employer covenant working group

Employer Covenant Working Group Limited
Regis House First Floor 45 King William Street London EC4R 9AN
Telephone: 020 3102 6763 Email: secretariat@ecwg.co.uk

Submission to the February 2017 Department for Work and Pensions Green Paper "Security and Sustainability in Defined Benefit Pension Schemes" (the "Green Paper")

1. The Employer Covenant Working Group

The Employer Covenant Working Group Limited (the "ECWG") is an organisation formed in 2012 and incorporated in 2015 with the following objectives:

1.1. To discuss technical, legal and regulatory issues relevant to providing financial advice to clients – trustees or sponsoring employers – on matters connected with the employer covenant;
1.2. To participate in discussions on relevant matter with bodies such as the Pensions Regulator ("tPR), Pensions Protection Fund ("PPF") and, where appropriate, to promote the views of the ECWG with those bodies;
1.3. To produce and circulate reports, guidance and other documents related to the employer covenant or associated matters; and
1.4. To act as a vehicle for raising the profile and standards of, and promoting, the employer covenant financial advisory industry generally amongst the pension community, including trade bodies, regulatory bodies, professional groups and potential clients.

2. Executive summary

The ECWG is a body formed to promote high quality financial advice on the "employer covenant". The comments below are based on our members' collective experience in this area and how pension liabilities are being dealt with generally in the UK by stakeholders and tPR. We have focused in this Submission on Questions 4 and 5 of the Green paper.

We would observe that in general the Green Paper is largely supportive of the current regulatory regime. We are generally in agreement with this.

We would make the following additional observations where change could be made:

1. We would like to see a slightly more assertive Regulator that when asked for help is able to be more opinionated or directive and is willing to use its powers to deliver optimal solutions for all stakeholders.

2. Greater flexibility, but under regulatory scrutiny from the Regulator and the Pension Protection Fund when dealing with stressed schemes and sponsors. This should include the

ability to renegotiate certain aspects of member benefits and be able to consider such arrangements not only when insolvency is inevitable within 12 months but also when it is highly probable and agreed by all stakeholders that full pension benefits are unlikely to be afforded by the employer in the longer term. We recognise that the hurdle for such arrangements will need to be high and that strong safeguards would need to be in place to protect against abuse.

3. Question 4

Is there a case for making special arrangements for schemes and sponsors in certain circumstances such as a different regime for employers who can afford to pay more, and/or new or enhanced flexibilities for stressed sponsors and schemes*?*

a) Do you have evidence that Deficit Repair Contributions are currently unaffordable?

It is intrinsic to the scheme specific funding regime that any recovery plan agreed through the triennial valuation process is based around deficit repair contributions which are reasonably affordable. Our members are heavily involved, in conjunction with other professional advisers to schemes and sponsors, in the negotiation of recovery plans on this basis. While there are cases where there is an affordability constraint and a smaller number with chronic longer term affordability issues we believe there is flexibility under the current scheme specific funding regime to deal with the majority of affordability constraints. Overall there is no evidence available to the ECWG that deficit repair contributions are currently generally unaffordable.

b) Should we consider measures to encourage employers who have significant resources as well as significant DB deficits to repair those deficits more quickly?

We do not think it is appropriate to apply a mechanistic link between the sponsor's resources, the deficit on its DB scheme and the structure of the recovery plan. In accordance with current Regulatory guidance in this area, the covenant assessment should provide a reasoned projection of financial and business risks over the short, medium and longer-term which integrates with the assessment of the funding progression and investment risk that can be taken consistent with covenant risk and affordability projections. This should then determine the structure and tenor of the recovery plan. We believe that tPR should be able to provide pro-active support to trustees seeking to negotiate such options within its existing suite of powers particularly when they believe an employer is not committing sufficient or proportionate funding to the scheme.

We would reiterate our suggestion made to the Work and Pensions Committee Inquiry that it may be worth the DWP considering measures which would position affordability within the overall risk management of a scheme with its sponsor, consistent with the emphasis now being placed on IRM by the Regulator:

- A requirement for trustee boards to produce an annual "scheme risk and uncertainty statement", consistent with that required under corporate reporting, whereby the sponsor and the trustees agree the risks associated with the funding approach that is being taken and how they are being addressed;
- Increasing the robustness and formality of contingency planning consistent with IRM. For example, agreeing and documenting steps that the parties will take to mitigate adverse experience in the scheme's funding position, or covenant strength.

c) If measures are needed for stressed sponsors and schemes, how could "stressed" be defined?

