysis paralysis':

> *For trustees [of stressed schemes], the options are not clear and nor is the objective, if full benefits are not on the cards. So they ask for more advice and when it doesn't give them the answer, they ask for yet more. In many cases, the result of this process is 'analysis paralysis.' Trustees conclude that there is no obvious correct action, that a compromise action is risky – a 'damned if you do; damned if you don't' double bind – and that the best course of action is to do nothing that might put the sponsor at risk.*

An interviewee said that it's not just the trustees who feel 'stuck':

> *If the employer is really struggling, the trustees are unlikely to impose demands that would push the company under. I'm not sure if it's a good or bad thing, but, in many tough cases, the only point of alignment between trustees and sponsors is to agree to do nothing.*

Interviewees said that numerically, the schemes that most need professional expertise:

- Might not realise the seriousness of their situation. For example, if they haven't paid for an expert covenant assessment, they might not know how weak the covenant is or is likely to become.
- Might realise their plight, but assume they can't afford the fees that experts command. Interviewees pointed out that the level of work required for a smaller or medium-sized scheme can be the same as for a larger scheme, so professional fees can look disproportionate for the former. One interviewee said that adviser costs for a complicated case could be north of £1.5m, irrespective of the size of the scheme. However, another said that some of the best-known experts in the market charge fees that would be proportionate in TPR's view.
- Might realise their plight, have asked TPR for help, only to discover they are not a priority due to their size.

There was a great deal of concern among interviewees about the compound effect of problems facing smaller schemes in particular. One said:

> *They [smaller schemes] have no traction with TPR – they are just a tiny ripple if they enter the PPF. The problem is that so many smaller employers – wrongly in my opinion – were sold DB schemes in the 1970s and 1980s by commission-based salesmen, on the basis of the compelling tax breaks. Where are these advisers now? Long gone.*

Another said:

> *As a regulator, TPR doesn't intervene – it expects employers and trustees to handle the situation. When it comes to smaller CG4 sponsors, it's unlikely to intervene. It might argue that there is little it can do to help, but I suspect the real reason is lack of resources.*

TPR makes it clear that it keeps intervention to the minimum and targets its limited resources where it can make the biggest impact.[38] It says:

> *The factors we take into consideration when deciding on whether to engage further include:*
>
> - *The position of the scheme compared to our risk indicators*

[38] Defined benefit funding regulatory and enforcement policy, June 2014

- *The size of the scheme's liabilities*[39]
- *The potential complexity and resource intensity of our engagement compared to the impact and the value we can add through further engagement*
- *The overall resources we have available.*

While interviewees understood the need for prioritisation, many were concerned that sponsors and trustees of smaller and medium-sized schemes are neglected and that, where TPR does intervene, it allocates few resources to cases that would have a lower impact on entry to the PPF:

> *I've seen cases where a small scheme and distressed sponsor have gone cap in hand to TPR. I had no doubt in these cases that they qualified for TPR intervention, but they didn't get it.*

One interviewee made a rather moving observation, which we quote here in full, because it captures the sense of anger and frustration, and also desperation and impending doom, that characterised so many of our conversations with experts:

> *Medium-sized businesses, and in particular smaller companies, are the backbone of the economy – at least they used to be – I'm not so sure that still holds true. They certainly won't be if hundreds go bust because of their DB deficit. But from where I'm sitting it looks like TPR's approach is to ignore them and let them die a slow and painful death. I don't see how that fits in with the sustainability objective. Don't get me wrong – TPR really does its best and given its limited resources and the pressure it's under from the Government, it does a very good job. But that's not the point, is it? It's like the NHS – not enough resources, so the focus is on A&E and not on prevention. I'm an economist by training and we're not supposed to get emotional, but it seems so sad. Is there really nothing that can be done?*

Experts said that smaller schemes were particularly vulnerable to PPF drift. One noted:

> *In a small scheme, it only takes the retirement of one or two high-liability members – usually, but not always, directors – to knock the funding from comfortably above PPF to well below. This is a disastrous scenario and unfortunately we suspect in some of the cases we've seen, it might have been a deliberate ploy on the part of the retiring directors to keep the company afloat until they secured the guarantee of the full headline*[40] *rates of benefits under the PPF.*

A second interviewee echoed this view and explained why PPF drift is so common:

> *The age profile of the membership will depend on when the scheme closed to new members. Many were closed at the turn of the century, with most of the remaining schemes closed by*

[39] Nevertheless, the regulator said that in 2013 almost half of its interventions related to smaller and medium-sized schemes. We cannot account for the discrepancy between this fact and the views of interviewees which indicated an alternative scenario.

[40] The 'headline rate' is generally used to denote the initial level of pension, i.e., the initial annual rate. The focus here is on the initial level, rather than subsequent increases. 'Full headline rate' generally denotes the target level of pension promised by the scheme. When a scheme enters the PPF, a member, post-NRA, will receive PPF compensation that is uncapped and has no 90% adjustment, so the member receives the 'full headline rate' promised by the scheme. The 'headline rate' of PPF compensation for a pre-NRA member will be capped, where relevant, and subject to the 90% adjustment, so it will be less than the 'full headline rate' promised by the scheme – possibly significantly so if the cap applies. Both members will receive PPF increases in payment on their PPF compensation, i.e., no increases on pre-1997 pension and LPI 2.5% increases on post-1997 pension.

around 2005-06. A scheme that closed in 2005 could have members in their 40s. However, in aggregate, the majority of members of closed schemes are in the 50-65+ age range, so each year that the company keeps going adds post-97 statutory pension increases – and pre-97 increases if they are written into the trust deed and rules – plus an annual cohort that reaches NRA.

3. Helping trustees to identify a stressed scheme

Given the sheer number and complexity of the stressed scheme market, we argue that it calls for greater recognition and attention than it currently receives. But first, trustees need to know that their scheme is stressed – and also to what extent – because this will dictate the policy implications and the potential course of action.

The research identified three main categories of stressed scheme. In each case, insolvency was the greatest concern, but the policy implications and potential course of action will be different. Trustees should identify, or be helped to identify, which of the following three categories their scheme is in:

- The sponsor's insolvency appears to be inevitable before the end of the recovery period and the scheme is funded to below PPF after allowing for any potential recovery from the sponsor.
- The sponsor's insolvency appears to be inevitable before the end of the recovery period and the scheme is funded at or above PPF after allowing for any potential recovery from the sponsor.
- The sponsor faces a potential insolvency that is contingent on the DB deficit, i.e., the sponsor might have a viable future without this debt on the corporate balance sheet.

4. Proposals to help trustees directly

a) Trustees of stressed schemes should clarify the sponsor's prognosis

Although the pension scheme is underwritten by the sponsoring employer, these two entities operate under different laws and regulation, so addressing the problem of stressed schemes requires consideration of both.

Ideally the trustees and sponsor's directors will work closely together and the sponsor will share all relevant information with the trustee board. However, interviewees said that this is not always the case and that the relationship between these two parties can become very strained. At times, trustees may not know in advance if the sponsor plans to take a corporate action that might affect the strength of the covenant.

It seems that the way businesses are run in practice is not necessarily the way the regulator assumes is the case. Trustees need a set of diagnostic tools for their corporate analysis. Factors to consider include:

- The prognosis for the business might be clear, i.e., insolvency is inevitable. 'Zombie companies' can do little more than pay the interest on their loans.[41] An example would be an older manufacturing company that makes products that have been replaced by newer technology and which does not have the necessary capital to invest to change its business model.
- The sponsor's business sector might be subject to variations in economic cycles. This could lead to a sudden weakening of the sponsor's covenant at a crucial time, e.g., if banks decide to review lending policy. If the trustees' response to a weakening covenant is to reduce investment risk by switching into bonds (which can be understandable), this will, in turn, worsen the scheme's funding position, potentially leading the trustees to seek higher contributions from the sponsor, exacerbating the sponsor's difficulties still further.
- The sponsor's business may make products or provides services that remain attractive to the target market. However, in order to survive, it needs to raise capital (debt and/or equity) and the presence of the scheme deters new investors and prompts existing lenders to consider calling in the debt.
- The directors might want to sell the business, but exit strategies are complicated by the size of the scheme relative to the value of the business. So the DB scheme, once more, presents the biggest impediment to M&A activity.

To clarify the position, we propose that, **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.**

This would significantly enhance the quality of information trustees receive about the long-term health and strategy of the sponsor, and it would raise the bar for trustees' risk management of stressed schemes.

[41] See http://lexicon.ft.com/Term?term=zombie-company and http://www.ft.com/cms/s/0/96307326-665e-11e3-aa10-00144feabdc0.html#axzz3fJ23uNzs

We suggest that the FRC should require directors to notify the trustees of any planned corporate actions in advance, so that the trustees have time to consider the implications and take advice on the impact on the covenant.

The FRC might also require company directors to adhere to a statutory code of practice in relation to the information they should provide in a timely manner to trustees (and also to investors and non-pension scheme lenders), such as information in respect of a corporate action that might weaken the covenant. Working with the FRC, TPR could publish a list of questions trustees should ask of their sponsors on an annual or more frequent basis.

Directors' business viability statement

With reference to the prognosis for the sponsor, TPR tends to take a short-term[42] view of impending insolvency as the benchmark for regulatory intervention: for example, 12 months. We suggest TPR might adopt a longer horizon and work with the Financial Reporting Council (FRC) to develop a better framework for trustees and TPR to operate within, using, as a model, the new code of corporate governance (2014) that requires directors of listed companies to provide a longer view of the business's viability (a 'viability statement') in the strategic report to investors – see the box below.

The aim of the directors' viability statement to investors is to provide an improved and broader assessment of long-term solvency and liquidity. It is expected that this statement will look forward significantly longer than 12 months. It will be based on a period chosen as appropriate by the directors who have to explain why they have chosen that period. Audit practitioners have suggested that most directors believe three to five years to be an appropriate time-frame under which to report the viability statement. The theory is that the statement will significantly enhance the quality of information investors receive about the long-term health and strategy of listed companies, and that it will raise the bar for risk management. And, of course, where a large DB scheme is sponsored by a significantly smaller UK-listed sponsor, then the DB scheme should be part of the directors' thinking and should be reflected in the viability statement.

There is a clear parallel between the viability statement provided to investors (for listed companies) and the statement that we are proposing be provided to trustees (for all companies sponsoring a DB scheme).

[42] The 12-month view is written into current legislation (e.g,. Reg.7A of the Occupational Pension Schemes (Employer Debt) Regulations 2005, on when regulated apportionment arrangements can be used).

The UK corporate governance code 2014[1]

There has been a UK corporate governance code for more than 20 years. The first was produced by the Cadbury Committee in 1992.

The main feature of the FRC's September 2014 code, which applies to accounting periods beginning on or after 1st October 2014, relates to the directors' responsibility to shareholders and lenders regarding the prognosis of the business.

Historically, directors have been required to present a 12-month view of the business prospects in the annual report and accounts. In its announcement of the new code the FRC said:[1]

> *[The new Code] significantly enhances the quality of information investors receive about the long-term health and strategy of listed companies, and raises the bar for risk management. The FRC has confirmed proposals for boards to include a 'viability statement' in the strategic report to investors. This will provide an improved and broader assessment of long-term solvency and liquidity. It is expected that this statement will look forward significantly longer than 12 months.*

In the Preface of the report the FRC says:

> *In this update of the Code, the FRC has focussed on the provision by companies of information about the risks which affect longer term viability. In doing so, the information needs of investors has been balanced against setting appropriate reporting requirements. Companies will now need to present information to give a clearer and broader view of solvency, liquidity, risk management and viability. For their part, investors will need to assess these statements thoroughly and engage accordingly. In addition, boards of listed companies will need to ensure that executive remuneration is aligned to the long-term success of the company and demonstrate this more clearly to shareholders.*

The FRC does not specify what period is denoted by 'longer-term' in relation to viability, but interviewees suggested that shareholders and lenders would expect to see a three-to-five year view.

The code also requires a clearer identification of principal business risks and how these will be managed:

- *Companies should robustly assess their principal risks and explain how they are being managed or mitigated;*
- *Companies should state whether they believe they will be able to continue in operation and meet their liabilities, taking account of their current position and principal risks, and specify the period covered by this statement and why they consider it appropriate.*

While the Code focuses primarily on the relationship between the company and its shareholders, 'companies are encouraged to recognise the contribution made by other providers of capital.' For the sponsoring employers of stressed schemes, the size of the DB deficit relative to market capitalisation (or the enterprise value of a private company[1]) will be a principal risk, as will be the presence of the DB scheme trustees as a major creditor.

