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PYRRHIC VICTORY?

The unintended consequences of the Pensions Act 2004

A Pensions Institute report for employers, trustees, advisers and policymakers

Debbie Harrison
Alistair Byrne
Bill Rhodes
David Blake

"There is no point in having the best regulation in the world, if there are no schemes left to regulate"

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List of abbreviations

The Act . . . *Pensions Act 2004*
DB . . . . *Defined Benefit*
DC . . . . *Defined Contribution*
FD . . . . *Finance Director*
FRS . . . . . . *Financial Reporting Standard*
HR . . . . *Human Resources*
HRD . . . . . . *Human Resources Director*
IAS . . . . *International Accounting Standard*
MD . . . . . . *Managing Director*
MNT . . . . . *Member-nominated Trustee*
NAPF . . . . . *National Association of Pension Funds*
PMI . . . . . . *Pensions Management Institute*
PPF . . . . . . *Pension Protection Fund*
SFO . . . . . . *Statutory Funding Objective*
SFP . . . . . . *Statement of Funding Principles*
SME . . . . . . *Small or Medium-sized Enterprise*
Regulator . *The Pensions Regulator*
TKU . . . . . . *Trustee Knowledge and Understanding*

Foreword

This is the second of our new series of reports that focus on pensions issues of direct relevance to pensions practitioners, employers, trustees, and policymakers.

The 2004 Pensions Act has turned the defined benefit pension promise into a pension guarantee and has established the Pension Protection Fund (PPF) in order to secure this guarantee where a company becomes insolvent and the scheme is underfunded. The Act has greatly upset corporate pension sponsors, not only because it has fundamentally altered the voluntary arrangements that these companies provide for their own workforce, but also because it forces financially strong companies to subsidise financially weak companies via the PPF levy. Importantly, it appears that this cross-subsidy relates to jobs as well as pensions.

In addition to these observations, we found that the Act will have a number of serious unintended consequences. One consequence is that, as a result of conflicts of interest, company directors increasingly will cease to be members of the trustee board and that as a result of this disconnection between scheme and sponsor, many trustee boards will become rudderless. There is no help from the Act in redressing this situation, but participants in our research suggested a range of sound governance principles that could be used to address how this two-way information vacuum may be filled in future.

A further very significant consequence is that the Act will accelerate the demise of defined benefit pension provision in the UK private sector and its replacement with defined contribution schemes in which workers bear all the risks.

As with our first report *Delivering DC? Barriers to participation in the company-sponsored pensions market*, Debbie Harrison and Alistair Byrne have conducted most of the interviews with practitioners. I am delighted to say that they have been joined by Bill Rhodes, who not only conducted the remaining interviews, but was also responsible for raising the sponsorship funding from Pendragon plc, Boots plc and Rentokil Initial plc. We are very grateful to these companies for their generous sponsorship, especially since it was given freely and without conditions.

I should stress that the views expressed in the report are those of the authors and respondents and not necessarily those of the Pensions Institute, which itself takes no policy position.

Professor David Blake Director, Pensions Institute
October 2005

Sponsors

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Boots plc
Pendragon plc
Rentokil Initial plc

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Aon
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Russell
RSM Robson Rhodes
Scottish Equitable
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Wragge & Co

Preface

The implications of the Pensions Act 2004 for UK occupational schemes are now becoming clearer and in many cases are not consistent with the stated aims of the government when it drafted this landmark legislation.

The purpose of this research is to report how employers, trustees, and the many organisations that provide services to occupational pension schemes are responding to change, and to look beyond the current tactical positions these parties are adopting, in order to consider the longer-term impact of the Act on company-sponsored pensions.

The government introduced the Act to ensure occupational pension schemes are sufficiently well funded to meet their liabilities in terms of benefits to members. At present most schemes register a deficit and in a significant minority of cases this is large relative to the sponsoring company's market capitalisation.

For trustees the Act provides clear guidance on the steps they must take to restore full solvency under the new Statutory Funding Objective (SFO), which replaces the discredited Minimum Funding Requirement (MFR) for actuarial valuations that occur from October 2005. The Regulator's guidance introduces a more confrontational approach to the trustees' negotiations with sponsoring employers than has hitherto been the case.

For employers the Act means that as sponsors they now have significantly reduced power and control over their pension schemes compared with the legal and regulatory environment that pertained when they first established these voluntary arrangements. After 11 June 2003, when the government introduced rules that prevent solvent employers from walking away from their defined benefit (DB) pension liabilities without paying the full buy-out cost, pension fund deficits became legal debts. The Act formalises this reclassification of schemes and states that these debts are akin to bank loans and trustees akin to bank lenders. What employers originally established as a voluntary promise has become a legal guarantee, so long as the sponsor remains solvent.

We found that employers are deeply concerned and angry about this fundamental change in the nature of occupational pensions risk, which is affecting the way they can do business, raise finance, pay dividends, and engage in corporate activity. They look with longing at competitors who do not have DB schemes but instead have only ever offered low cost defined contribution (DC) arrangements.

The Act requires trustees to negotiate robustly with the employer to set the period over which solvency must be achieved and the rate of employer contribution. In the event that agreement cannot be reached, the Regulator has the power to intervene. Recovery periods are likely to be fixed at between five and ten years, with an increasing number of lay and independent trustees favouring the shorter time frame. This may put a significant restriction on the extent to which companies are able to pay dividends to their shareholders.

Our respondents thought that the conflicts that will arise over the time frame for the recovery period will have important implications for advisers and in particular for the business model of the actuarial and investment consultants who historically have strongly influenced – some would say controlled – both the corporate and trusteeship aspects of pension schemes in the UK. This dual role is under scrutiny and may not be viable in future. As one consultant observed: "It's very simple. If I feel that I am unable to do the job, then it shouldn't go to one of my colleagues."