We do not think it is appropriate to use a single measure or set of measures to define a stressed scheme and sponsor, as this will inevitably drive behaviour around the metrics chosen. We therefore agree with the comments made in para 224 that it would not be appropriate to define a stressed scheme and sponsor purely on the basis of the scheme's funding level and that a sponsor's affordability is complex and scheme specific.

d) Are there any circumstances where stressed employers should be able to separate from their schemes without having to demonstrate that they are likely to become insolvent in the near future?

We consider that for the purposes of deciding whether to allow a separation of a scheme from an employer, inevitable insolvency alone may be too rigid a test.

There are certain situations where insolvency may not be inevitable within 12 months, but where it is highly probable that the funding burden of the scheme is unlikely to be met leading to insolvency in the longer term.

It may be helpful to consider a measure that enables consideration of scheme separation or other scheme restructuring options (see f) below) at an earlier stage, for instance, where there is a reasonable probability that the employer will not be able to fund the scheme to ensure that it can meet all members' liabilities in full.

We recognise the risk that this may bring for unscrupulous shareholders or employers to potentially manipulate such a system to offload their DB liabilities. As such we maintain that the burden of proof should remain high and that the ultimate arbiter of the decision to allow full separation based on such a measure should lie collectively with tPR and the PPF. See e) and f) below for further comment.

The s.71 skilled person regime is rarely used. We suggest (as in our submission to the Work and Pensions Committee enquiry) that in order to support decision making and to accelerate decisions in this area the DWP may wish to consider enhancing the skilled person's regime to provide greater support to the Regulator in considering the merits or otherwise of such proposals. The current limited use of this option may be as a result of a requirement to go to the Determinations Panel and we think this process may be able to be streamlined with the cost of the skilled persons being met by the parties promoting the relevant transaction(s).

e) How would it be possible to avoid the moral hazard of employers manipulating such a system in order to offload their DB liabilities?

Checks and balances would clearly be needed to safeguard members and avoid moral hazard. These could include:

1. Both the sponsor and the trustees agreeing that the current position is not sustainable;

2. The requirement for tPR and the PPF to approve such proposals

3. Increased participation for the scheme or PPF in the future economic success and/or legal ownership of the employers and its business.

f) Are there any circumstances where employers should be able to renegotiate DB pensions and reduce accrued benefits?

We believe that in a small minority of cases where there are stressed schemes and stressed sponsoring employers more flexible options in a wider variety of circumstances may help produce results where members' outcomes are improved and corporate restructuring is promoted.

In addition to the reasonable probability test as opposed to just the insolvency test (see d) above), we believe this should include the ability to agree amendments to and reductions in member benefits where scheme separation and PPF entry may be capable of being avoided. Whilst benefits may be reduced they would need to remain better than the alternative available through the PPF and remain supported by a restructured sponsoring employer.

We recognise that allowing even stressed employers to renegotiate pensions and reduce benefits would be a radical move and is potentially contentious, as it undermines the nature of the hard promise of a pension as deferred pay. As noted in d) above, we consider that there needs to be a significant threshold before any such reduction is even contemplated (including comparable treatment of other stakeholders). That said it is equally the case that a pension promise is a form of contract and, as with any contract, should be able to be renegotiated between the parties as long as the parties are able to negotiate from a position of equality of bargaining position and knowledge of all relevant information; and that the members are then able to come to a decision which is democratically valid. We note the limited instances of similar pension scheme restructurings under the current regime, notably that in 2016 of the Halcrow pension scheme, and believe greater flexibility but under strict regulatory scrutiny may be useful in a small minority of complex stressed situations and help avoid the 'cliff edge' type outcomes that are currently achieved at or around PPF level of benefits.