For a UK listed company sponsoring a stressed DB scheme, the risks associated with the pension scheme will be a key input for the analysis underlying the viability statement. It is too soon to assess the practical implications of these new requirements, but our research suggests that they will be significant. Two code provisions in particular are expected to prompt penetrating analysis on the part of investors and lenders in the light of contingent liabilities and technical insolvency:

> *C.2.1.The directors should confirm in the annual report that they have carried out a robust assessment of the principal risks facing the company, including those that would threaten its business model, future performance, solvency or liquidity. The directors should describe those risks and explain how they are being managed or mitigated.*
>
> *C.2.2. Taking account of the company's current position and principal risks, the directors should explain in the annual report how they have assessed the prospects of the company, over what period they have done so and why they consider that period to be appropriate. The directors should state whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary.*

b) TPR should tell trustees if the sponsor covenant is in CG4 or is on a rapid downward trajectory

At present, TPR does not tell the trustees and the sponsor if the covenant is categorised as 'weak', which is the lowest of the four grades and which would indicate the need for urgent trustee action. Nor does it tell trustees if the covenant is on a rapid downward trajectory, which is equally important. Interviewees said:

> *It's not just the grade; it's the speed of a downwards trajectory. Some employers with covenants that TPR classes as weak might remain at the top of Covenant Grade 4 for many years and therefore in practice might actually be pretty stable. Others experience a rapid downward trajectory. Some, like Lehmans, happen really quickly – so these are the ones TPR and the PPF are scared sh****** about.*

The regulator uses its covenant grades for internal purposes and intervenes only in what it judges to be genuine crisis cases. Even then, interviewees told us that TPR is more likely to intervene if the scheme liabilities are large, i.e., it allocates its resources to the schemes that, if the sponsor became insolvent, would have greatest impact on the PPF. This is not ideal for trustees, yet is understandable given the limited resources of TPR.

TPR might notify trustees and sponsors where there is a risk that the recovery plan is likely to be longer than the lifespan of the sponsor's business, although, under the current framework, this is information that sponsors should already have shared with trustees. However, if this is not the case, and given the crucial nature of such information, this could be delivered direct by TPR in an annual notification to CG4 schemes. Such a notification might use a graphic illustration of the spectrum in CG4 and the position of the covenant. The spectrum might be colour-coded with accompanying text to explain just how weak the covenant is.

Our proposal is to **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**.

It seems right that trustees and sponsors should know if they are assessed by TPR as being in CG4, or if their covenant is on a rapid downward trajectory as measured against a pre-defined industry or TPR metric. It also seems right that the PPF has the option to become involved with CG4 schemes at an earlier stage to help trustees understand what early-intervention actions they might take. Finally on this point, it also seems right that sponsors are made aware of their covenant weakness. They might be given the opportunity to apply for a re-assessment of TPR's grading, with appropriate justification. A clear indication of where the covenant sits in CG4 might prompt the sponsor and trustees to take action without TPR or PPF intervention.

Wherever possible, sponsors and trustees should be allowed and enabled to take appropriate action without formal intervention. Several interviewees stressed this point. They were concerned about the potential for over-intervention in corporate life. The phrase 'on the road towards nationalisation' and similar descriptions cropped up frequently in our discussions.

Having said that, TPR and the PPF might need to encourage sponsors and trustees to work together towards a common goal. Several interviewees said that TPR's description of the relationship between trustees and sponsors in CG4 was overly optimistic in view of the reality in a lot of cases:

> *TPR's description of CG4 schemes makes them sound like everyone is pulling together – that the trustees and sponsor are having meaningful conversations. If only that were true! I've dealt with schemes where the first job is not the covenant assessment – which is what it should be – but to get the trustees and sponsor round the same table and actually talk together.*

c) Trustees need expert help, which they may feel the scheme cannot afford

Trustees who realise they need expert help may hesitate because of the cost, although inaction on cost grounds short term can often be more costly in the long run. Trustees may also hesitate because they do not know where to find the right expertise.

Most interviewees, however, agreed that cost is definitely an issue and is almost certainly the primary reason for inaction. TPR says that fees for external advisers should be 'proportionate', i.e., the cost should be appropriate in relation to the scheme size and available resources, including what the sponsor might bear directly or indirectly through additional contributions.

This makes sense, but 'proportionate' is not a precise measure and, accordingly, there needs to be a clearer benchmark or metric. Otherwise trustees will be concerned that if they pay fees for expert

help, at some future point, TPR might decide that the cost was not proportionate. At present most trustees will therefore choose not to take the risk.

In this we believe that trustees need a clear steer. They need to know in advance that what they plan to spend will be acceptable – this could be seen as a form of clearance. We therefore propose to **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'.**

Appointment of a professional trustee

TPR might also be stronger in its intervention. If it is concerned about the trustees' ability to handle a complex corporate situation, it might actively recommend and endorse the appointment of a professional trustee, irrespective of the scheme's funding position.

This leads us to another dilemma, however. From our research it seems clear that there are a limited number of genuine experts in this field, i.e., those who combine expertise and experience in pensions, corporate finance and restructuring, in relation to stressed closed DB schemes. Therefore, it might be appropriate that the appointment of a professional trustee is made from a list of suitable vetted firms compiled by the regulator and the PPF. TPR and the PPF already have lists of suitable firms, on which they might build.

Interviewees from all professions agreed that the professional trustee is the most important appointment:

> *Without a professional trustee with expertise in insolvency cases, the trustees will remain conflicted, especially in the case of smaller schemes, where the company-appointed trustees are likely to dominate, due to their financial expertise. Should the trustee board support TPR's sustainability objective? Should they get the best PPF+ deal for members, which could mean letting the sponsor continue without any real hope of a future improvement in the scheme's position? In most cases, they will adopt a wait-and-see approach – and who can blame them.*

The professional trustee would then decide what further expert help is required, for example, a covenant assessment and legal expertise on the trustees' powers relative to the sponsor. An expert professional trustee should also be skilled in negotiations. Case history demonstrates that, where trustees and sponsors can be brought to the same table and can be counselled so that they accept the facts of the case, this opens the door to an appropriate course of action for all stakeholders to the scheme.

One interviewee suggested that CG4 trustees and sponsors be given 12 months to improve the covenant and funding position. If they failed – and this might be through no fault of their own – the trustees would be required to appoint a professional trustee from TPR and the PPF's list of approved firms. The trustees would decide if the professional would act as the new chair. The additional skills that the trustees might need access to include covenant analysis and corporate restructuring.

Advice from a pensions de-risking specialist

A pensions de-risking specialist will work closely with the professional trustee to help steer the trustee board through the process. They will use expertise and experience to help devise a solution, e.g., an immediate PPF+ buyout or setting up a framework to monitor covenant strength and PPF

drift. The role will include significant actuarial input; this can be from the scheme actuary, or from a specialist firm offering the extended range of skills required for a stressed scheme.

The covenant adviser

This is not a statutory requirement. However, we were told that professional covenant advisers have achieved increasing prominence through both TPR regulatory guidance and the sustainable growth objective. Their main role in stressed circumstances will be to provide the trustees with an objective view of the financial strength of the operating business supporting the pension scheme, in the context of the other obligations impinging on the sponsoring employer and its broader group. This will include understanding the historical financial position, the prospects for the group in the context of the industry it operates in, and the legal structure of the group that provides the covenant support. Most covenant advisers are also restructuring experts, or have access to these experts within their teams. The analysis from the covenant adviser, including a view on the potentially affordable cash contributions, will provide a basis for the parties to make decisions regarding any upcoming negotiations on funding or corporate events, such as a balance sheet restructuring.

The corporate restructuring specialist

This is usually an offshoot of the insolvency teams of large accounting practices, albeit not limited to such. The lead role would be taken by the sponsor's adviser, who ultimately might be appointed as insolvency practitioner depending on the ultimate direction of travel. There are a number of professional trustees with significant experience of restructuring/distress scenarios, and these might play a very active role in the proceedings, including helping to devise possible solutions.

d) Communications to scheme members

This is a particularly contentious issue and we appreciate the arguments on both sides. Nevertheless, communications needs to be discussed openly, given the asymmetry of information between the trustees and the members. The latter will typically assume that 100% of their benefits are guaranteed.

Interviewees were divided on this point, however:

- Some interviewees said trustees should not 'spook the horses', as this might trigger an uninformed or panicked DB-to-DC transfer exit on the part of pre-NRA members. Transfers can work well for all stakeholders, but they do need to be fair and consistent given the circumstances of a weak covenant.
- Other interviewees argued in favour of plain communication to members with an indication of the likelihood that the scheme will not reach a full buy-out funded position, although how this is calculated would be a source of debate. They also called for a more accurate measure of the funding position. In terms of 'telling it how it is', they said that if the Government believes DC savers are rational enough to have total freedom over how and when they take their pension pot – which has a clear monetary value – then this same assumption of rationality should be made in the case of DB members.

Regulation requires a certain amount of disclosure, in that trustees must set out the scheme funding position in the annual summary funding statement to members. However, the language prescribed is impenetrable to the average member. In addition, we were told that the calculation method is questionable and may well illustrate that the funding of the schemes is better than is the case, since it discounts future cash-flows using the expected rate of return on assets. The estimated position on

buy-out is shown but usually given much less emphasis in the communication materials than the ongoing funding position. Often, and worryingly, this is because trustees do not like the number presented by the buy-out calculation.

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5. Proposals to help via regulation

a) Change TPR's remit from protection of benefits to protection of members' interests.

Protection of benefits means doing everything possible to ensure members receive full benefits, with the focus always being on 'full'. This makes it difficult for trustees and other stakeholders to acknowledge that, in reality, full benefits will never be delivered by many schemes.

One interviewee said:

> *The system is flawed because it's binary. The assumption on the part of TPR – and the Government, which imposed the new sustainable growth objective – is that schemes will either pay full benefits or the sponsor becomes insolvent and the scheme enters the PPF. The only alternative is to do a PPF+ buyout and that is currently only possible if the scheme enters assessment,[43] so we're back to the binary option again.*

Another said:

> *Trying to protect full benefits leads to strange behaviours when they are not affordable. Protection of benefits at present means doing everything possible to ensure members receive full benefits, with the focus always being on 'full'. This makes it difficult for trustees and other stakeholders to acknowledge that in reality, full benefits will never be delivered by many schemes. Protection of members' interests is more practical and could be defined as 'doing the right thing in the circumstances, all things considered'. So, if a compromise deal (i.e., PPF+) is going to be the optimal outcome in reality, then the trustees should take the necessary actions.*

Interviewees said that protection of members' interests is more practical than the protection of members' full benefits. Our proposal therefore is to **change TPR's remit for trustees of stressed schemes from 'protection of member benefits' to 'protection of members' interests'.** This proposal is well aligned with other proposals that aim to help the regulator, the PPF, trustees and sponsors to take a more realistic view of their position and options.

b) Clarify trustees' responsibility in relation to PPF drift

Trustees might argue that – broadly speaking – helping the sponsor to kick the deficit can down the road is well-aligned with their duty to act in the members' best interests, since each year the business is kept away from insolvency results in better benefits for at least some members. This is due to additional statutory pension increases (and scheme-specific increases above this, where relevant) and additional members reaching NRA.

Interviewees said that this is common practice on the part of trustees of stressed schemes:

> *Many trustees know the sponsor's business won't last long but they have decided to sit it out. PPF drift works to members' advantage. For obvious reasons, the PPF doesn't like this attitude – but it happens all the time, although it's never recorded in meeting minutes to my knowledge.*

[43] Technically it's possible 'to do a PPF+ buy-out' without entering assessment, if the trustees agree to give up eligibility for the PPF.

It's there [the PPF]. Get over it. It might be the right thing for trustees to take account of the PPF because they can support the sponsor and, each year, more members will reach NRA. We might ask why trustees should care about PPF drift, since their job is to protect member benefits. End of. But PPF drift prior to entry [to the compensation scheme] places more of a financial burden on the PPF and this is paid for partly by the levy on solvent sponsoring employers. So the PPF is a cost to business.

The younger pre-NRA deferreds do not benefit from PPF drift, as their PPF compensation will not increase. Moreover, they lose the opportunity of achieving benefits better than PPF compensation, as a direct result of PPF drift and assuming a PPF+ buyout is viable at some point. This raises important questions about intergenerational transfers within pension schemes and who is representing the interests of the younger pre-NRA members. It also raises a question about the apparent objectives of trustees and how well they are aligned with the objectives of members.

More generally, it has to be recognised that the existence of the PPF will tend to incline trustees towards inaction, at least where the scheme is not funded substantially above PPF level. Despite the fact that case law directs that trustees should not take account of the prospective availability of PPF compensation when determining how to act, interviewees said that the reality is that it is well-nigh impossible to prevent the existence of the PPF from influencing trustees' approach to the assessment of the relative risks of action versus 'wait and see'.

Moreover, the most relevant example in case law, *ITS vs. Hope*,[44] refers to a case where the trustees wanted to take a very specific action – namely, to buy annuities to protect the benefits of just some of the members – which the High Court determined was an example of selecting against the PPF. To be aware of the existence of the PPF in relation to the membership as a whole might not be considered to be a breach of the law and regulation, especially if trustee discussions on this point are not included in the minutes of meetings, as several interviews suggested was the case.

It seems to us that trustees are bound to have at the back of their minds the fact that there is a floor below which members' benefits will not be reduced: after all, schemes are effectively paying a substantial insurance premium for this benefits protection floor, in the form of the PPF levy. Realistically, that fact might make them less likely to take action which may prematurely terminate the sponsor and the scheme, and with it, any prospect that members' benefits might end up being better than PPF compensation. In other words, waiting to see how things pan out for the sponsor carries with it only a fairly low level of adverse risk for the trustees because the PPF is there as a safety-net, whereas it leaves open the possibility of an upturn in the sponsor's fortunes, from which the scheme and the members may benefit in the long run. Given this relatively low level of risk in what is otherwise a risk-filled area, we believe this to be the most likely mind-set of the majority of trustees of stressed schemes.

We conclude that while *ITS v Hope* makes it clear that an explicit action to 'game' the PPF would not be justifiable, it is much less clear that *inaction* in relation to reliance on the relative security provided by the PPF is necessarily a breach of trustees' duties. This is because, in the absence of an identifiable, significant and imminent threat to members' benefits, it is generally fairly difficult to pin

[44] In particular, *ITS v Hope* (High Court, 2009). The trustees of the Ilford Pension Scheme asked the High Court whether they could buy annuities for certain members before the scheme entered the PPF. The High Court said no, because, in its opinion, this meant that the trustees were selecting against the PPF by buying annuities only for certain members, while relying on the PPF to pick up the tab for the larger proportion of benefits for the rest of the members. For further details, see, for example: http://www.sackers.com/pension/independent-trustee-services-ltd-v-hope-high-court-10-november-2009/

legal liability upon trustees for failing to act and instead waiting to see how events develop. Indeed, only if trustees had perfect foresight, or, more workably, were provided with full disclosure from the sponsor in respect of its ongoing viability, could any reasonable charge of failure to act be levelled on trustees.

c) Should the role of TPR and the PPF be reviewed, with greater powers of intervention?

Interviewees questioned whether TPR had the right type of powers:

> *'I have huge sympathy for TPR – it doesn't have the right sort of powers. What it's got is draconian [moral hazard]; what it needs is power to intervene in a more proactive or productive way.'*

Some interviewees said they would like to see the PPF involved at an earlier stage where a scheme is stressed. One said:

> *TPR is a pensions regulator and is not the expert in corporate finance and restructuring – it's not an expert in insolvency or near-insolvency cases. The PPF is the expert here and it needs to be able to intervene as soon as possible.*

Another said:

> *We've had cases where we really needed to talk to the PPF, but TPR has said no. It's a good gate keeper, but it's keeping out cases where the PPF could really help because it has the insolvency practitioner expertise and it's got commercial insurance company nous. The thing is, most importantly, it has a major economic interest in the outcome of these cases.*

And again:

> *The relationship between TPR and the compensation scheme [the PPF] needs to be reconsidered. It's more than 10 years on from the [2004] Act and, while it makes sense for the FSCS to be subordinate to the FCA, in many ways it would be better if the PPF had more of a direct role in the practical intervention that is needed where schemes and sponsors are really struggling. And the PPF needs the resources to help the hundreds of smaller schemes and smaller companies that it can't help right now because of the prioritisation of larger schemes.*

There was a range of suggestions about what additional powers of intervention would be appropriate for the PPF. The most popular proposal related to the risk trustees take in their investment strategy, which, frequently, is higher than the weak covenant might be able to support. Although this is only one aspect of trustee behaviour, interviewees said that it goes to the heart of the problem and that nudging trustees towards a low-risk investment strategy would 'flush out' the real concerns about the sponsor's weakness.

Two interviewees proposed that the PPF might take over the role of reviewing the extent of risk-taking within schemes in CG4, and would have the power to require trustees to reduce risk where the covenant is too weak. Interviewees said this would be consistent with the need to protect the PPF and that it would also protect the stronger sponsors that pay levies.

However, some interviewees were far more cautious on this point, arguing that this proposal goes too far. Instead, they proposed that TPR and the PPF should monitor trustee actions, but should not have the power to compel, apart from in exceptional circumstances that are already covered by TPR's moral hazard powers.

A potential interesting compromise suggested to us was to give the PPF the power to take a position on these arguments, whereby the PPF could request (not require) that the trustees should take less investment risk and that if the trustees did not respond, the PPF might consider excluding the scheme from PPF eligibility.

Another idea suggested by interviewees was overriding legislation so that where a scheme is poorly funded against the PPF measure, e.g. less than 80%, then the trustees cannot provide (or can apply to TPR for the power not to provide) or TPR should have the power to direct trustees not to provide non-statutory increases until the PPF funding position has been improved. We therefore propose to **make non-statutory pension increases contingent on the scheme's funding level, i.e., introduce conditional indexation**. In other words, the ability of a scheme to provide non-statutory increases is contingent on its funding position relative to PPF. This is reminiscent of the Dutch model. Moral hazard provisions would again have to be robustly structured to prevent abuse of this type of compromise – which is effectively a benefit compromise.

d) Make the sustainable-growth objective more realistic so that it is better aligned with the objective to protect the PPF. Develop a 'stressed scheme assessment tool'.

Interviewees said that TPR's new sustainable growth objective (2014) does not sit comfortably with its objective to protect the PPF – one of the original objectives in the Pensions Act 2004. One said:

> *These two objectives are mutually exclusive. So, TPR might encourage a longer timeframe before assessment starts, but for every year, month, and week the scheme continues with the sponsoring employer, members get pension increases and more retire, so the PPF liability goes up. That's not protecting the PPF.*

Another said:

> *The sustainable growth objective creates real conflicts for TPR. Its original objectives were to protect member benefits and to protect the PPF. The new objective tilts in favour of protecting member benefits at the expense of the PPF, because, in corporate distress cases, delays in recognising an inevitable insolvency – even if this is three or five years down the line – mean that the scheme liabilities relative to PPF compensation rise and the business value reduces at a rate of knots. This result is the worst possible outcome for the PPF and for levy payers too.*

Sustainability, interviewees said, needs to be 'handled with care' because there is no guarantee that capital diverted from scheme contributions and invested in a company that's likely to fail will add value. It's not just rising scheme liabilities relative to PPF that concerned interviewees, it's the fact that there is a potential reduction in the value of the business assets which might otherwise be claimed by the compensation scheme – which would become the sponsor's biggest creditor on the failure of the business.

Interviewees also questioned how trustees could be sure that the diversion of available capital for the scheme into the business would result in a stronger sponsor covenant. In its 'Annual defined benefit funding statement 2015', TPR says:

If investment in an employer's business is being prioritised at the expense of such contributions, it is important that this investment is being used to improve the employer's covenant. Trustees should seek to understand what the employer is looking to achieve, how these plans will benefit the covenant and how and when growth will fund increased contributions to the scheme where necessary.

In addition, TPR said trustees should make sure they are being treated fairly, as one among several creditors:

The scheme should be treated fairly and the other stakeholders of the employer should likewise adequately support its growth plans, e.g., through dividend blocks or restrictions.

Again, interviewees said that it was unclear how trustees would know for sure, unless there is a requirement on directors to tell them – a requirement that TPR does not appear to have the power to impose.

To help trustees make informed decisions, we propose TPR and the PPF conduct an annual survey of anonymised sponsors whose covenants fall into Covenant Grade 4. The analysis could measure whether a reduction in sponsor contributions over a period of one to five years, for example, was matched by a corresponding improvement in the covenant. The results could be reported annually, including a simple graphic that measures the spectrum and also the aggregate covenant strength (including 'covenant drift') relative to PPF funding level and to PPF drift.

From the design of the survey, it should be possible to develop a 'stressed scheme assessment test' that could be used by trustees in relation to their own scheme. This would enable trustees to gain a clearer view of the arguments for and against supporting a sponsor's decision to direct more resources towards the business. In the absence of a mechanism of this type, there is a risk that sponsors will have too much opportunity to pay lower than optimal contributions, ultimately to the detriment of schemes and their stakeholders.

One other proposal in relation to sustainable growth is to remove or adjust the statutory indexation requirement. While controversial, the removal or reduction of statutory indexation would help to prevent PPF drift. Enabling schemes to remove or adjust non-statutory indexation, which was invariably awarded at a time when the economic position of schemes seemed much more buoyant (e.g., increases on pre-97 benefits), would similarly be helpful.

Interviewees supported this proposal, but said the Government and regulator would need to consider carefully how to justify this change. The rationale, they said, might be to highlight the protected DB benefits of older workers versus the pensions time-bomb faced by younger workers. There are two intergenerational inequalities here:

- First, although historically the economic output of younger workers has been directed towards helping to maintain the DB pensions of the older generation (which has worked reasonably well in the past), the situation now is radically different. The younger generation is facing a pensions time-bomb due to the switch to DC with no prospect of support from future generations. A large component of the economic output of younger workers is propping up the DB pensions of the older generation, reducing the capacity for the young to save for their own retirement.
- Secondly, younger workers are in DC schemes, often with minimum employer contributions. In these schemes, the members bear all of the risks that are not faced by older workers in DB schemes, including investment, interest rate, inflation and longevity risk.

We suggest that intergenerational inequality presents a powerful argument for change.

e) Extend the PPF assessment period to include 'pre-assessment'

This was a very popular proposal. One interviewee said:

> *Between PPF and full funding levels there is a big grey area. Common sense dictates that one or more parties – in particular the trustees and/or the sponsor – has to make a judgement call when to crystallise the funding level and arrange a PPF+ buy-out to make sure members get a better deal than if their scheme goes into the PPF. The question is, at what point do you crystallise? There needs to be more scope to consider bold actions before it's too late and the insolvency has happened.*

This proposal touches on an earlier point about whether the PPF might get involved at an earlier stage, i.e., before an insolvency has taken place. Even if insolvency proves to be inevitable, early action such as a de-risking investment strategy and/or imposing a contribution level on the sponsor (via an appropriate funding basis), might prevent a worsening in the scheme funding position. Early action becomes increasingly important where the financial state of the sponsor is parlous. Such intervention might also help prevent what can be argued is unfair treatment towards the younger deferreds, who might otherwise benefit from a PPF+ buy-out, which could give them more than the pre-NRA level of PPF compensation. The PPF may also see a missed 'opportunity' if has to take in a scheme that has fallen below 100% PPF funding as a result of PPF drift, when previously a PPF+ buyout might have been possible. [45]

To this end, we suggest TPR and the PPF consider introducing a 'pre-assessment' PPF period for cases where there is a risk that insolvency might happen within a five-year period, for example. We were told that this innovation does not necessarily require a formal change in law and regulation, but rather a change in mindset, focus and prioritisation, i.e., a willingness on the part of TPR and the PPF to consider an increase in the number of PPF+ cases and also in corporate restructuring. We therefore propose to **introduce a PPF 'pre-assessment' period to facilitate early intervention**.

The following observation reflected the views of many interviewees:

> *A key question for stakeholders and regulators is whether the rules can be changed to permit more compromise deals, where the trustees arrange a buy-out above PPF level in order to avoid sponsor insolvency. At present, this is only possible if the sponsor passes the PPF test which means insolvency has to be inevitable and usually this has to be very shortly, e.g., within the next year. We would like to see this rigid approach relaxed a bit, so that effective deals can be made before the sponsor reaches the point of no return. At present, everything is too black and white – let's explore the grey areas and make earlier interventions possible, so we can do the right thing for the members and also for the sponsor's business. This would also enable insurance companies to take some of the pressure off the PPF.*

We asked interviewees what 'pre-assessment' might look like. They suggested the following ideas:

- The options available might represent a balance between the current PPF assessment test, which broadly speaking is based on 'inevitable insolvency', and non-intervention, which is based on 'might go bust but not immediately'. Eligibility for pre-assessment might be based on a stressed scheme profiling tool, as we have outlined above, i.e., a financial assessment

[45] Schemes funded above PPF usually do not enter the compensation scheme even if there is an insolvency event. Instead they arrange a PPF or PPF+ bulk purchase annuity (BPA) buy-out with an insurance company.

that weighs up the benefits of any additional sponsor contributions over a five-year period, relative to anticipated further PPF drift and the relative strengthening or weakening of the sponsor covenant, among other factors.

- The scheme actuary would have a statutory role to estimate projected future PPF drift and the hypothetical level of contributions that would be required to cover the projected future PPF drift.

- Trustees would use the information from the scheme actuary to monitor projected PPF drift in the scheme. Trustees might also be required to report the PPF drift information to TPR through the annual scheme return. If the sponsor cannot afford or refuses to pay contributions at the level required to cover PPF drift, then trustees would have the power (but not be compelled) to begin discussions with the sponsor about a PPF+ compromise deal.