Our research suggests that if the current chain of events continues to its logical conclusion the Act will succeed in improving the governance of occupational pension schemes and will enhance the short-term security of members' pension benefits, but it will do so at the expense of employer commitment. Many employers are looking to remove their pension liabilities from their company balance sheet as quickly as possible and several respondents said they were working on ways to help corporate clients do this. And so it will be a Pyrrhic victory for pensions policymakers. As a pensions lawyer succinctly put it to us, "There is no point in having the best regulation in the world if there are no schemes left to regulate."

Many of our respondents believe that as trustees and the Regulator put pressure on companies to reduce pension scheme deficits over relatively short recovery periods, companies will respond by closing their schemes to future accrual by existing members and will shift ongoing pension provision for all employees to a DC basis. It is not easy to see what can stop this trend once it takes hold.

The DB schemes of small and medium sized enterprises (SMEs) are likely to be the first major casualties. This should be cause for concern given that these companies represent the powerhouse of the UK economy and many will become the larger plcs of the future. We make specific reference throughout the main research sections to the position of SMEs under the Act, which is often quite different from that of larger companies.

Our interviews were conducted with over 70 representatives selected from major participants in the following groups:

- Actuarial and investment consultants
- Accountants
- Pensions lawyers
- Insurance companies
- Asset managers
- Investment banks
- Company, member-nominated, professional and independent trustees
- Corporate pensions managers
- Pension scheme members

The most important feature of our methodology is that our findings are based on interviews with a wide and representative range of organisations, conducted on the understanding that information provided and opinions expressed would be quoted on a non-attributable basis. This methodology enables us to "tell it how it is" and express the personal opinions of senior figures in the industry, rather than the organisations they represent. Our acknowledgement section reflects only a selection of the organisations involved. In many cases individuals – particularly employers – felt that even when quoted anonymously, their comments could be traced back to the company if the name were included in the Acknowledgments.

What is particularly significant in the analysis is how many of the most striking views are consistently held across all of the participating groups, from member nominated trustee (MNT) to finance director, from pensions lawyer to asset manager, and from the smaller actuarial and benefits consultancy operating in the SME market to the major actuarial and accountancy practice with FTSE 100 company clients.

We hope our approach helps those responsible for the running and supervision of DB schemes to understand the early impact of the new legislation and to see how others are approaching it. Equally we hope that readers will find this report illuminating in its fresh approach to contemporary pensions problems.

Debbie Harrison
Alistair Byrne
Bill Rhodes
David Blake

Executive summary

The Pensions Act 2004 introduces a framework for restoring defined benefit pension scheme solvency over an extremely short recovery period. Our research suggests that this will risk alienating the voluntary corporate sponsors on which occupational pensions in the UK rely. It reduces their powers, their control, and their ability to manage this significant business risk. As the report explains, employers are angry because they feel that their pension schemes are being used to achieve social and political objectives in the areas of employment and welfare.

The historic alignment of the interests of trustees and the sponsoring employer is under threat. Respondents warned that unless trustees and the Pensions Regulator can structure the recovery process with a clear focus on the long-term implications of their actions for the financial health of the sponsoring companies, employers would respond by closing DB schemes to future accrual.

Our research indicates that in the place of a final salary-linked pension, all but a minority of very large companies will introduce contract-based defined contribution schemes – a trend already well under way. Our findings also suggest that companies with existing trust-based occupational DC schemes are looking to move to a contract basis, reflecting their general weariness with, and their desire to withdraw from, the complexity of trust-based benefits.

In the light of these findings it seems very likely that in future the main burden of private pension provision will fall directly on individuals, who are ill equipped to manage the associated investment and longevity risks. The burden will also fall on the taxpayer, who ultimately will be forced to pick up the bill for the increasing demand for Pension Protection Fund support when employers become insolvent, and for state retirement benefits when DC arrangements fail to deliver adequate private pensions.

The government has stated in the past that it aims to shift the balance between state and private pension provision from 60:40 to 40:60 by the year 2050. The most significant unintended consequence of the Pensions Act 2004 is that measures designed in theory to shore up the occupational pensions sector, in practice risk undermining it and hastening its demise. This is the Pyrrhic victory of our title.

In the meantime sponsoring employers face a difficult 5-10 year period while they restore their underfunded DB schemes to solvency. The detrimental impact on business of the expected trend towards an accelerated recovery process will not be limited to isolated cases but is likely to have effects across the economy.

Key findings

The key findings of this report are set out below. More detail is provided in the corresponding section of the report.

1. The Act disconnects the historic alignment of the interests of trustees and the sponsoring employer

Respondents argued that the legislation significantly raises tensions between trustees and sponsoring employers, putting at risk their traditional conciliatory approach to negotiating scheme funding.

2. Company directors are likely to withdraw from trustee boards

Directors who are trustees could be forced to act in ways that would undermine the company's competitive position and the value it is able to deliver to shareholders. They could also see their performance-related pay suffer as a result of the fulfilment of trustee responsibilities. However, where company trustees withdraw, this will exacerbate communication difficulties between the trustee and the company boards and create governance problems.

3. The new requirements for Trustee Knowledge and Understanding (TKU) may alienate older, highly capable trustees

The profile of the traditional trustee, so highly valued by respondents, is an older worker with a long period of service, who therefore understands the company and its benefits policy. These are the trustees who have the ability to ask important, commonsense questions. They are likely to be replaced with younger employees from middle management.

4. The business model of actuarial and investment consultants is under scrutiny and is expected to change

Actuarial and investment consultants have built their businesses on a model that assumes they will advise both the trustees and the sponsoring company. The Act may make this approach untenable.

5. Clearance is likely to favour trustees but create problems for employers

The Pension Regulator's clearance procedures for activities that may weaken the employer's covenant appear to be positive for trustees, securing additional funding in most cases. However, the benefits for employers are far less clear-cut. Employers appear to have lost their initial enthusiasm and become much more wary of the perceived interference in the business clearance entails.