As in d) above we consider that for the purpose of deciding whether to allow such proposals the burden of proof should be high. We believe that it would need to be evidenced that the position of the scheme and sponsor is particularly stressed and that if insolvency is not likely within 12 months then the sponsor's inability to meet its full pension obligations is highly probable in the longer term and is agreed as such by all key stakeholders (i.e. tPR, PPF, Trustees and sponsor). It will also be incumbent on the parties involved to evidence that the proposal being suggested was fair and equitable to the members and was not putting the PPF unduly at risk. It may be that there may be need for tPR to use the skilled persons regime to support this decision making process or if tPR were not able to adjudicate on this then this may need to be passed to an independent party to assess such as a court.

We consider that checks and balances would clearly be needed to safeguard members and avoid moral hazard. These could include:

1. Both the sponsor and the trustees agreeing that the current position is not sustainable;
2. That the revised benefits, taking account of the likelihood of them being paid, are demonstrably better than those provided by the PPF;
3. The requirement for tPR and the PPF to approve such proposals;
4. Consultation with and agreement from a majority of members (albeit 100% agreement may not be practical or possible); and
5. Increased participation for the scheme or PPF in the future economic success and/or legal ownership of the employers and its business.

g) Is there any evidence to suggest that there is an affordability crisis that would warrant permitting schemes to reduce indexation to the statutory minimum?

We are not aware of any such evidence.

h) Should the Government consider a statutory over-ride to allow schemes to move to a different index, provided that protection against inflation is maintained?

Yes, the ECWG believes that there is a case for rationalising indexation following the Government's change of its statutory measure of inflation from RPI to CPI

Our members have seen evidence of different schemes applying different measures to inflation, many of which appear a consequence of the chance of historic drafting. However, we also appreciate the strong arguments made against a statutory over-ride. Nonetheless, current uncertain and inconsistent position places Trustees in a very difficult position. We suggest that, as with i) below, in a consensual restructuring, where multi-stakeholders are bearing some form of impairment of their claims, moving from RPI to CPI may be part of a solution.

i) Should the Government consider allowing schemes to suspend indexation in some circumstances?

This relates back to points made in f). To enable a consensual restructuring, where multi-stakeholders are bearing some form of impairment of their claims, suspension of indexation may be part of a solution, avoiding the need for formal separation of the scheme and the sponsor. Where any such suspension of indexation takes place, it should be consensual for the members - with possibly appropriate mechanisms to restore indexation previously paused if the financial circumstances of the sponsor materially improves.

j) How would you prevent a sponsoring employer from only funding a scheme to a lower level in order to take advantage of such an easement?

There is no reason why this cannot be addressed through the current scheme specific funding regime and by making the hurdle when this approach can be used sufficiently high.

k) Should Government consider allowing or requiring longer, deferred or back loaded recovery plans?

We suggest that, as with our response to question 4(b) above, there should not be a firm allowance or requirement for longer, deferred, or back loaded recovery plans we believe this will inevitably drive behaviour across the board irrespective of the individual scheme's financial risk profile. Rather, a scheme specific approach should be emphasised consistent with the Regulator's current approach which already allows such recovery plans to be agreed if needed.

l) Should it be easier to take small pots as a lump sum through trivial commutation?

This is an area on which other professional groups will have considered views. We simply comment that matters such as trivial commutation could form one part of an agreed negotiated package.

4. Question 5

Do members need further protection, and should this be delivered by a stronger and more proactive Regulator, and/or trustees with enhanced powers?

a) Would greater clarity over the requirements for scheme funding be helpful to members and to sponsors?

We are not convinced this is necessary. However, the publication by the Regulator of regular guidance updates and the advertising of what good practice looks like including case studies is helpful.

b) Is it possible to design a system of compulsory proactive clearance by the Regulator of certain corporate transactions, without significant detriment to legitimate business activity?

The Green Paper correctly notes the consequences of a compulsory clearance regime in terms of timing issues as it could make beneficial corporate transactions and turnarounds more difficult (para 314) and might fail to address “internal” business restructurings and asset transfers within groups (para 317). The experience of practice in the period shortly after the establishment of the Pensions Regulator is instructive – the breadth of potential “Type A” events and advisory caution led to a significant number of clearance applications and detailed involvement by the Regulator in the commercial terms of the transactions.

Whilst, with suitable resources, it may be possible to design a compulsory proactive clearance regime which can handle a large volume of cases, we question whether this would be a proportionate use of resource and whether it would still not hinder legitimate corporate transactions. We also question whether it would be capable of covering all types of transactions that could impact on a scheme.

What may be more appropriate would be to provide Trustees with the ability to raise any concerns they have regarding a transaction with tPR and provide tPR with sufficient power capable of being exercised within a sufficiently short time frame to obtain information to retrospectively consider the transaction and if it was found to be detrimental to the scheme to impose sanctions on the parties concerned or obtain mitigation for the scheme albeit subject to the usual rights of appeal.

c) Should the Regulator be able to impose punitive fines for corporate transactions that are detrimental to schemes?

The Regulator already has powers for such situations (e.g. Financial Support Directions and Contribution Notices) and we are not convinced that additional powers to issue punitive fines would change behaviour or be proportionate. However, the DWP may wish to consider whether the current requirements for the issuance of a Contribution Notice are sufficiently broad to act as a realistic deterrent against detrimental corporate behaviour.

Where Clearance is sought there is an opportunity for trustees to engage formally with the sponsor within a known regulatory framework. Where (as is often the case) Clearance is not sought there is no such opportunity and trustees are reliant on other means to get a “seat at the table” which can risk the relationship with the sponsor. The DWP could consider whether it would be appropriate to reinforce the rights of trustees to notify or bring such transactions to the

Regulator's attention and the scope for the Regulator to engage following such an approach (see (b) above).

d) What safeguards could ensure that any additional powers given to the Regulator do not impact on the competitiveness of the UK market?

Significant powers have been held by tPR since the Pensions Act 2004, and in many instances these have potentially been under-utilised. We consider that any additional powers will be subject to the same strenuous tests applied in relation to the existing powers available, but acknowledge that in certain areas e.g. any ability to be involved in material corporate transactions, there may be a need for additional resources.

e) Should the Regulator have new information gathering powers?

The Regulator already has powers to request information and we do not see a case for additional powers being provided to it subject to the comments in (b) above.

f) Should civil penalties be available for non-compliance?

There may be a case to argue for civil penalties to apply in relation to the non-compliance with information gathering powers. However there should remain protections with regards to honest mistakes or oversights and privilege.

g) Should levy payers be asked to fund additional resources for the Regulator?

There is a case for any additional resources for the Regulator being funded by those who use the system i.e. UK sponsors, rather than from general taxation, as with the FCA and the Takeover Panel in the corporate space.

h) Should trustees be given extra powers such as powers to demand timely information from sponsors, to strengthen their position?

Trustees in many cases would benefit from more timely information provision, recognising that in some cases there are factors (such the restrictions imposed by the Takeover Code or the Listing Rules of the FCA) which limit when and how information can be disseminated. Information sharing protocols are often agreed between sponsors and trustees, bearing in mind such limitations. However, sometime there is an inequality of bargaining position and having the Regulator make known what it would normally expect trustees to be allowed access to would in some situations be useful to trustees.

i) Should trustees be consulted when the employer plans to pay dividends if the scheme is underfunded – and, if so, at what level of funding?

There is currently no requirement to consult on any proposed corporate activity, including dividend payments. To impose such a requirement would be potentially costly to employers, particularly given that many pension schemes involve a range of companies within larger groups where intra-group dividends and payments to external investors are often made in the ordinary course. We can also see difficulties in defining underfunding unless a standard set of assumptions is applied.

Value can be removed from the sponsoring employer group by dividends or other forms of value transfer. We support the current regulatory regime based around addressing the situation where this is "materially detrimental" to the sponsor covenant; as not all dividends will be materially detrimental.

If the introduction of an additional requirement to consult was to provide the trustee with a veto over any dividend then this would have notable consequences on other stakeholders – for instance affecting the support from equity investors (particularly for quoted companies) and the potential to adversely impact on legitimate corporate activity. We are not in favour of this. If it does not provide a trustee veto but rather an opportunity to make representations then this is more likely to garner support.

j) Is action needed to ensure that members are aware of the value of and risks to their DB pensions?

Member communications tend not to set out the inter-play of risks to their DB pension scheme, and very rarely in our members' experience are the risks relating to the sponsor covenant set out. We would support initiatives to improve the quality of communications in this respect.

Legal disclaimer

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15 May 2017