- Stressed schemes in pre-assessment might have greater flexibility in relation to pension increases, for example, the trustees might have the ability to reduce non-statutory increases, and possibly even statutory increases, depending on the funding level. The ability of a scheme to provide increases contingent on its funding position is a feature of the Dutch collective defined contribution (CDC) system, so there is a relevant EU precedent.

Pre-assessment would require a clear set of rules in order to avoid moral hazard and to ensure the fair treatment of stakeholders. For example, it might include a requirement for a larger financial commitment from the sponsor to the scheme, in exchange for the ability to offload the liabilities to an insurance company through a BPA buy-out. For want of a better expression, we might call this PPF++ (PPF-double-plus). For example, PPF++ might involve an insurance company buy-out that gives all members – deferreds as well as pensioners – 100% of benefits but with PPF indexation, which is nil for pre-97 service and CPI capped at 2.5% p.a. for post-97 service.

Careful consideration would need to be given to what constitutes eligibility for pre-assessment, which would be a separate test from the current PPF assessment period. Eligibility could depend on meeting a specified number of criteria from a range that might include:

- A sponsor in Covenant Grade 4.

- A rapid transition of the sponsor down to Covenant Grade 3, which would indicate a serious decline in the sponsor's financial outlook.

- A recovery period that is unrealistic relative to the business profile and covenant.

- More than one request to extend the recovery period.

- The sponsor is technically insolvent, i.e., it would be insolvent if the full buy-out cost and contingent debts were taken into consideration.

- The deficit as a proportion of shareholders' capital is 100% or more.

- The sponsor cannot afford contributions at a level sufficient to cover PPF drift.

Once a scheme has demonstrated eligibility for pre-assessment, it is likely there would be requirements for certain changes, for example, the immediate appointment of an expert professional trustee.

f) Eradicate the PPF compensation 'cliff edge' for pre- and post NRA. Convert compensation limits to a tiered system.

On this point, interviewees were unanimous: the PPF compensation cliff-edge is unfair for pre-NRA members. Given the maturity of many closed schemes, the majority of members might be within five or 10 years of retirement, depending on when the scheme closed. They might also face unemployment post-insolvency, which means that their presumed ability to make good any pension shortfall through future earned income is illusory.

> *There is no doubt that this causes self-interest to drive the decision to go into voluntary insolvency. This cliff-edge in pre- and post-NRA PPF compensation makes directors and other influential high-liability members want to keep the company going until they have passed the winning line [reaching NRA]. If the pre-NRA compensation cap applied across the board it would remove this moral hazard. And hey, a pension of £35k per annum is hardly to be sneezed at! Directors who set up the DB scheme also decided what pension they should have – but that's only fair if the company can fully support the liability. Fine if a PPF+ deal can increase benefits, but the base line should be a single level of capped compensation – it just feels more equitable to me.*

> *I'd like to see more equity between cohorts of high-liability members. It doesn't seem fair that a 64-year-old should receive a much lower level of compensation than a 65-year-old. Also, in PPF+ cases, any scheme assets above PPF are shared across the board. So in the case of a high-liability member who is above NRA, the baseline is 100% of the headline rate of pension and he will receive additional benefits, e.g., pension increases. For the pre-NRA high-liability member, the baseline is 90% capped, so additional benefits are not going to bring the compensation anywhere near that of the older member. The 'plus' in PPF+ should first go to the members under NRA.*

> *There is a definite moral hazard here, particularly where one or more of the members close to NRA are directors. Of course, under TPR's new sustainability obligation, it is only too easy for the directors to say they are just doing their level best for the company, the employees, the economy, and so on. The fact that they segued from deferred to NRA was just a coincidence, etc.*

While some interviewees criticised directors for 'keeping the company on life support until they reach NRA', others argued that the root cause of the unfairness here is not the directors' actions, but the combination of the PPF compensation terms (with the NRA cliff-edge) and the s.73 priority order (the winding-up priority order), both of which, interviewees argued, are 'inherently inequitable':

> *Targeting directors' benefits by triggering insolvency before their NRA in an effort to redress the balance could be seen as an attempt to use two wrongs to make a right.*

Several suggestions were offered as ways to address the compensation cliff edge. One was the application of a benefit compensation cap, in the form of a single mid-point figure, e.g., compensation set at 95% of all benefits, or possibly a tapered approach. A precedent for this is stamp duty, which until recently was a cliff-edge or 'slab' system; in the Autumn Statement 2014,

the Chancellor announced that the old stamp duty system would be abolished and replaced with a new graduated or tapered system, which the Chancellor argued was much fairer.[46]

Interviewees also suggested that the Government might set a normal pension age (NRA) of 65 for the PPF, rising in line with the state pension age (SPA), and use this, rather than a scheme-specific pension age, which might be lower for many older schemes, especially in the case of directors. We therefore propose to **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**.

The previous (coalition) Government set in train a change that would address the cliff-edge issue in part – in this case for pre-NRA members with long service (20 years or more). In 2013 it included a provision[47] in the drafting of the Pensions Act 2014, which has not yet been introduced. Its introduction would require a change to secondary legislation and would be backdated for schemes that have not completed wind-up.

The provision said:

> *Long service is not currently taken into account when a person whose defined benefit pension scheme collapses and is then taken over by the Pension Protection Fund (PPF). The Government is to increase the maximum level for those receiving capped compensation by 3% for every year of service over 20 years.*
>
> *This means someone who has contributed to a pension scheme for 40 years and accrued a pension of £50,000 pa, only for the scheme to wind up and have insufficient funds to pay out, would receive £45,000 pa – rather than the current capped amount of £31,380.*

In the DWP statement, Steve Webb, then pensions minister, said:

> *People whose employer becomes insolvent can already get compensation when they retire through the PPF. But the scheme does not recognise the long service of those who were members of their pension scheme for over 20 years.*
>
> *It cannot be right that someone who has been with a company for much of their working life – and relies heavily on that for their pension income – gets the same in compensation as someone with far shorter service and who could also have other pension income to fall back on.*

We were unable to discover when the provision might be implemented and, when we discussed this point with interviewees, they said that it would not eradicate the main inequalities:

> *If and when brought into force, it would reduce some of the cliff-edge issue, in that those for whom the cap bites because of long service, rather than high earnings, will get more. But it won't remove it altogether, since it won't take away the cap altogether and it won't remove the 90% / 100% differential based on NRA.*

Interviewees also said the provision would have an impact on PPF funding as pre-NRA beneficiaries with long service would represent a greater liability than at present. The extent of the impact would depend on the proportion of qualifying pre-NRA members, but the net effect will be to increase the buy-out cost of PPF benefits, which would reduce the opportunities for a PPF+ buy-out.

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[46] https://www.gov.uk/government/topical-events/autumn-statement-2014

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

Appendices

Appendix 1 - Estimates used in this discussion paper[48]

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. If these schemes fall into the PPF, then a 10% reduction will apply to all pre-NRA members; and a compensation cap will apply to those with larger benefits.

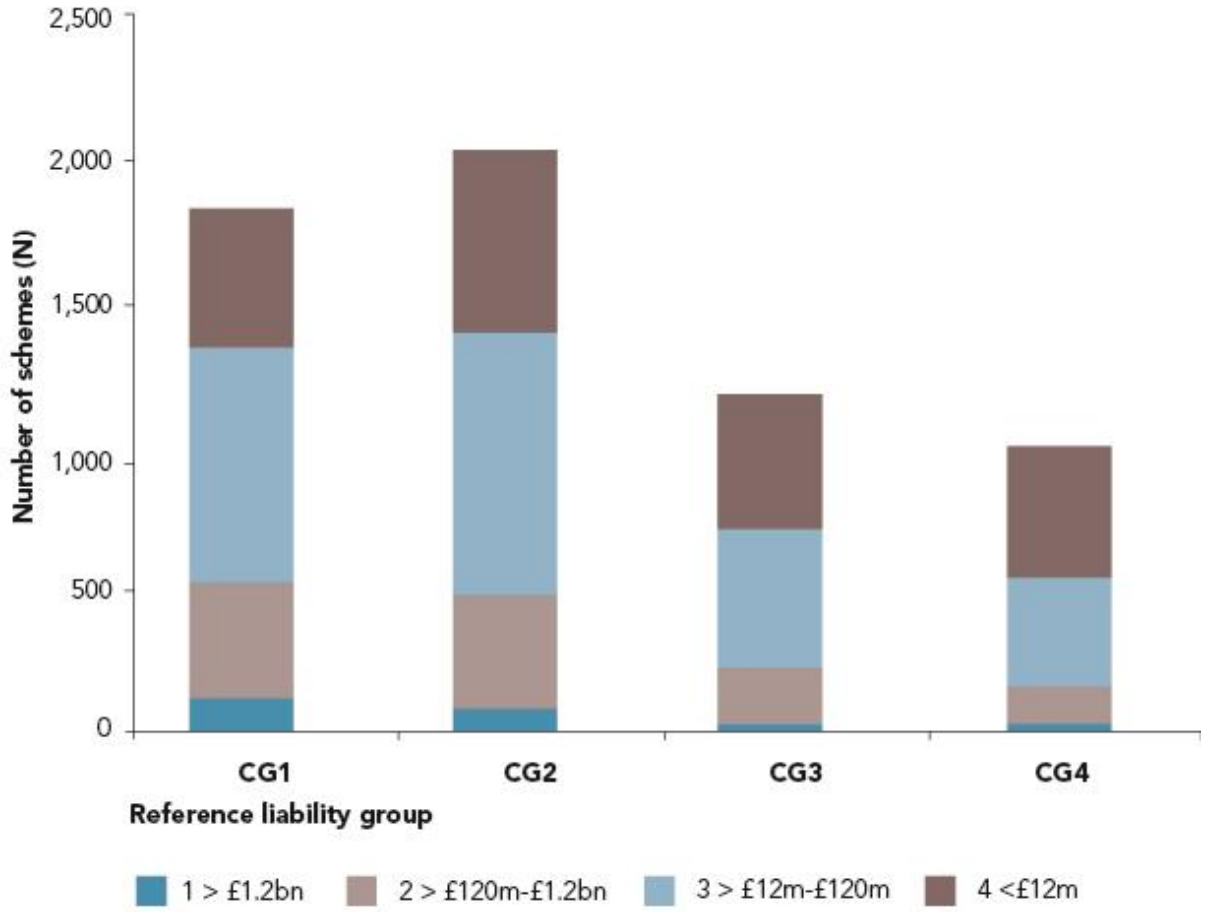
We also said that while, for some sponsoring employers, insolvency is likely to be inevitable due to the nature of their business, for others, the business may have a viable future, but it will sink under the weight of the pension scheme burden.

We have based these figures on our research. Several interviewees with considerable expertise in these matters gave us their own best estimates, based on similar investigations to our own. We made particular use of 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'.[49] Chart 4.2, reproduced below with the permission of TPR, appears in Appendix G on page 43 of the consultation document.[50] We have included the accompanying notes.

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,[51] 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.

[48] Pensions Institute estimates based on the analysis of available data, including the chart in this appendix, and on experts' insights provided in confidential interviews.
[49] http://www.thepensionsregulator.gov.uk/doc-library/regulating-defined-benefit-pension-schemes.aspx
[50] The chart was kindly provided to us by TPR.
[51] http://www.thepensionsregulator.gov.uk/codes/code-funding-defined-benefits.aspx

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.

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: 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 of 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 up to 17%) of the total PPF Index, are in serious risk of default.

Appendix 2 - DB pension fund valuation methods

We distinguish between the following DB pension fund valuation methods:

- **Buy-out/Section 75 debt:** This measure involves valuing liabilities on the basis of an estimate of the amount necessary to insure the members' full benefits with a regulated insurer in a transfer of liabilities to the insurer through a bulk annuity buy-out. The Section 75 debt is the shortfall in scheme assets below the amount that is estimated to be required for a full buy-out. It is the trustees' objective to meet the benefits in full, unless special circumstances arise.

  TPR explains this point as follows: [52]

  > *The Pensions Regulator ('the regulator') expects trustees' starting point to be that any arrangement that breaks the link with the existing employer may not be in members' interests, unless the full section 75 debt (the full amount necessary to insure members' benefits with a regulated insurer) is paid, or unless the scheme remains supported by an employer of substance and is suitably compensated for any change in the employer's covenant. Trustees must consider the situation with great care.*

- **'PPF'/Section 179 (s179)** is a measure of liabilities based on the value of the benefits that would be provided by PPF compensation. As PPF compensation is lower than full benefits, this measure is invariably much lower than the full buy-out cost.

  Several interviewees said that this is the most relevant funding measure for the analysis of stressed schemes. The PPF funding level is also known as Section 179 (s179), which refers to the section in the Pensions Act 2004 that sets out how the scheme's assets and liabilities are calculated for the purpose of determining the scheme's PPF levy. The results of the valuation are combined with the results of the s179 valuations for all other schemes that are eligible for the PPF to assess the general level of scheme funding across the UK.

  S179 is very close in value to the s143 measure of liabilities, which represents an estimate of the insurance buy-out cost of PPF compensation. The s143 measure is used to determine whether a pension fund in PPF assessment has to try to secure a PPF+ buy-out because it has enough assets to secure a bulk annuity, or whether PPF compensation must instead be provided to the members by the PPF. In comparing the value of a scheme's assets against the s143 measure of liabilities, any recovery of the s75 debt from the insolvent plan sponsor is included.

  Both s179 and s143 measures are calculated by reference to gilt yields and we use the term PPF funding position to cover both. We stress that the PPF funding position is not constant, but continually shifts in line with market movements, in particular, as gilt yields have fallen recently.[53]

[52] See http://www.thepensionsregulator.gov.uk/guidance/guidance-abandonment.aspx

[53] A reduction in gilt yields of 0.1% (10 basis point) increases aggregate scheme liabilities by approximately 1.8%.

A funding level that is at or above PPF plays a factor in cases where the sponsor and trustees negotiate a separation of scheme from sponsor, but the sponsor's business continues. The latter type of case has been rare to date and usually involves a final contribution to the scheme's assets in lieu of the full s75 debt, for example in the form of a significant equity stake in the ongoing business (i.e., a debt for equity swap). See Examples in Appendix 3 - The language of corporate finance, corporate restructuring and debt restructuring.

- **Technical provisions** is the measure of liabilities that is used to determine the level of contributions made by sponsors from time to time whilst the scheme is ongoing. Formal reviews of sponsor contributions are usually carried out once every three years. Where there is a deficit, a recovery plan is agreed between the trustees and sponsor with the aim of eliminating the deficit by the end of the recovery period.

  Under the technical provisions approach, the full benefits are valued and the discount rate used is a prudent estimate of the expected return from the scheme's investment policy.

  Trustees of schemes with weak sponsors are expected to have lower investment return expectations because the sponsor cannot support or tolerate much investment risk. For the weakest sponsors the technical provisions basis should be close to buy-out.

- **Corporate accounting** measures of liabilities are used to determine how to represent the pension scheme in a company's accounts. The key accounting standards are those applying in the UK, the US and internationally. Whilst these standards vary in their details, they all use a corporate bond based discount rate that is higher than gilt yields, typically reflecting AA credit spreads. Full benefits are valued.

Appendix 3 - The language of corporate finance, corporate restructuring and debt restructuring

- **Corporate finance** is a very broad term, and corporate finance analysts cover the legal structure / capital structure / trading prospects of businesses in order to see whether shareholder value is being maximised. Corporate finance covers more than the raising of development capital. This is what private equity and venture capitalists do, often when a business is in its growth cycle.

- **Corporate restructuring** can be internal or external and does not have to relate to businesses in decline. However, in the context of this discussion paper, broadly, 'corporate restructuring' describes strategies that might enable a company that is in a declining financial position to avoid insolvency and to be turned around, so that it can continue, albeit possibly in a different guise. Typically, these strategies will involve changes in the legal structure, the ownership/management, the capital structure, and operational structures, among others.

- **Turnaround management** can involve and be part of a corporate restructuring plan if a business is in decline. It describes the expert corporate analysis that identifies the causes of financial stress and determines the steps necessary for the business to recover.

- **Debt restructuring** often takes place as part of a corporate restructuring. Where the PPF is involved, it might agree to taking on the DB deficit and, in return, it would take an equity stake in the new ongoing business. In these cases, the decision made by stakeholders to the agreement is based on the view that the business is viable, but that it may become insolvent if the DB deficit remains on the corporate balance sheet.

Appendix 4 - The DB scheme as a creditor to the sponsoring employer

Under UK and international corporate accounting rules,[54] where there is a DB deficit against the Corporate Accounting measure of liabilities, the deficit appears as a liability on the sponsoring employer's balance sheet. In effect, the employer has 'borrowed' capital from the scheme, equal to the difference between the scheme's assets and liabilities. This measure of deficit will be much lower than the s75 (buy-out) debt on insolvency. Where scheme assets exceed the Corporate Accounting measure of liability, then no liability needs to be shown in the company accounts.

This analysis represents the legal reality that the trustee board – under UK trust law, the legal 'owner' of the fund, holding it on behalf of the scheme's beneficiaries – is a potential creditor (i.e., lender) to the sponsoring employer. For insolvency purposes, creditors are ranked broadly as follows (in terms of decreasing security):

- **Secured creditors** have a fixed security interest over some or all of the business assets. An example is a bank lender with security over a business's property.
- **Preferential creditors** have priority over unsecured creditors either for the whole amount of their claim or up to a certain value. Examples include employees who are owed wages or accrued holiday pay.
- **Holders of floating charges** have security over the business's assets, but in a form which is not linked to any specific asset (unlike a secured creditor with a fixed charge on a particular asset). They have priority over unsecured creditors, except in relation to a prescribed percentage of the available assets.
- **Unsecured creditors** (the position of the trustee board) do not have any security interests or priority rights and generally receive a pro-rata share of any assets left after secured and preferential creditors and holders of floating charges have been paid. Examples include the trustees of a DB scheme in deficit (in the absence of any more favourable special arrangements), trade creditors, insurance providers and unsecured bond holders in the employer. In the cases considered in this research, the DB scheme will often be the biggest unsecured creditor.
- **Shareholders** (investors or equity holders) receive a pro-rata share of any assets left after the above distributions to creditors.

It is important to remember that, unlike bank lenders, the trustees have not formally provided a loan to the employer; the trustees are only contingent creditors, as the s75 debt generally becomes due only on the insolvency of the sponsoring employer or the winding-up of the scheme.

It is relatively rare for the trustees to negotiate secured creditor status – one such example was BAA – which means that most trustee boards are unsecured creditors. To increase their security, the trustees might negotiate contingent funding arrangements with the sponsor, e.g., an escrow account, where the funding becomes available when a trigger event occurs, such as insolvency. Other options include a charge on the employer's business premises. If the sponsor is part of a wider group of companies, the trustees might also seek a parent company guarantee, for example.

[54] http://www.lcp.uk.com/news-publications/news/2015/pa/2015-07-28-mira-trustees-use-business-sale-to-secure-benefits-above-ppf-levels/

While such arrangements might give more security to scheme members, they also place the trustees in a position where they become much more directly involved in the running of the sponsor's business. Several interviewees pointed out this was far from ideal, since the trustees' role is not to run the sponsoring employer's business (which involves dealing with a wide range of investors, lenders and suppliers), but to manage the pension scheme.

Appendix 5 - Technical insolvency and contingent liabilities

The subject of technical insolvency arose several times in the interviews. Some experts argued that a company in this position was not able to support the DB scheme and should be required to enter formal insolvency. Others completely disagreed with this view. We do not attempt to act as referee here, but offer an explanation of the issues under examination.

Technical insolvency is where the business is sound on a cashflow basis (i.e., it can afford to pay its bills as they fall due, for example), but not on a balance sheet basis (i.e., it doesn't have enough money right now to cover the capital value of all the bills that must be paid at some point in the future, including the DB deficit).

Contingent liabilities, in the context of this research, refer to the s75 debt (see Appendix 2 - DB pension fund valuation methods) that becomes due on company insolvency or scheme wind-up, where the s75 debt is the estimated shortfall against the cost of a buy-out of full benefits. It is 'contingent' because it is not a formal liability until the sponsoring employer becomes insolvent, i.e., insolvency is the trigger that converts the contingent liability into one which can be claimed by the trustees as a crystallised debt.

There are two basic tests for a company's solvency – the balance sheet test and the cashflow test. The main difference between the two is the treatment of contingent liabilities. In company reports and accounts, contingent liabilities are treated as a disclosure item, so they do not appear on the balance sheet in a set of accounts.

If the contingent liabilities were taken into account, a company could, in effect, be insolvent on a balance sheet basis (i.e., its liabilities could exceed its assets), even if it was not insolvent on the basis of being able to pay debts as and when they fall due (i.e., a cashflow basis).

The best explanation of technical insolvency is provided in the Accounting Standard Board's report FRS 12, 'Provisions, Contingent Liabilities and Contingent Assets', which sets out the principles of accounting for provisions, contingent liabilities and contingent assets.[55] The FRS provides the following definitions:

- A provision is a liability that is of uncertain timing or amount, to be settled by the transfer of economic benefits.

- A contingent liability is either:

    - A possible obligation arising from past events whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the entity's control; or

    - A present obligation that arises from past events but is not recognised because it is not probable that a transfer of economic benefits will be required to settle the obligation or because the amount of the obligation cannot be measured with sufficient reliability.

[55] http://frc.org.uk/Our-Work/Publications/ASB/FRS-12-Provisions,-Contingent-Liabilities-and-Cont-File.pdf

- A contingent asset is a possible asset arising from past events whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the entity's control.

Pension liabilities are disclosed under UK GAAP in accordance with FRS102,[56] and under international GAAP in accordance with IAS19. Under FRS102, no additional liabilities need be recognised on a company's balance sheet in respect of a 'schedule of contributions' that has been agreed in order to address a scheme deficit. These are in effect contingent assets within a pension scheme.

The relevant point of these accounting rules is that contingent liabilities and the sponsor's schedule of contributions are less visible from a corporate accounting perspective because they are not crystallised. If an employer is financially strong, contingent liabilities might not be an issue.

Technical insolvency is not necessarily a problem for sponsors with a strong prognosis for the business going forwards. But for sponsors with an outdated business model, it can mean that there is simply not enough available capital to meet recovery plan contributions and to invest in the business. It can also mean that new shareholders might be buying in at the wrong price and that lenders might not be aware of the real extent of the risk.

The question of what trustees might or should do where the sponsor covenant is weak and the business is technically insolvent led to one of the most wide-ranging spectrum of views from experts. To illustrate:

> *There is a diversity of views on the subject even with the regulators, and I hear similar conversations on company boards. There are employers that, for all practical purposes, are owned by the pension fund because all earnings are being ploughed back into the scheme to fill the deficit. Many businesses are technically insolvent if you consider the technical provisions and if the business has no apparent future, so you've got a big problem.*

Some argued that this scenario demanded immediate action, as the following three comments demonstrate:

> *Where insolvency is inevitable, then trustees need to act quickly to secure as much of the sponsor's assets as they can. But the real problem is where insolvency might seem very likely, but is a few years off. There is a strong argument for letting the company plod on because every pound in contributions is a pound towards the members' benefits.*
>
> *As soon as trustees are aware that the sponsor will never be able to pay the full benefits – for whatever reasons – they have a fiduciary duty to act immediately. To do nothing is an act in its own right – it's an abrogation of responsibility. The same is true of company directors under the Financial Reporting Council's new governance code. To delay is likely to result in a far worse outcome for all stakeholders – with the exception of members who have reached NRA. Pre-NRA members will suffer, as will the business, its creditors, and the PPF levy-payers.*
>
> *If the sponsor's covenant is weak and it's technically insolvent, it should be required to declare actual insolvency.*

[56] August 2014. https://frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/FRS-102-The-Financial-Reporting-Standard-appli-(1).pdf

Others were more cautious:

> *Where the sponsor's covenant is weak and the trustees believe the business will not survive, the biggest problem is knowing when to pull the plug. How could they possibly know unless it's blindingly obvious?*

Where a crisis is likely to lead to insolvency, then the role of the regulator and advisers to the trustees and sponsor is to help ensure that negotiations lead to the best possible outcome. Where there are strong disagreements between the trustees and the sponsor, the advisers will need to bring the parties to the same table. While the types of intervention that can be used by TPR are prescribed in regulation, via pensions law, advisers can be – and often are – more dynamic and innovative. A successful outcome, therefore, often depends on the willingness of the trustees and sponsor to engage in talks, and on the 'people skills' or 'emotional intelligence' (EI)[57] of the advisers.

[57] EI is a poorly understood 'science' derived from the humanities. A more developed transposition from the humanities to finance is behavioural economics, which strives to explain why people are not always rational when it comes to financial decisions. In the context of this research, EI might be described as the ability of advisers to trustees and sponsors to counsel stakeholders, and to maintain 'soft' control. With skill, EI can be used to help unite adversaries.

Appendix 6 - The law and regulation as it applies to UK company directors

The regulation of directors of quoted companies is less clear-cut than is the case with trustees; it is even less clear-cut in relation to directors of private companies.

There are two main organisations involved in regulation:

- The Department for Business, Innovation & Skills (BIS) is the Government department for economic growth.[58] We understand that this Government department 'notionally owns' company law and is the regulator for company directors.
- Separately, the FRC is not the regulator for company directors, but it is responsible for 'The UK Corporate Governance Code', last updated in September 2014. The FRC also sets the governance standards for accountants, actuaries and auditors.

Directors' duties, under Section 172 of the Companies Act 2006, require them to promote the success of the business while the business is not actually insolvent, unless shareholders agree that the business should be brought to an end. Similarly, directors' risks of personal liability with reference to wrongful trading mean that it is not reasonable to expect them to keep the business trading where insolvency is looming. This suggests that they should not allow a few more years of PPF drift to occur if the main reason is for them to reach NRA and to secure a 100% pension under the PPF compensation scheme. The salient points in s172 are as follows:

- A director of a company must act in the way s/he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:
    - The likely consequences of any decision in the long term,
    - The interests of the company's employees,
    - The need to foster the company's business relationships with suppliers, customers and others,
    - The impact of the company's operations on the community and the environment,
    - The desirability of the company maintaining a reputation for high standards of business conduct, and
    - The need to act fairly as between members of the company.
- Directors also need to act in the interests of creditors of the company.

[58] https://www.gov.uk/government/organisations/department-for-business-innovation-skills

Appendix 7 - TPR's covenant grades in detail

Schemes are required to submit an annual scheme return to TPR. Using information from the scheme return, information from Experian and publicly available information, TPR grades the covenant of a pension scheme's sponsor. The grading is not disclosed outside TPR.

The grading indicates the sponsor's resilience, including its ability to meet the contribution schedule, as set out in the recovery period plan, and to manage downside risk if it is necessary to increase contributions. TPR has stated that, when assessing employer covenant, it takes into account the outlook for the sponsor and the plans for sustainable growth as set out in any business plans provided to the trustees, and in particular: [59]

- The strategic outlook for the sector and the position of the employer within the industry including the age, brand and public profile of the employer
- The income streams, cash generation and profitability of the employer, and the trends in these over time. The ability to fund future increases in pension contributions and any adverse impact this may have on these
- The level of reinvestment of profits/cash/income within the business to ensure sustainability
- The level of debt of the employer, and the ability to service this comfortably from income streams and cash generation within the business
- The strength of the balance sheet and its ability to withstand trading shocks or decreases to its income streams
- The size and value of the balance sheet and assets in comparison with the size of the pension liabilities and deficit and their availability to reduce deficits, including, where the employer is considered weak, the likely asset cover in insolvency
- Any restrictions on income, assets or reserves
- The level and sustainability of dividends (or other distributions, e.g., to members of limited partnerships), as a proportion of profitability and cash generation.

The 6,000+ schemes are categorised as follows:[60]

- **Covenant grade 1 (CG1) – Strong**
  Very strong trading, cash generation and asset position relative to the size of the scheme and the scheme's deficit. The employer has a strong market presence (or is a market leader) with good growth prospects for the employer and the market. The scheme has good access to trading and value if the employer is part of a wider group. Overall, low risk of the employer not being able to support the scheme to the extent required in the short/medium term.

- **Covenant grade 2 (CG2) – Tending to strong**
  Good trading, cash generation and asset position relative to the size of the scheme and deficits. Operates in a market with a reasonably positive outlook and the employer has a stable market share. Outlook is generally positive, but medium-term risk of employer not being able to support the scheme and manage its risks.

[59] Appendix A: Defined benefit funding regulatory and enforcement policy, June 2014
[60] For further details, see Appendix B, Defined benefit funding regulatory and enforcement policy, June 2014

- **Covenant grade 3 (CG3) – Tending to weak**
  Concerns over employer strength relative to the size of the scheme and deficit and/or signs of significant decline, weak profitability or balance sheet concerns and/or high vulnerability to economic cycle. No immediate concerns over insolvency but potential risk of decline.

- **Covenant grade 4 (CG4) – Weak**
  Employer is weak, to the degree that there are concerns over potential insolvency, or where the scheme is so large that, without fundamental change to the strength of the employer, it is unlikely ever to be in a position to adequately support the scheme.

Appendix 8 - TPR's risk indicators and views on a covenant review

a) TPR's risk indicators

The regulator uses a range of risk indicators to identify schemes it wants to 'engage with' or investigate further. In assessing funding plans, its focus is the balance between reliance on investment returns and contributions in light of the employer covenant. It its 'Annual defined benefit funding statement 2015', it says:

> *When we decide to engage with a scheme, we seek to understand the trustees' decisions in relation to specific risks and the quality of their decision-making process. For instance, we look to understand whether they have assessed the employer covenant (including affordability and, where relevant, sustainable growth plans), undertaken due diligence with respect to understanding the implications of their funding strategies, especially in light of the uncertain future market conditions, and considered what appropriate action they might take if downside risks crystallise.*

The risk indicators are set out in Appendix C of the 'Defined benefit funding regulatory and enforcement policy', published in June 2014.[61] These are:

1. **Bespoke covenant assessment:** TPR carries out a high-level assessment focusing on those employers with legal obligations to the scheme, based on publicly available information. The focus of this exercise is to assess the likely ability of the employer to support the scheme, including its ability to afford contributions, support scheme risks now and in the future, the prospects for sustainable growth, and the risks of insolvency. This assessment also feeds into TPR's other indicators (e.g., funding risk indicator and investment risk) and it also checks for materially detrimental events and how this may change the overall balance of covenant, funding and investment risk.

2. **Funding risk indicator:** TPR assesses the appropriateness of the planned contributions by looking at the scheme's maturity, the level of assets relative to a standardised liability measure, and the strength of the covenant. It aims to judge whether the planned contributions look appropriate given the position of the scheme and the strength of covenant.

3. **Investment strategy risk:** TPR assesses the level of investment risk the scheme is running in relation to the scheme's maturity, based on the most recent information it has on the scheme's asset allocation. It then tests whether this level of investment risk can be supported by the employer covenant over an appropriate period of time. In general, schemes which hold a higher proportion of growth-seeking assets, have a greater proportion of pensioner members or are supported by weaker covenants are more likely to show a higher level of risk under this indicator.

4. **Mortality:** TPR checks if the scheme's mortality assumptions have been set prudently. For this assessment it looks at the two parts of the assumptions: the base table of current mortality rates and the expectations for future improvements in mortality. If significantly higher than average mortality rates (and hence lower life expectancies) are being used in

[61] http://www.thepensionsregulator.gov.uk/docs/db-funding-regulatory-enforcement-policy.pdf

the base table, it considers whether such an adjustment is justified based on the characteristics of the membership of the scheme, for example, industry sector and liability per member. For the future improvements it checks that the expected improvements in life expectancies are not significantly lower than prevailing industry practice.

5. **Back end loading:** An important indicator of short/medium term risk is the concentration of contributions in the later years of the recovery plan, for example, recovery plans where the deficit reduction contributions over the period until the next valuation are materially lower than subsequently.

6. **Reductions in contributions:** Where contributions have reduced from the previous recovery plan, TPR checks that this can be justified by a material improvement in the scheme's position, a reduced level of affordability, or that employer resources are being used to improve the employer covenant balanced with the scheme's needs.

7. **Avoidance issues:** TPR reviews the recent transactions of the employer(s) to check if they could indicate possible avoidance activity.

8. **Actions taken to weaken the covenant:** TPR identifies any specific issues and/or concerns relating to a deterioration in the strength of the employer's covenant, for example, excessive dividends in the context of the covenant strength and contribution needs of the scheme.

9. **PPF funding risk**: TPR reviews the deficit on the 's179 valuation basis',[62] against the covenant strength, to provide an indicator of the risk to the PPF.

10. **Reliance on investment outperformance in the recovery plan:** TPR assesses how much reliance is being placed on investment outperformance to make good the deficit in the recovery plan and checks if this appears excessive.

11. **Governance:** TPR considers reports of material poor governance which indicate improperly managed risks, e.g., conflicts of interest, inadequate internal controls, inadequate exchange of information between employers and trustees, or failure to commission adequate professional advice proportionate to the scheme.

12. **Specific risks**: These include underlying risks such as late payments[63] or 'section 75 double-counting'.[64]

13. **Asset-backed contributions (ABCs):**[65] TPR evaluates the nature of the scheme's interest in the ABC and assesses the proportion of the scheme's assets made up of the net present value attributed to the payment stream. Where it considers that the valuation of the

[62] See Appendix 2 - DB pension fund valuation methods and also http://www.pensionprotectionfund.org.uk/Pages/PPF7800.aspx and http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/PPF_7800_june_15.pdf.
[63] See Appendix 2 of the Code of practice on funding defined benefits at www.tpr.gov.uk/code3
[64] See paragraph 139 of Statement on double counting of Section 75 debts/scheme funding obligations at www.tpr.gov.uk/counting
[65] An ABC arrangement is a contractual funding arrangement under which an income stream is provided to a scheme, usually via a special purpose vehicle. The income stream derives from an asset which is transferred to the vehicle. Sometimes, that income stream is given a net present value by the trustees, thereby reducing or eliminating the scheme's reported funding deficit.

payment stream is material, it 'unpacks' the effect of the ABC. In other words, when considering the valuation and the scheme's funding plans, it looks behind the net present value attributed to the ABC and considers the aggregate funding stream provided under any recovery plan, the ABC, and the value of the contingent security provided.

14. **Any issues raised at previous valuations**: Where TPR has raised 'significant issues' at previous valuations, it is more likely to investigate.

15. **Other interactions:** This catch-all phrase refers to any other significant engagement with schemes or employers.

b) TPR's views on a covenant review

The following are issues that TPR suggests trustees might consider within the scope of an employer covenant review:

- The employer's position within the group and the wider group structure, including inter-company relationships, reliance and policies (for example, inter-company trading), transfer pricing, dividend policy and group cash pooling.
- The employer's trading and balance sheet position and financing strategy. This should include looking forward to forthcoming material events (for example, debt refinancing and financial covenant compliance tests) and understanding the impact of the employer's and group's financing arrangements on the scheme's priority as a creditor (for example, the impact on the creditor priority ranking of any inter-creditor agreement, both in terms of the ranking in an insolvency and in priorities against cash generation and asset realisations on a going concern basis).
- The employer's forecast profit and cash generation, business plans, growth prospects, need for investment, levels of debt and ability to service this from cash generated, ability to provide support for: (a) ongoing benefit accrual (if applicable) and (b) deficit repair contributions, and its ability to address any adverse experience compared with that assumed in the scheme's investment and funding plans.
- An estimate of the value that might flow to the scheme on the insolvency of the employer or a scheme wind-up (taking account of the extent to which the trustees are able to limit the damage from an uncontrolled insolvency and hence maximise value to beneficiaries), as well as the likelihood of such an eventuality, based on the employer's current position and prospects. Alternatively, the trustees might decide that a more high-level consideration of an insolvency outcome is appropriate where they consider insolvency risk to be low.
- The nature of the industry in which the employer operates and its position in that industry. This would include the key drivers of demand in the sector, likely future trends and other factors that may affect the resilience of the employer's business (for example, corporate governance, ownership, and management structures).
- If the employer is subject to any price control regulation, for example, if it is a regulated utility, and how this affects the employer.[66]

[66] Other regulators often develop models for factoring in the cost of the scheme when applying price controls. Trustees should not place direct reliance on these models and their outputs in funding negotiations. However,

Appendix 9 - The requirements for trustees to commission reports

Trustees are required to commission the following reports:

1. **Triennial actuarial valuation**: The full review is usually triennial and the scheme actuary sets out the findings in the valuation report. This valuation is scheme-specific and represents the outcome of negotiations between the trustees and the sponsor, taking account of an assumed level of future return on scheme assets. Where the covenant is weak, one would expect this to be reflected in a more cautious set of assumptions. The report is not submitted to TPR. Members receive a summary of the valuation report in a summary funding statement.

   The deadline for completing the triennial valuation is 15 months from the effective date. At the end of the process, the trustees and the sponsor agree the following documents:

   - Statement of funding principles: this documents the methodology and assumptions agreed between the trustees and the sponsor for the valuation. Submitted to TPR.
   - The recovery plan: this documents the deficit contributions agreed between the trustees and the sponsor to restore full funding on an ongoing (technical provisions) measure. Submitted to TPR.
   - Schedule of contributions: this documents all the contributions agreed between the trustees and the sponsor. Submitted to TPR.

   However, TPR is somewhat non-committal in its response to valuation submissions:

   > *We undertake a risk assessment of all the valuations that we receive. For the vast majority, we decide not to engage further. We send the trustees of these schemes a valuation submission acknowledgement letter. This acknowledges that we have received their valuation submission and we have no further questions. This does not mean we consider the valuation and recovery plan to be appropriate.*[67]

2. **Annual actuarial reports:** Annual actuarial reports are produced by the scheme actuary in intervening years between triennial valuations, based on the methodology agreed for the most recent triennial valuation. The report is not submitted to TPR. Members receive a summary of the actuarial report in the annual statement to members.

3. **The annual scheme return:** This is completed by the trustees and sent to TPR. It is used as a risk filter by TPR when it considers recovery plans and applies its covenant grading system. It contains information from the triennial valuation, the s179 valuation, and the sponsor's corporate pensions accounting statement under FRS102 or IAS19. The trustees are not asked to provide information on the sponsor's covenant strength. The information is passed from TPR to the PPF in order to calculate the scheme's PPF levy, so trustees naturally present information in a way that will minimise the PPF levy where possible.

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they may form part of the assessment of the employer's covenant and when assessing reasonable affordability for the employer in formulating the scheme funding plan.

[67] Defined benefit funding regulatory and enforcement policy, June 2014

Appendix 10 - TPR guidance on funding and covenant analysis

TPR published the following guidance:

- 'Assessing and monitoring the employer covenant' provides practical guidance to trustees on self-assessment. www.thepensionsregulator.gov.uk/guidance/guidance-assessing-monitoring-employer-covenant.aspx
- 'Code of practice 3: Funding defined benefits' (the DB funding code) provides a principle-based framework on how to comply with scheme funding requirements under Part 3 of the Pensions Act 2004. www.tpr.gov.uk/code3
- 'Asset-backed contributions' provides guidance to trustees on best practice when considering entering such arrangements. www.tpr.gov.uk/abc
- 'Identifying your statutory employer' helps trustees understand why it's important to be clear who has legal obligations to their scheme under the legislation, and what they need to do. www.tpr.gov.uk/statements
- 'Statement on double counting – section 75 debts/scheme funding obligations' is aimed at trustees and employers of multi-employer DB schemes, and their advisers. http://www.tpr.gov.uk/counting
- 'Multi-employer schemes and employer departures' helps trustees and employers of multi-employer schemes understand the different mechanisms by which an employer can depart from the scheme. www.tpr.gov.uk/multi-employer
- 'Abandonment of DB pension schemes' outlines how trustees should deal with a proposal which involves the abandonment of a DB pension scheme. www.tpr.gov.uk/abandonment
- 'Clearance' provides support to trustees and employers when dealing with scheme or employer-related events that may impact on their scheme, and when there is an application for a clearance statement. www.tpr.gov.uk/clearance
- 'Record-keeping' describes an approach that TPR considers to be good practice for measuring the presence of member data items which are important in the administration of a pension scheme. www.tpr.gov.uk/guidance-record-keeping
- 'Integrated risk management' describes how trustees can develop and implement an integrated framework for managing risk. http://www.thepensionsregulator.gov.uk/guidance/guidance-integrated-risk-management.aspx

Appendix 11 - PPF assessment

Following an insolvency event, an eligible scheme goes through an assessment period to determine whether the PPF will provide compensation to the members or whether the scheme has enough assets to enable the trustees to secure a PPF+ buy-out. The PPF aims to complete assessment for most schemes within two years, but it can take longer for the insolvency practitioner to realise all the sponsoring employer's assets. During assessment, pensioners receive benefits at PPF compensation levels.

When an eligible DB scheme transfers into the PPF, the PPF generally pays a starting level of compensation of 90 per cent of scheme pension (subject to a compensation cap) to members who have yet to reach their normal retirement age (NRA) at the date the scheme entered assessment. The PPF will generally pay a starting level of compensation equivalent to 100 per cent of scheme pension to those who were already over their NRA at the start of the assessment period. Once the assets are realised, if the scheme is above PPF funding level, the trustees will look to secure benefits for members at a higher level than PPF compensation with an insurance company in a PPF+ deal.

The assessment process is described by the PPF as follows: [68]

1. Section 120 Notice Received

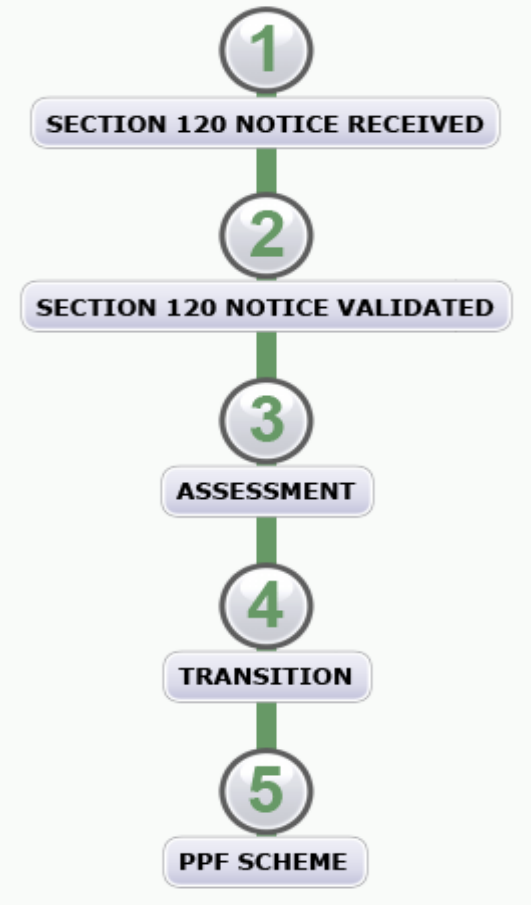
We must be notified when an insolvency event occurs (such as the appointment of administrators) at a company that sponsors a pension scheme. The insolvency practitioner looking after the affairs of the company will notify us by sending a Section 120 Notice.

2. Section 120 Notice Validated

We will now work with the scheme's trustees to obtain the necessary information to determine if the scheme is eligible to pass into the PPF or not. Once we have this information, we have 28 days to make a decision. If the scheme is eligible, we will validate the Section 120 Notice and the scheme will be deemed to have started the Assessment Period. The start date of the Assessment Period is the date of the insolvency event.

3. Assessment

During assessment, we want to ensure that all the data held for the scheme is accurate. This will ensure that members receive the right compensation payments.



During this lengthy process, trustees are responsible for informing their members about all aspects

[68] http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/trustee_gpg.pdf; http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/insolvency_guidance.pdf

of the assessment process and the progress it is making. Trustees also remain responsible for paying pensions throughout the assessment period. Pensions must be paid at Pension Protection Fund levels of compensation. Generally, this means that those members at or above the scheme's normal pension age at the date the assessment period begins or who are in receipt of an ill-health pension, or are in receipt of a survivor's pension, will receive 100% of their pension. Those under normal pension age at that date will receive 90% of their pension entitlement, subject to a compensation cap.

The final stage of this section is the production of a section 143 valuation by an actuary. This is a confirmation of whether the scheme can pay member benefits at or above PPF levels. If not, the scheme will transfer to the PPF.

4. Transition

Transition involves reviewing and transferring the scheme's assets and member data, and reviewing and terminating any contracts (i.e., with lawyers or advisors) that are in place as part of the scheme.

We start the transition stage during the previous assessment process itself to minimise the time it takes to complete the overall assessment period. This stage takes about six months from the point at which the PPF requests the section 143 valuation and ensures that the scheme is prepared to pass from the trustees, into PPF ownership.

5. PPF Scheme

Once all of the activities have been completed, and if the scheme has demonstrated it has insufficient assets, the PPF will take over responsibility for the scheme. This should have very little impact on members in receipt of pension as benefits will already have been paid at compensation levels during the assessment period. All members of the scheme will be notified of the relevant contact details for the Pension Protection Fund.

Appendix 12 - Restructuring: The PPF's principles[69]

1. Insolvency has to be inevitable – this means that the PPF will have to take on the pension debt whatever happens.

2. The employer's pension scheme will receive money or assets which are significantly in excess of what it would have received through the otherwise inevitable insolvency and are considered by the PPF to be realistic compared to the pension buy-out deficit.

3. What is offered to the pension scheme in the restructure or rescue is fair compared to what other creditors and shareholders will receive as part of the deal.

4. The pension scheme will be given 10% equity in the new company if the future shareholders are not currently involved with the company. It will receive at least 33% if the parties are currently involved. This is 'anti-embarrassment' protection to make sure the PPF hasn't made the mistake of taking on a large pension debt with little to show for it, while the new company goes on to become very profitable as a result of losing its pension deficit.

5. The PPF needs to make sure the pension scheme would not have been better off by the Pensions Regulator issuing a contribution notice or financial support direction.

6. The fees charged by the bank(s) are reasonable where the deal involves a refinancing.

7. The other party pays legal fees incurred as part of the deal for both the PPF and the scheme trustees.

The PPF looks at what the sponsor can afford. It deals with the investors and lenders to the business and negotiates its share of the value of the business. It's in a very strong position because lenders to the business would get nothing if the employer went bust, so the PPF gets a share of the capital the lenders and others receive.

> *It also gets a share of the business going forwards, i.e., an equity stake. This has to have genuine value. However, the PPF is pragmatic and accepts that occasionally its judgment call will be wrong, which is what happened in the case of Jessops, where the PPF took in the scheme, the company restructured, but it went bust a year later anyway, so the PPF's equity stake in the employer proved to be worthless.*
>
> *In a couple of reported cases, this was 10% of the new business, but 10% is not a rule of thumb. In other cases, where it is in effect the same business with the same management, this might be 33%.*

The reason for the difference is that the PPF usually looks to take a 10% equity stake if the old shareholders are losing everything, and a 33% equity stake if the old shareholders are to remain involved in the new business.

[69] http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/Restructuring_and_Insolvency.pdf

Appendix 13 - What is a 'pre-pack administration'?[70]

Pre-pack (i.e., pre-packaged) administration is where the assets of an insolvent but otherwise viable business are sold to a third party or a phoenix company prior to the business going into administration or liquidation.

By selling the company's assets before going into administration, the creditors are not aware that pre-pack is going on and therefore the company's assets are protected while the sale takes place. Once the sale has taken place the old company goes into administration and, at this stage, the creditors are notified.

The process allows the new company to run the business without the burden of the debts and liabilities of the old company. The decision to enter pre-pack is usually made by the company's directors if they find that their current debts are preventing them from running their business.

While some people believe that pre-pack allows assets to be sold for pennies rather than pounds, the strict laws governing pre-pack means that the process must be conducted under a licensed insolvency practitioner and the assets must be independently valued in order that a fair price is paid for them.

If the assets of the old company are being bought by the directors who have formed a new company, they must still pay a fair price for the assets, so will need to have funds in place to do this. While the directors are able to access funds for this, they have decided that it is more worthwhile to put their funds into running a new business rather than bailing out the old business.

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http://www.insolvencyhelpline.co.uk/prepack_administration/how_does_a_prepack_administration_work.php

Appendix 14 - Insights on a possible process to adjust the benefits provided by stressed schemes. Section 50 of Ireland's Pensions Act 1990 (the 'Act'): A summary[71]

The UK regime has the PPF and Ireland does not, so direct comparisons with Ireland can be misleading. Nevertheless, we suggest that the Irish s50 process is a useful example from a different regulatory regime, from which the UK might learn in relation to the potential development of a process to adjust scheme benefits in stressed circumstances.

a) Background

Section 50 of the Act enables the Pensions Authority (the 'Authority')[72] to direct trustees to reduce the benefits that would be payable in respect of active and deferred members, including preserved benefits. It also enables the Authority to direct trustees to reduce future increases in benefits payable in respect of pensioners.

b) How does Section 50 work?

The Authority can issue a direction in writing following an application from the trustees of a scheme. For the section 50 process to be applicable, a scheme must be experiencing significant funding difficulties, and the legislation therefore provides that an application can only be made in one or more of the following circumstances:

- The trustees fail to submit an actuarial funding certificate within the period specified in the Act;
- The actuarial funding certificate certifies that the scheme does not satisfy the funding standard and the trustees have or have not submitted a funding proposal in accordance with the Act;
- The Authority consents to the amendment of a scheme in accordance with section 50A of the Act;
- The trustees of the scheme fail to submit a funding standard reserve certificate within the period specified in the Act; and
- The funding standard reserve certificate certifies that the scheme does not satisfy the funding standard reserve and the trustees of the scheme have or have not submitted a funding proposal in accordance with the Act.

The Authority has a discretion as to whether or not it will give a direction following the submission of a section 50 application. It should also be noted that the legislation provides the Authority with the power to independently issue a section 50 direction in the absence of an application, but to date this power has never been exercised.

[71] This Appendix was provided by Eversheds' Dublin office with input from LCP.
[72] The statutory body set up under the Act to regulate and influence the policy environment surrounding pensions in Ireland.

c) What happens after a Section 50 direction is issued?

A deed of amendment for the relevant scheme will invariably have to be drafted and executed following the issuance of a written section 50 direction by the Authority.

Section 50(3)(a) of the Act provides that the trustees shall put such measures in place as specified in the direction within one month of the date of the notice or if no measures are specified, such measures as may be necessary to reduce the benefits under the scheme.

The relevant deed will therefore have to be executed within that one month period in order for it to be valid.

The trustees must also notify the members of the reduction in benefits within two months of the date of the direction.

d) Available data

The Pensions Authority has published limited statistics relating to section 50 applications.

Unfortunately, information relating to the precise form of benefit reductions implemented using the section 50 process is not publicly available.

In 2014, 25 section 50 applications were received by the Pensions Authority. Of these applications, 21 were approved, one application was withdrawn, and at year end the remaining three applications were being considered by the Authority. In 2013, 35 section 50 applications were received. One of these application was withdrawn. In 2012, 27 section 50 directions to reduce benefits were issued by the Authority.

To put those figures in some sort of context, there were 886 defined benefit schemes in operation in Ireland at the end of 2014.

Glossary of terms[73]

Administrative receivership: The position in which an insolvent company may find itself when debenture holders, e.g., banks, have appointed an administrative receiver (often called the receiver) to realise a company's assets and use the proceeds to pay any preferential creditors and the debenture holders themselves.

Assessment date: The date on which the sponsoring employer suffers an insolvency event which potentially qualifies the scheme for entry to the PPF.

Assessment period: This starts on the assessment date and is the period of time during which the Pension Protection Fund works with the scheme trustees to assess whether it can assume responsibility for the scheme. The period lasts a minimum of a year.

Back-end loading: An arrangement between trustees and employer allowing the employer to make good a deficit by paying the extra contributions needed in unequal instalments. The early instalments will be smaller than the later ones. This expression is used in relation to the recovery plan.

Beneficiary: A member of a pension scheme who is entitled to a benefit from the scheme or a dependant who will become entitled on the death of the member.

Buy-out debt: The shortfall in the scheme's assets below the amount of money required to purchase annuities from a regulated life insurer for each member of a scheme, which will guarantee pension benefits equal to those which would otherwise be paid by the scheme. This may also be referred to as the 'section 75 debt' or 'debt on the employer'.

Cash flow: The amount of money received and spent. In the case of a pension scheme, the amount of money being received into the scheme in contributions and investment returns and the amount of money being paid out by the scheme. In the case of DB schemes, projected cashflows usually refer to cash required in the future by the trustees to pay for pension liabilities when they fall due.

Combined code: The combined code on corporate governance sets out standards of good practice in relation to issues such as board composition and development, remuneration, accountability and audit and relations with shareholders. The code was devised and is maintained by the Financial Reporting Council.

Companies House: An executive agency of the Department of Business, Innovation and Skills, which examines and stores company information delivered under the Companies Act and related legislation and makes this information available to the public on request. This includes annual financial statements from every limited company, whether or not it is quoted on any exchange.

Compromise agreement: A legal agreement, the effect of which is to reduce the amount of the debt due from a sponsoring employer to a scheme under section 75 of the Pensions Act 1995. Where a compromise agreement has been reached, a scheme will not usually be eligible for PPF compensation, unless the PPF agreed to the compromise at the time it was made.

[73] Sources include previous Pensions Institute reports and TPR (e.g., http://www.thepensionsregulator.gov.uk/doc-library/statements.aspx#s18839 and http://www.thepensionsregulator.gov.uk/glossary.aspx).

Conflicts of interest: A conflict, for example, between a trustee's interest as an employee, e.g., financial director, and his or her duty as a trustee. A second example is the duty of a professional to the employer as well as to the trustees, where they are acting for both.

Contingent assets: Assets which are owned by the employer or employer group and which may be offered as security to the trustees of a pension scheme in deficit, for example, where the employer covenant is weak and where the contribution required is not acceptable to the employer. The term may also be used more loosely to cover other forms of arrangement used to provide additional financial support to the scheme, such as a guarantee from the employer's parent company to the trustees.

Debt notice: The notice served on the employer by the trustees of a scheme in wind up, setting out the debt due from the employer to the scheme. The debt is the shortfall between the value of the assets and the liabilities.

Deficit: The amount by which a scheme's liabilities (on a particular measure) exceed its assets.

Deficit repair contributions (DRCs): DRCs are contributions made by sponsors to the scheme, in order to address any asset-to-technical-provisions deficit, in line with the schedule of contributions and the recovery plan.

Discount rate: The discount rate is the rate at which the projected benefit payments are discounted in order to place a value on the liabilities. Discount rates can be based on the certainty of the benefit payments or alternatively on an expectation of investment returns.

Effective date: The date at which the liabilities and assets of the scheme are measured for the purpose of a valuation.

Employer covenant: The extent of the employer's legal obligation and financial ability to support the scheme now and in the future. (As defined in paragraph 61 of TPR's DB funding code.)

Funding level: The relationship (normally expressed as a percentage) between the actuarial value of a scheme's assets and liabilities at a specified date.

Funding position: The absolute amount of any surplus or deficit.

Funding target: The desired funding level, typically 100% on the ongoing (technical provisions) basis.

Liabilities: Amounts which a pension scheme has an obligation to pay now or in the future. The value of liabilities payable in the future can't be accurately determined, and will be dependent on the use of assumptions.

Liquidation: A type of insolvency in which the company usually closes down, the assets of the business are realised, and the proceeds distributed amongst the creditors in a prescribed way.

LPI (limited price indexation): The minimum annual rate of indexation which must be applied to pensions in payment, where they relate to service after 5 April 1997. LPI is the lesser of the actual rate of inflation (currently assessed using CPI, i.e., the Consumer Prices Index) and either 5% or 2.5% depending upon the date when the pension was accrued. Many schemes award increases in pension payments over and above LPI, either as a requirement or a discretion under the rules.

MFR (minimum funding requirement): A requirement under the Pensions Act 1995 that the actuarial value of the assets of a defined benefit scheme should not be less than the actuarial value

of its liabilities, given a prescribed set of actuarial assumptions. This requirement has been superseded by the scheme funding legislation under the Pensions Act 2004.

Mortality rates: Statistics relating to the ages at which people die.

Notice (of wind up): A formal written notification, usually issued by the employer to the trustees, that the winding-up of the scheme is to commence. The format of any such notice will vary from scheme to scheme and should be discussed with the scheme lawyer. Note, winding-up trigger notices are not a feature of every scheme's deed and rules.

NPA: Normal pension age is a statutory concept, and means the earliest age at which a member can draw his pension without a reduction for early payment. It is not necessarily the same as the normal pension date or normal retirement age (NRA) defined in a scheme's rules. Note, in this discussion paper, we use the term NRA.

NRA: Normal retirement age for members of a pension scheme.

Participating employer: An employer who contributes or has contributed to a multi-employer or industry-wide occupational pension scheme after being admitted to participate in the scheme under the scheme rules.

PPF buy-out quote: A quote obtained by the trustees, usually when their scheme is in the PPF assessment period, which gives the cost of providing benefits on the basis of PPF levels of compensation.

PPF levy: A levy on all occupational pension schemes eligible for protection under the PPF, which is used to fund the PPF and which is based on a combination of scheme-based and risk-based factors. The scheme-based element relates to the size of the liability. The risk-based element takes account of the funding level of a scheme and the assessed risk of insolvency for the sponsoring employer. It may also take account of the investment strategy and the value of certain contingent assets, guarantees and other commitments to the scheme from the sponsoring employer.

Preferential creditor: A creditor who is entitled to receive certain payments in priority to other creditors. These creditors include occupational pension schemes (members' contributions for the four months prior to the insolvency event, and employers' contracted-out contributions for the 12 months prior to that date); and employees (for wages in the four months prior to the insolvency event and accrued holiday pay).

Present value: A method used to calculate the current value of a series of future pension payments and future receipts such as contributions.

Priority order: The provisions contained in the scheme documentation or in overriding legislation setting out the order of precedence of liabilities to be met when allocating the scheme's available assets, if the scheme is winding up.

Profit before tax: Profit before tax is a profitability measure after deduction of all operating expenses, interest on debt and depreciation, but before the deduction of corporate tax. TPR uses profit before tax as a reasonable indicator of cash generation after debt service and maintenance capital expenditure (capex). It makes no adjustments to remove the impact of any pension items already included in the reported figure.

Protected liabilities: A term that applies where a scheme is in wind up or an assessment period for the PPF. It is the value of members' benefits at PPF compensation levels, plus any liabilities which do not relate to members' benefits, plus the estimated expenses of winding up the pension scheme.

Recoverable debt: The amount of the s75 debt due from the employer (i.e., the shortfall between the assets and the liabilities on a full buy-out measure) which the trustees of a scheme in wind-up can actually recover from the insolvent company.

Recovery plan (RP): Under Part 3 of the Pensions Act 2004, where there is a funding shortfall at the effective date of the actuarial valuation, the trustees must prepare and submit to TPR a plan to achieve full funding in relation to the technical provisions. The plan to address this shortfall is known as a recovery plan.

Relevant date: The date at which the assets of the scheme must be valued for PPF purposes (where a scheme is in the PPF assessment period); this is usually at close of business on the day immediately before the assessment date.

RPI: Retail Prices Index. The index of retail prices (for all items) published by the Office for National Statistics, which is still used by many schemes to determine the rate of inflation over the previous 12 months for the purpose of indexation of pensions.

Recovery period: The time over which a scheme is projected to recover any shortfall, based on conditions at the effective date of the actuarial valuation, so that, by the end of the recovery plan, it will be fully funded in relation to the technical provisions. In this sense, the recovery plan is equivalent to a corporate debt repayment schedule.

Reference liabilities: An estimate of liabilities used by TPR that enables a consistent comparison between schemes by removing the impact of varying degrees of risk between schemes.

Schedule of contributions: Specifies the contributions payable by the sponsor over a given period of years, and includes any contributions paid under a recovery plan.

Section 143 valuation: An actuarial valuation carried out on a prescribed basis, required under the Pensions Act 2004 to determine whether the value of a defined benefit scheme's assets is less than the amount of its protected liabilities at the PPF assessment date.

Section 179 valuation: S179 (after Section 179 of the Pensions Act 2004) is the measure used to determine the funding position for the purpose of calculating the PPF risk based levy. This measure is also used by the PPF in order to estimate the aggregate funding position for DB schemes that are potentially eligible for PPF entry. Broadly speaking, it is what would have to be paid to an insurance company to take on the payment of PPF levels of compensation.

Section 61 Trustee Act 1925: This states that the Court can excuse a trustee for a mistake made, if the trustee acted honestly and reasonably and should not necessarily have asked for the Court's directions at an earlier stage.

Section 73 Pensions Act 1995: S73 determines the priority in which the scheme's assets should be applied on winding-up.

Section 75 debt: See buy-out debt.

Section 89: A TPR report on a non-standard case following buy-out or entry to the PPF.

SORP: Statement of Recommended Practice. Guidance on accounting practice for the presentation of financial information prepared by the particular sector to which the SORP relates (in this case, occupational pensions).

Sponsoring employer: The employer with responsibility for meeting the liabilities of a DB pension scheme.

Statutory discharge: The discharge of trustee liabilities, for example, on completion of a wind-up.

Statutory funding objective: The requirement for an ongoing scheme to have sufficient and appropriate assets to cover its technical provisions, or a recovery plan to reach that position.

Statutory independent trustee: An independent trustee, appointed at the discretion of the regulator, to a scheme where the employer has become insolvent. The independent trustee must be chosen from the regulator's register of approved independent trustees.

Technical provisions (TP): The funding measure used for the purpose of ongoing scheme funding under Part 3 of the Pensions Act 2004. The technical provisions are a calculation undertaken by the actuary of the assets needed at any particular time to make provision for benefits already considered accrued under the scheme using assumptions chosen prudently by the trustees – in other words, what is required for the scheme to meet the statutory funding objective. These include pensions in payment (including those payable to survivors of former members) and benefits accrued by other members and beneficiaries, which will become payable in the future.

Tranche: A TPR term, 'tranche' refers to the set of schemes which are required to carry out an ongoing scheme funding valuation within a particular time period. Schemes whose valuation dates fell between 22 September 2005 and 21 September 2006 were in Tranche 1, between 22 September 2006 and 21 September 2007 were in Tranche 2, etc. Because ongoing scheme funding valuations are generally required every three years, schemes whose valuations are in Tranche 1 will also be likely to carry out valuations in Tranches 4, 7 and 10.

Transfer value: The amount of money which a scheme will pay to another pension arrangement in lieu of benefits which have accrued to a member. Sometimes referred to as a CETV (cash equivalent transfer value).

Trigger: Used to describe the particular situation which puts a scheme into wind-up. It enables trustees to pinpoint the precise moment when this occurs, which becomes the effective date for calculating benefits.

Trust deed: A legal document, executed in the form of a deed, which establishes, regulates or amends a (pension scheme) trust. Commonly, the trust deed will have a set of rules attached to it which contains the detailed provisions under which the pension scheme trust will operate, including membership eligibility and benefits.

Winding up: The process of closing down an occupational pension scheme and applying the scheme's assets to secure benefits for the members. In the case of a DB scheme, this is usually achieved by applying the assets in order to purchase insurance policies (annuities) for the members, or by transferring the assets and liabilities to another pension scheme, in accordance with the scheme documentation or legislation. Alternatively, if the sponsor is insolvent and the scheme has insufficient assets to pass the s143 test, then the PPF will take the scheme assets and provide PPF compensation to the members.

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