6.There are serious doubts over the longer-term viability of the PPF

While the PPF funding position looks comparatively stable in the short term, it lacks control over its exposure to the risk of a flood of new entrants in the event of adverse economic conditions, while its taxable franchise will diminish over the longer-term as schemes close to future accrual and wind up.

7. Employers feel they have lost control of their DB schemes and will close to future accrual

Respondents fear that employers will lose their commitment to pensions as a result of the Act and close DB schemes to future accrual. Most will transfer existing members to DC schemes and these are likely to be predominantly contract rather than trust-based.

8. To proceed with confidence employers need the flexibility to design benefits that are appropriate to their size and financial strength

Employers feel that the Pensions Act, in effect, removes much of the flexibility they need in designing appropriate employee benefits. It raises the risks associated with DB pension provision to a level that exceeds the perceived benefits.

The research in detail

In the following pages we set out the results of our focused interviews with employers, trustees, members, and professional advisers to pension schemes. We identify the respondents only by category and their responses are in serif.

Section 1: Scheme funding

The Act disconnects the historic alignment of the interests of trustees and the sponsoring employer, putting at risk their traditional conciliatory approach to negotiating scheme funding.

The Act sets out a statutory funding objective (SFO) that pension schemes must meet and requires schemes to prepare a statement of funding principles (SFP) designed to meet the SFO.

The Pensions Regulator's Code of Practice 'Funding Defined Benefits' sets out in more detail its expectations of the content of the SFP and of the nature of a scheme's recovery plan should there be a deficit.

"Trustees should … aim for any shortfall to be eliminated as soon as practicable since full funding in relation to the technical provisions is the statutory funding objective. What is possible, however, will be dependent on the financial circumstances of the employer." TPR, Funding Defined Benefits, 53.

What the Act says:

222 Statutory Funding Requirement
Every scheme is subject to a requirement – the statutory funding objective – that it must have sufficient and appropriate assets to cover its technical provisions. Technical provisions are defined as the amount required on an actuarial calculation to make provision for the scheme's liabilities.

223 Statement of Funding Principles
The trustees must prepare, and from time to time review and if necessary revise, a written statement of their policy for securing that the statutory funding objective is met.

226 Recovery Plan
If having obtained an actuarial valuation it appears to the trustees of a scheme that the statutory funding objective was not met on the effective date of the valuation, they must within a prescribed timescale prepare a recovery plan if none is in place, or review and if necessary revise any recovery plan already in force. The recovery plan must set out the steps to be taken to meet the statutory funding objective and the period within which that is to be achieved.

1.1 *The Act establishes an adversarial relationship between trustees and sponsor*

Almost all respondents held the view that the new requirements create a more adversarial relationship between trustees and corporate sponsors in terms of negotiating funding of the scheme. The exceptions were certain advisers and independent trustees with FTSE100 clients, where the trustee board governance was particularly well developed and/or where the deficit was not large relative to market capitalisation.

Trust law is specifically designed to manage conflicts and has done so in the past with considerable success. Respondents felt that the Act fails to recognise that the interests of trustees (as employees and scheme beneficiaries) and the sponsor in most cases are well aligned. This historical basis for the operation of occupational schemes has changed beyond recognition.

> "The 1995 Act also recognises this conflict and trust law has done so for hundreds of years. Conflict is good – it gets different views out on the table and stimulates discussion. The issue has always been to spot when a conflict becomes unmanageable. What has changed though is that the new Act appears to positively encourage conflict rather than conciliation. The Regulator is encouraging trustees to take an aggressive and confrontational approach in negotiations with the company." Pensions lawyer

> "The cosy relationship between trustees and employers has ended. Trustees are finding out that there should never have been one in the first place." Accountant

> "The 2004 Act codifies conflict." Asset manager

> "It's the situation companies and trustees face that is causing the conflict. We have a situation that has no real precedent – with schemes significantly underfunded and companies in a relatively weak position." Consultant

1.2 *Funding: Conflicts of interest*

We asked how companies and trustees would negotiate over the Statutory Funding Objective (SFO) and Statement of Funding Principles (SFP). Most respondents thought the Act redefined the relationship between trustees and corporate sponsors when it came to negotiating funding:

> "The government has laid down in great detail the process trustees are required to follow in setting the SFP and the schedule of contributions. This is much more intrusive regulation than we have had before. In some cases, it will change the dynamic between the company and the trustees, creating conflicts." Trustee

> "The financial relationship between the company and trustees must be redefined. The biggest debate will be over the recovery period. For a company rated B- it makes no sense to use a recovery period of longer than five years because the ratings say that the company has an over 40% chance of not being in existence in five years time. In these circumstances it's a joke to talk about a recovery period of 10-15 years – it fails the sanity test. The trustees' priority must be to negotiate contributions over the next few years." Consultant

"Trustees need to negotiate like a bank that has agreed a loan to the company. They should insist on being informed if the company wants to take certain corporate actions. They should impose constraints and conditions. They need the finance director to provide an information flow – to present the insider's view of the company's prospects and its ability to meet the funding schedule. Trustees can effectively force the company because they can go to the Regulator." Consultant

1.3 *Prudential use of trustee powers*

There was concern amongst some respondents as to whether trustees would use their new powers prudently. Effectively trustees have the power to push a company into insolvency if they can demonstrate that this is in the best interests of the pension scheme. The Regulator can back them in this approach.

"Trustees need to recognise the business strains that will arise if they insist on a very tough recovery schedule. Trustees need to understand corporate structures and corporate financing. This has not been a traditional area of trustee knowledge." Accountant

"Member security will be eroded if trustees push for a high company contribution rate that, if it does not force the company into insolvency, may well reduce the company's competitive position and weaken its financial strength." Consultant

"Trustees are likely to push for recovery periods of 5-10 years. Five years would be scary – it would push the company into insolvency or damage it irreparably. One of my clients has already had to agree to pay 80% of its profits to the scheme. The trustees – and possibly the Regulator – will have to spread that out, otherwise the company will go bust." Consultant to SMEs

1.4 *Solvency issues*

The precise definition of solvency was an issue for some respondents and most felt that the use of different measures – SFO (which takes effect for valuations from October 2005), the buy-out basis, and the PPF solvency level (which takes effect on 31 December 2006) – merely adds to the confusion already created by the move to the FRS 17 accounting measure and the new international standard, IAS19. The clearest and cleanest measure is the full buy out cost, as this is the only way a company can discharge its liabilities in full, through the purchase of immediate and deferred annuities. However, the adoption of the buy-out funding level is not practicable for most companies at present, due to cost and insufficient capacity in the buy-out market. Currently only two players are active in the open market – Legal & General and Prudential.

"The PPF solvency test will be regarded as the main priority and this is less than full solvency. We need a single measure of solvency against the full buy-out – everything else is a waste of time and adds to the confusion. SFO encourages a target that is not sufficient. The buy-out capability is what really counts." Consultant

"We think of the buy-out cost as the gold standard for DB schemes, as following June 2003 solvent employers cannot shift DB liabilities off their books unless they take this route. But what is the right cost of a buy out if there is no market?" Consultant

"There is now a requirement for actuaries to include [the buy out cost] amongst the information they provide to trustees. Trustees can still choose to use an alternative basis of funding, but they can no longer claim to be unaware of the buy out cost." Insurance company

"There is also going to be hard disclosure to members from April 2006, with the benefits statement showing the solvency coverage of their own individual benefits. For active members this might amount to only 30% to 40% of accrued benefits, which is going to provoke some interesting conversations." Insurance company

1.5 *Asset allocation: More bonds?*

We asked whether trustees would change asset allocations as a result of the Act. Most respondents thought the trend to greater bond allocations was already well under way prior to the Act and that, if anything, the Act simply reinforced that trend.

"We will not see much change as a direct result of the Act – most schemes have already moved to a more cautious asset allocation." Consultant

"The gradual transition to bonds will be driven by maturity and schemes will mature automatically as they close to new members and to future accrual." Consultant

"Employers will plug the hole and then invest in whatever will ensure the situation will never arise again. This isn't just about a traditional equity to bond switch – it's about using new financial instruments that can guarantee a liability match." Accountant

"Once the PPF starts to take the investment strategy of the fund into account when it sets the levy, schemes will move to a higher bond weighting." Consultant

"The idea of bond investing does seem to be more widely accepted. Most of the big asset managers have liability-driven investing teams and the proponents of bond investing are not as isolated in the actuarial profession as they once were." Investment bank

1.6 *Is the trend towards bonds misguided?*

However, some respondents thought the drive towards bonds was misguided and that with a long time horizon, most funds could continue to afford to take equity risk. In due course the PPF will take account of asset allocation in setting the (80%) risk-based element of the levy. If it favours a higher bond weighting as the more secure approach to matching liabilities this is likely to increase pressure on schemes to move from equities.

"The strength of pension fund investment has always been based on the fact that they can take long term risks. Legislation is driving the trend towards liability-matching strategies that in most cases introduce a higher bond weighting. Finance directors might be forced to agree to this, as they put themselves personally at risk if they push for a higher equity allocation and it backfires. Personal risk is clouding the investment strategy for both trustees and the company." Asset manager

"Allocations have already changed due to actuarial advice, legislation and accounting regulations. The legislation is now going to drive the allocations – not the needs of the scheme. The drive towards bonds is just another herd instinct and there will be a backlash next time inflation starts to rise."
Pensions lawyer

1.7 *Trustees need to protect against weak employer covenants*

Trustees need to understand much more clearly the strength of the covenant they have from the sponsoring employer. The strength of this covenant will depend on the company's ability to pay the required contributions, which in turn reflects its financial position. Put simply, if the company has a strong balance sheet and is making healthy profits, this implies a strong covenant; a weak balance sheet and poor profit forecasts implies the reverse.

The Pensions Regulator's guidance makes specific reference to the requirement for the length of the recovery plan to take into account *"the ability of the employer to pay contributions in accordance with the recovery plan."* (TPR, Funding Defined Benefits, 58) There is a difficult balance to be struck.

"Trustees need to review the strength of the covenant and the position of the scheme as an unsecured creditor in the event of insolvency." Accountant

"Understanding the covenant is not the trustees' main area of knowledge and in fact the trustees who are likely to be most knowledgeable are the company representatives, who are in a position of conflict. The situation requires specialist advice from an insolvency practitioner and knowledge about the company that is not available in the marketplace, which could be expensive to obtain." Pensions manager

"The biggest issue is the strength of the employer's covenant, as this will dictate the period over which the trustees should aim to collect the deficit money. In theory the poorer the covenant the faster the recovery schedule, but this could actually push the employer into insolvency, which would be counter-productive." Pensions manager

"An important question is in which circumstances the trustees should be pushing for the highest contribution rate – when the employer is strong or when it is weak? You can argue it both ways, particularly where schemes have large numbers of active members who will be concerned about the impact on jobs." Insurance company

"Where the employer asks the trustees to rely partly on equity investments to fund the deficit, trustees need to find out whether the employer has the ability to pay the contributions if the equity market does not deliver." Accountant

1.8 *Contingent funding strategies*

One option available for trustees is to look to improve the security of their claim on the employer, for example by taking a charge on specific assets. Contingent funding strategies could also be used. In essence, these are arrangements that enable the trustees to obtain insurance that pays out in the event the employer is unable to meet its funding obligations. This could take the form of a bank guarantee or some type of credit derivative. However, it remains to be seen whether the PPF will accept such arrangements in calculating the scheme's funding level when assessing the risk based levy.

> "Trustees need more instruments to protect against credit risk. Their investment consultants need more education on credit default swaps, for example, and how to include these in the asset-liability model." Investment bank

> "For each trustee action on asset allocation there will be a corresponding reaction in the level of employer contribution. Employers may look to non-cash strategies as a way to avoid higher contributions and the potential 'loss' of a future surplus." Consultant

Section 2: Trustee conflicts of interest

Company directors are likely to withdraw from the trustee board to avoid conflicts of interest. Alternative mechanisms are required to ensure a smooth flow of information between the company and the trustees

Almost all respondents thought that company directors serving as trustees faced potential conflicts of interest. A minority thought the potential conflicts were a price worth paying for the knowledge and insight into the company's views that they brought to the trustee group.

> "Finance directors and HR directors bring considerable knowledge and experience to the board. If they go there is a knowledge gap and also a concern that the company is keeping at arms length from the board and not revealing its agenda." Trustee

> "I'd rather have the trustees evenly represented and let them fight it out, even if this leads to uncomfortable situations" Trustee

> "In some cases the company board has written the to the HR director, who is a trustee, and said 'We recognise that your principal responsibility is to the trustee board and that you are at liberty to disclose any material information. We also recognise that in this situation your position as a company director may be constrained.'" Consultant

2.1 *Majority see era of company trustee drawing to a close*

However, the vast majority of respondents anticipated that the era in which company directors could serve on trustee boards is coming to an end, particularly in the case of finance directors, managing directors and chief executive officers.

Our research indicates it is the perception of conflict rather than the practical management of this fundamental feature of trusteeship that will force finance directors and chief executive officers, and other senior directors, off the trustee board. With pensions in the news headlines on a daily basis and with strong union activity in this area, high profile companies in particular need to appear to be following best practice on trustee and corporate governance.

Opinion was divided over whether resignations would be pre-emptive, for example as a matter of company policy before the next actuarial valuation (which is the trigger point for the SFO and the recovery plan) or whether an application for clearance would be the trigger.

Without exception respondents said that the loss of company directors would significantly reduce the skill set of the trustee board, and would damage the information flow and the trustees' understanding of the company context and perspective.

> "I have difficulty seeing how an FD can be a trustee without coming across conflicts of interest. At every turn there is a potential conflict." Insurance company

> "[The idea of company directors serving as trustees] has got to be on the way out. You can just about get away with it when nothing is happening, but if there are any issues over funding it is not sustainable." Investment bank

> "The requirement to negotiate with the employer is not that simple for member nominated trustees. It is, of course, even worse if you are an executive. In effect you have to act in a way deliberately designed to redistribute corporate wealth towards the pension scheme. This could have the impact of lowering shareholder value, reducing the chance of a company meeting its key performance indicators. These are usually the very key performance indicators that executives are measured on determining ultimately how much they get paid and if they get promoted or vilified by investors. Executives who are trustees could therefore be required to act in a way that would reduce their own pay. If this is not a conflict of interests then what is?" Accountant

> "Company executives bring important financial knowledge to the trustee board. However, in practice many will find it increasingly difficult to stay on the board. A few years ago FDs were worried about whether they should act as chairman of the trustee board – and this is now quite rare. Now they are wondering if they should be on the board at all." Investment bank

> "In theory company trustees bring essential expertise and a sense of direction to the trustee board. In practice it's getting very difficult for the FD to remain as a trustee. Understandably it's hard to justify the dual role. Trustee boards will be the weaker for the loss." Pensions lawyer

> "In practice company trustees are resigning or considering this step. This is a sad loss – it's their scheme too, it's their company and they bring the expertise the Pensions Regulator demands." Consultant

2.2 *New governance arrangements required in the absence of company trustees*

The Act provides no guidance on pension scheme governance in the event of company directors resigning from the trustee board. The loss of company executives as trustees will require new governance structures that ensure the continuation of a two-way flow of information between the company board and the trustees.

> "I've seen schemes where there is no senior company trustee and they behave as though they are rudderless – there's no sense of direction without the company position and where the scheme fits in with the company's future."
> Consultant to SMEs

> "This is the key question – if company trustees withdraw the trustees still need the commercial knowledge." Accountant

> "There is no system to deal with this. In practice company directors will have to inform trustees about notifiable events but that's it. However the company will need to keep contact with the trustees to see what direction they are taking. There is a mutual need for information here and without company directors on the trustee board there is no mechanism to deal with this vital requirement." Pensions lawyer

2.3 *Trustees and their 'cheque book' still need to communicate*

Several respondents suggested that board members would still need to attend trustee meetings even if they were no longer trustees.

> "There needs to be a close relationship between the trustees and the employer. They need to understand each other. There is no point in the trustees taking a totally theoretical, distanced view. They are more than just an unsecured creditor. They need to work with the company. There should be some kind of formal arrangement for trustees and the company to interact." Pensions manager

> "A reasonable compromise might be where the company executives attend meetings as 'visitors'." Trustee

> "If I were the finance director I would not want to be a trustee but I would demand a seat at the table. I'm the cheque book and my main concern is the governance of the board and risk control from the company's perspective."
> Asset manager

> "One model is for a subgroup to be set up with representatives of the trustees and of the employer. The subgroup will discuss any issues that will affect the employer covenant and will take a view as to whether it needs to be notified to the trustees. In effect, it acts like a filter." Insurance Company

2.4 *The FTSE 100 experience*

We asked pensions managers at 20 FTSE 100 companies about the role of company executives in relation to their scheme's trustee board. There were mixed views about how best to deal with the potential conflicts of interest while still ensuring good flows of information between the trustees and the company.

- All 20 pensions managers were aware of the potential conflict in having company executives on the trustee board
- Seven of the 20 said that main board directors did serve on the trustee board
- A further four said that the HR director was on the trustee board, but he or she was not a main board director
- In the remaining nine companies, company directors did not serve on the trustee board
- Where directors serve as trustees it was argued that the knowledge they bring to the trustee board outweighed any potential conflict
- Where directors did not serve on the trustee board, arrangements were in place to ensure there was a continued dialogue between the company and the trustees
- In some cases a sub-committee of the parent company board was charged with the task of negotiating with the trustees, while in others the FD or the HR director would be in attendance at the trustee board or the sub-committee meeting, although not in the formal role of a trustee
- Eight of the 20 pensions managers noted that their scheme had independent trustees as members of the trustee board or serving as chairman

2.5 *Trustee board governance issues for SMEs*

Smaller companies face particular problems in finding people outside the board who have the necessary knowledge and ability to be trustees.

> "It is not uncommon in small organisations for management to take on multiple roles. It could be that the senior management are the only people qualified to weigh up and make decisions based on complex financial matters. The company may simply not be able to afford the training costs for other employees to be prepared to take on such a role." Consultant to SMEs

> "We haven't reached the point where FDs shouldn't be there – but company trustees must know when it's time to stand down. This will be particularly difficult for SMEs, where the FD drives the trustee board." Consultant

2.6 *Independent trustees: Increasing demand?*

Many schemes already use professional or independent trustees. Strictly speaking these are different roles, although the terms tended to be used interchangeably by respondents. Professional trustees may have an interest in the scheme, for example they may do other work elsewhere for the company or they may be ex-employees who are also scheme members. The Pensions Management Institute describes independent trustees as:

"An individual or corporate body with no direct or indirect involvement with the pension scheme, employer or members, other than performing the duties of the trustee." PMI, www.pensions-pmi.org.uk/trustees

In theory, as conflict becomes more common, independent trustees will be in increasing demand, but most respondents, including the independents themselves, said that their skills and expertise could not replace the company knowledge of company directors and MNTs. Overall, two thirds of respondents felt there would be a greater need for independent trustees but, separately, about half said they were concerned about the loss of the company's control of the pension scheme and the additional costs incurred.

> "There is a growing need for professionals in the light of the withdrawal of company trustees and falling interest in MNTs." Investment bank

> "A good board would be a mix of professional and non-professional trustees. The professional trustee should not dominate the board." Consultant to SMEs

> "Some employers don't want more professionals and they shouldn't be seen as an alternative to replace MNTs. It can lead to loss of control for the company." Consultant

2.7 *Cost of independent trustees an issue*

Cost is an important consideration in the decision to hire independent trustees, especially for smaller firms.

> "To force schemes to employ independent trustees would be an added expense without necessarily adding any value." Pensions lawyer

> "The problem is that the professional might say to a small scheme that the cost will be £5000 a year but will then insist on doing an audit and may bring in a lawyer – and before you know it the scheme has got a bill for £30,000 for sorting out quite minor points. That doesn't help the scheme move forwards and it's £30k that could have gone into the scheme." Consultant to SMEs

> "Ironically it's the SMEs that would benefit most because of the likelihood of governance problems – the boards are far less formal than in larger companies. The only way independent trustees might work [from the cost perspective] is if the appointment led to a direct reduction in the PPF levy, for example." Consultant to SMEs

2.8 *Quality of independent trusteeship questioned*

There were also concerns about the quality of independent trustees and their ability to recommend controversial decisions without exposing themselves to criticism and blame.

> "Some of the big firms of independent trustees I've seen in action are a disgrace. Forever double dipping – taking fees from the scheme but not taking real responsibility. Their priority is protecting themselves. They may find life less comfortable in future." Pensions lawyer

"Independent trustees need to be more creative and to reconsider their business model." Asset manager

"If the proverbial hits the fan the professional trustee is first in the firing line. They are going to need deep-pocket insurers." Pensions lawyer

Section 3: Trustee knowledge and understanding

The new requirements for Trustee Knowledge and Understanding (TKU) may alienate older, highly capable trustees who have the ability to ask important, commonsense questions. Furthermore, many respondents think the target of having 50% member-nominated trustees is unworkable and undesirable.

The Act reinforces the requirements for one third of trustees in each scheme to be nominated by members and creates powers for the Secretary of State to increase the required proportion to one half at some future date. Furthermore, the Act sets out a number of areas relating to their own scheme and pensions matters in general with which all trustees must be familiar. The Regulator's Code of Practice on TKU sets out 13 areas it expects trustees to be conversant with.

What the Act says:

241 Requirement for member-nominated trustees

The trustees of an occupational pension scheme must secure that arrangements are in place that provide for at least one third of the total number of trustees to be member-nominated trustees.

243 Member-nominated trustees: supplementary

The Secretary of State may, by order, amend section 241 to require that at least one half of the total number of trustees be member-nominated trustees.

247 Requirement for knowledge and understanding: individual trustees

An individual who is a trustee of an occupational pension scheme must be conversant with:

- the trust deed and rules of the scheme
- the statement of investment principles
- the statement of funding principles
- any other document recording policy for administration of the scheme

An individual who is a trustee must have knowledge and understanding of:

- the law relating to pensions and trusts
- the principles relating to the funding of occupational pension schemes
- the principles relating to investment of pension scheme assets

The degree of knowledge and understanding required is that appropriate to enable the individual properly to exercise his functions as a trustee of any relevant scheme.

3.1 *Middle managers to replace older, more experienced trustees*

Almost all respondents support the continued role of the lay trustee. Only a few felt that the days of the amateur should be over. However, most respondents were concerned that the nature of lay trusteeship would change under the Act and that TKU would, over time, force out older trustees who do not have A-level or university education, and encourage middle managers to take their place. This would weaken the diversity of the trustee board as a whole.

All respondents thought that the most important role of the lay trustee is to ask searching questions of the professional advisers to which the trustee board delegates the management of the scheme assets. The Pensions Management Institute puts it this way:

'Trustees are not, however, specialists in any area of pensions management – the effective trustee will have a broad general knowledge and will be able to ask the right questions of the many professionals engaged in the efficient running of pension funds.' www.pensions-pmi.org.uk/trustees

3.2 *Amateur trustees: Highly valued*

There was widespread positive comment on the contribution from lay trustees.

> "Amateurs do a fantastic job." Pensions lawyer

> "In my experience the idea of amateur trustees does work. If you have the right individuals who are enthusiastic, their amateur status keeps them just distant enough to ask the obvious questions and cut through the jargon."
> Pensions manager

> "Lay trustees make commonsense decisions and ask commonsense questions. They also understand the company ethos and this is important where they must make discretionary payments on early retirement and ill health. They can reflect the company's benevolent attitude or whatever this attitude might be. Without lay trustees we don't get a feeling for how the whole organisation runs itself." Trustee

> "Lay trustees who work for the company add an enormous value to the trustee board. They are not supposed to be managers; they are directors, like non-executive directors – of the trust. Their job is to delegate tasks or to outsource the work and receive reports." Trustee

> "What concerns me is that TKU is using a sledgehammer to crack a nut. The role of the enthusiastic amateur has a lot going for it. Some of the most effective trustees I have experience of have been the workers' representatives in an industrial company – shop floor workers. They were not financially educated, but they were quick to learn. The most testing questions came from these people and it would be a shame if they were excluded from the process."
> Trustee

> "Member nominated trustees use a high degree of commonsense and ask the important, often awkward, questions. Moreover they have a vested interest in the scheme. What lies ahead is Blairism in pensions – decisions are being taken

away from anyone who is classed as a non-expert, even if they are experienced employees who understand the company. We need to maintain democracy in pension decision making." Asset manager

3.3 *Meeting required standards*

On the other hand, a few respondents were less sure of the ongoing role of MNTs in the light of the Act's requirement for trustees to behave in a more businesslike, expert manner.

"We have to question the role of amateurs on a board that the Regulator expects to be run as a corporate entity with control, risk management, and accountability." Accountant

"Democracy is a wonderful thing, but if you are looking for people to serve on the board of a complex financial organisation, you need them to have certain characteristics. Democracy may not produce these characteristics, especially in non-financial companies." Trustee

3.4 *TKU to drive choice of trustees*

The changing legal requirements are highly significant and respondents felt it was imperative that MNTs fully understand their responsibilities.

"There is still a role for [amateur] trustees but they should not take on the role lightly. Along with much greater power is much greater responsibility." Investment bank

"Amateur trustees still perform a vital role. But they really do need to understand the advice they receive and act on." Consultant

"The enthusiastic amateur is being replaced with the educated amateur – it will change the nature of the lay trustee moving the job up the management scale. MNTs increasingly will be drawn from middle management." Consultant

"Some, who bring the traditional common sense expected of an amateur trustee, do not have the interest in learning about pensions law and investment, while others simply don't have the aptitude." Consultant to SMEs

3.5 *One third MNTs sufficient*

Without exception respondents thought that the requirement for one third of trustees to be member-nominated was adequate and that to go further would be unrealistic and would serve no clear purpose.

There were questions about where an adequate supply of competent trustees would come from. Initially we assumed that this would mainly affect SMEs. However, the majority of the FTSE 100 pensions managers we interviewed also said that it was already difficult to fill MNT places, although some said they had found no problem at all. All of the pensions managers agreed that it was likely to become more difficult to fill these places as the responsibilities and knowledge requirements are increased.

Some respondents also raised concern over the difficult position of MNTs in conflict situations where they had to oppose more senior members of the company. While this has always been an issue, the deficit recovery process will exacerbate these relationship problems.

> "It's time we recognised that trustee boards do not behave like the textbook rational investor. MNTs sitting opposite their boss will be very worried because they will fear that if they make difficult demands about employer contributions they will mark their cards in terms of future promotion."
> Investment bank

Scheme members were also aware of this problem:

> "You've got to have a strong person in there. They have to be prepared to put their head above the parapet." DB scheme member

> "The company representative could be the employee representative's boss."
> DB scheme member

The employees we spoke to could see the benefit of having some MNTs, but not too many. They were keen to see that "experts" were overseeing their funds.

> "I would have thought the best people to make these decisions are specialists in the field." DC scheme member

> "I think 50% is too many. It's good to have representatives to hold people accountable, but the balance should be experts." DC scheme member

3.6 *Trade union trustees: A useful source of MNTs*

The knowledge of union-trained trustees was highly rated by the majority of respondents. The TUC has trained over 1,000 members for their role as MNTs and provides both initial and ongoing training. More detail is available at www.tuc.org.uk/trusteenetwork

> "There is a growing recognition of the role union-trained trustees can fulfil."
> Investment bank

> "Union representatives probably can't be regarded as impartial, but there is an explicit acknowledgement now that no member of the trustee board is likely to be impartial." Investment bank

> "Union MNTs generally do not rock the boat – they know that jobs are on the other side of the pensions coin." Consultant

> "In my experience when a union trustee joins the board he or she quickly discovers just how difficult the employer's position is and how complex the role of trustee is. It is helpful for the union to understand the dilemmas the employer faces." Pensions lawyer

> "MNTs often come from unions which run good training courses and therefore are a useful addition to the board. But in general there is a marked decline in interest from members." Consultant to SMEs

3.7 *Will TKU be counter-productive?*

The vast majority of respondents regarded the TKU requirements as stretching for lay trustees. Many worried that the requirements would be counterproductive by deterring otherwise capable employees from the trustee role.

> "The schedule of areas where trustees are expected to be knowledgeable is a very formidable list. How on earth can they expect the ordinary trustee to get to grips with all this – it's unrealistic?" Trustee

> "TKU has been likened to an A level – it's a lot of work for someone who may not be professional and has a full time job. Many trustees are in their 50s and won't have studied for decades – in fact many left school at 15 or 16." Consultant to SMEs

> "TKU is tough and may have the opposite effect to the government's intention. It is important to distinguish between competence – which can be measured in qualifications - and capability – which relates to experience. Capability is the more important factor. In most larger companies the MNTs tend to be the older employees, who may lack a prolonged formal education and who will find the prospect of taking A-level trusteeship daunting. They will leave in droves. In their place, where employees do volunteer, we will see younger, 'better educated' employees from middle management. In ten years time trustee boards will be strong on competence and weak on capability. Pension schemes need the 45-65 year olds." Asset manager

> "The problem will get worse as trustees need to get to grips with more complex instruments such as letters of credit, credit default swaps etc. Even their advisers have problems with these." Investment bank

Furthermore, the problems with TKU weren't thought to be confined to MNTs. One respondent doubted whether company-nominated trustees would be able to find the time to meet the requirements.

> "Busy directors and senior managers simply won't have the time to learn about all the issues they are required to be familiar with. You will have to go down into the company to find people who have the time to learn what is now required, but those people may be less able and will certainly be less influential and have less clout." Trustee

3.8 *TKU should be at board rather than individual level*

Many argued that the requirement for all trustees to have the specified knowledge was misguided. The key issue is the skill set of the trustee board as a whole, and this requires a wide range of experience, qualifications, and personalities.

> "Why should there be such a distinction between the trustee board and the company board? Company directors don't have to demonstrate a specific level of knowledge and understanding – they don't have to go on training courses. Trustees bring common sense to the table not investment expertise. With good advisers this works." Pensions lawyer

"There is a contrast between the arrangements for a corporate board – where the board has to have the required skills as a corporate body – and the requirements of these regulations where every individual [trustee] is expected to have the knowledge to a certain level." Trustee

"The trustee board is like a company board – it is comprised of a range of individuals with diverse skills and it is the sum of these diverse skills that makes the board work. TKU should apply to the trustee board as a whole rather than to individuals." Asset manager

"On the board there should be a range of skills – there is no sense in them all having the same skills. Good governance calls for diversity. On a company board nobody expects the sales director to be an accountant." Trustee

Some respondents doubted the practical impact of the requirements.

"Trustees will continue to rely on their actuaries with or without TKU – probably too much reliance in fact. If you are a non-professional employee it is easy to be overawed by someone who is articulate and speaks a technical language." Consultant to SMEs

"It will work well enough as long as it's not overly policed. It's similar to juries – if we only have experts then we remove plain common sense from the judgment and that would be a terrible loss." Pensions lawyer

Section 4: Actuarial advice

The business model of actuarial and investment consultants is under scrutiny and expected to change. They have built their businesses on a model that assumes they will advise both the trustees and the sponsoring company. The Act may make this approach untenable.

The Act raises important questions for the sponsoring company and the trustees in the use of actuarial and investment advice in conflict situations – most notably the recovery period strategy. The sponsor and the trustees may have very different views on the employer contribution level and the asset allocation of the fund. Trustees are likely to demand greater security in the form of high employer contributions and a more conservative asset allocation, whereas sponsors may prefer the reverse.

What the Code of Practice says:

The Pensions Regulator's Code of Practice on Funding Defined Benefits (22) provides guidance on the issue of advice for the employer. It offers three options:

- The scheme actuary provides a calculation service for the employer, with all calculations and advice copied to the trustees. In this case the actuary cannot recommend different things to each party, which puts a constraint on the trustees.
- A colleague of the scheme actuary provides advice to the employer based on calculations done by the scheme actuary. In this case the calculations should be provided to the trustees, but the advice need not.
- An actuary from another firm is appointed to give advice to the employer based on calculations done by the scheme actuary. In this case the calculations should be provided to the trustees, but the advice need not.

4.1 *Regulatory guidance needed on adviser's position*

It will come as no surprise to learn that respondents had very different points of view over the appropriate response to the potential conflicts of interest. Some respondents thought it was possible to continue with a single firm as long as care was taken and separation of advice put in place when there were signs of conflict. However, this approach hinges on individual consultants being able to decide the precise point at which separate firms must be used. Most felt that the Regulator should provide clearer guidance on what is and is not acceptable.

> "This is getting much more difficult. In the past advisers have spotted conflicts and taken action – now they have to spot potential conflicts far sooner and that's going to be tough." Pensions lawyer

> "At the moment they clearly can and do [share advisers] – we need an indication from the Regulator on what is acceptable and what is unacceptable." Consultant

"Trustees and the company are usually happy to share factual information on the assumptions used and the impact these have on the recovery period. Both parties can ask the adviser to prepare figures based on different assumptions and different recovery periods. Confidential advice is relevant in the interpretation of these facts and in the recommendations, conclusions and tactics each party might adopt." Consultant

"A lot of employers are saying they will continue to use the same firm of actuaries, but what they want is number crunching rather than advice. If there is a point of conflict and they require advice, they will go to another firm." Insurance company

"The scheme actuary can provide all the data – the company can use a separate actuary to act on this data and ask the scheme actuary relevant questions." Trustee

4.2 *Serious conflict requires separate advisers – but what is 'serious'?*

While the basic actuarial data can be shared, all respondents agreed that in very serious conflicts the trustees and company would need separate advice.

"The era of trustee and plan-sponsor conversations about funding and investment being brokered by the trustee's adviser is coming to an end." Consultant

"There needs to be a clear separation of advisers for deficit issues." Investment bank

"Lawyers are appalled that the same advisers can act for both sides. Actuaries are perpetuating a situation that will create conflicts because they want to hang on to the business." Accountant

"The decision to use separate advisers in certain circumstances is not confrontational – it's good practice. An adviser can't act in your best interests as well if the firm is acting for both sides, as it can if it is just representing your position. There are certain situations were it is impossible for an adviser to represent both sides." Trustee

4.3 *Separate firms or Chinese walls?*

Opinion was divided, however, as to how separate advice could be delivered – whether this would require separate firms or could be dealt with by different partners in the same firm. Over half of respondents – including some of the consultants themselves – said that attempts to create Chinese walls are likely to backfire.

"It's very simple. If I feel that I am unable to do the job, then it shouldn't go to one of my colleagues." Consultant

"It is impossible to establish effective Chinese walls." Investment bank

"The company and trustees should have separate advisers if there is a deficit. Chinese walls don't work – you need separate firms, otherwise the advisers are setting themselves up for a fall. