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PENSIONS AFTER BHS AND BRITISH STEEL

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2016 saw one of the most eventful years in recent history for the pensions market, with many high profile cases hitting headlines across Britain. Two of the most notable cases, British Homes Stores (BHS) and British Steel, have separately led to a public consultation (British Steel), a parliamentary inquiry (BHS) and calls for the powers of almost everyone involved in pension schemes to be strengthened.

Three observations

There is no doubt that the high profile cases have been the catalyst for a discussion in the industry about whether things need to change. Looking in from the outside, one can imagine the frustrations of some of those involved in those cases, frustration which will perhaps reflect the experiences of many pension scheme trustees and professional advisers. There are three key moments which perfectly illustrate the difficulties.

First, difficulty negotiating contribution rates and an apparent reluctance of the Pensions Regulator (tPR) to want to give clear views about what outcome it expects. It is not uncommon for an employer to take the stance that it has a fixed budget for contributions, perhaps because it wishes to use any spare cash to reinvest in the business. Trustees usually have no power under the scheme's rules to demand any more and so they are faced with a dilemma. Do they accept what the employer is telling them and somehow get themselves comfortable with, say, a longer recovery plan? Or do they seek to involve tPR, a move which might destroy a previously good relationship with the employer and which, in the experience of many professional advisers, may be unlikely to elicit clear views about an appropriate outcome from tPR?

Secondly, the processes that are intended to help protect members' benefits are slow and unwieldy. In the BHS case, this was illustrated by the apparent difficulties in implementing

Project Thor, the proposed company and pension scheme restructuring. For this type of restructuring, regulatory requirements mean that tPR has to be satisfied that employer insolvency is otherwise inevitable and that the pension scheme restructuring will offer members a better outcome than PPF level benefits. For tPR to be satisfied, it needs due diligence information. It appears that in Project Thor, the due diligence information was not forthcoming, neither tPR nor the trustees had the ability to force other parties to provide the information, and so Project Thor was subsequently derailed.

Similarly, in the British Steel matter, there is a proposal which will offer a better outcome for members rather than falling into PPF, but the legislation does not exist to allow it to be implemented easily. This kind of proposal ordinarily requires the agreement of all members, but with 130,000 affected members, obtaining individual member consents would be almost impossible. The only other way of implementing the proposal is for there to be a change in the law specifically to allow for the restructuring.

Finally, if a corporate transaction or reorganisation is planned, trustees are often the last to know. When the clearance regime was introduced alongside tPR's moral hazard powers, we saw an immediate uplift in companies seeking clearance for corporate transactions, and often having to offer mitigation in order to obtain clearance. The numbers seeking clearance soon dropped. The Work and Pensions Committee's report issued in December 2016 gave the numbers: 263 clearance applications in 2005/06 compared to 9 in 2015/16. The comparison is stark: as it became apparent that tPR was not going to use its powers in most cases but was instead going to seek to extract a 'price' for its clearance, some companies took a more aggressive stance to corporate activity, preferring the view that they would offer mitigation if tPR required them to at some later date. This leaves trustees and schemes in a more vulnerable position - if they are told about a proposed transaction, they have limited ability to negotiate mitigation against the backdrop of a Regulator which has only pursued a small handful of moral hazard cases, usually only after insolvency has occurred.

Pension deficits: the wider picture

It is recognised that the cost of defined benefit pensions is still increasing despite scheme closures. This, in turn, causes a drag on company performance as well as the wider UK economy, providing a clear concern from the Government that we might see more cases like BHS if nothing changes.

At the same time, there is a movement to suggest that companies need to be more mindful of their pension deficits when considering dividends. A report published by LCP

last year suggested that the combined pension scheme deficits of FTSE 100 companies as at the end of 2015 was £42.3 billion. Yet the same companies paid out combined dividends of £53 billion - 25 per cent higher - compared to contributions of £13.3 billion. There will of course be many schemes whose assets are invested in FTSE100 companies which benefit from those very same dividend policies and so the picture becomes even more complicated. Do not be surprised, though, if we see more to try to constrain dividend policies in the future where deficits need to be eradicated.

What's next?

What can be done to prevent such issues in the future? It may be that, in fact, there are some schemes which will just inevitably end up in the PPF - after all, you could argue that that is exactly why the PPF was put in place to start with. It may also be equally fair to say that the current system works pretty well in most situations. The vast majority of employers take their responsibilities towards their schemes very seriously indeed and evolutions since 2005 have seen the introduction of more independent professional trustees and an increased focus on governance with the introduction of initiatives such as integrated risk management. While wholesale change is probably unwarranted, the cases do highlight the need for some "tweaks" to the current system.

The Work and Pensions Committee's December report puts forward some ideas which we might see in the Green Paper due out soon. Some of those ideas are certainly worth further exploration (for example, the consolidation of small schemes and mandatory clearance in limited circumstances) but others may ultimately prove to be unworkable (for example, a well governed scheme (however that is defined) is not any less likely to fall into the PPF and so arguably should not benefit from a reduced levy). That, of course, would be for the consultation to explore.

There may also be an opportunity for the Department for Work and Pensions to consider some more radical steps to help pension schemes.

Five things the Department for Work and Pensions might do

Here are five more radical things that the Department for Work and Pensions might consider putting into the Green Paper or otherwise seek to encourage:

1. The remit and resources of the Pensions Regulator

Is tPR a regulator or a supervisor? If its role is to be a supervisor, it will need more powers to allow it to supervise. If it is to remain as a regulator, it would benefit from additional skilled resource to allow it to test the use of its existing powers, perhaps combined with the powers it needs to more proactively engage with trustees and employers (for example, it should be able to intervene to ensure that employers provide all necessary information in a timely manner).

2. International reach of the Pensions Regulator

More clarity is required around how far tPR can enforce things like contribution notices and financial support directions against overseas companies. Again, tPR needs to be given resources to allow it to run enforcement test cases in EU countries and further afield. Many trustees whose sponsoring employer is part of a wider global corporate group would welcome this clarification.

3. Reviewing the current technical provisions basis

Perhaps the Green Paper could suggest a debate on whether measuring pension liabilities purely based on gilt yields is the "right" measure given that money will be invested for the long-term and gilts will probably not match the actual investments of the scheme?

4. Section 75 debt on scheme exits

The DWP might also consider whether the legislation around employers leaving multi-employer schemes should be looked at again. The current legislation is complex and arguably disproportionate, especially in certain cases.

5. Section 67 restrictions

In general terms, a rule which restricts the changes that a pension scheme can make so that benefits which have already accrued must be protected has to be correct. That said, the DWP could consider a limited statutory override to allow schemes to choose which is the most appropriate measure of inflation by which to increase benefits even where

(probably through an accident of drafting) under the Rules they are apparently forced to apply RPI. While the circumstances enabling such power ought probably to be limited, this could help some schemes to survive where they might not otherwise do so.

While 2016 was certainly an eye-opening year for the pensions industry, a renewed debate in the industry about the role of tPR is to be welcomed. While tPR arguably does already have many of the powers it needs, it is only by testing its powers that it can truly become the effective to shape and change behaviours. In order to be able to do that, it needs more skilled resources to enable it to move to that next level and fulfil the role which is needed.

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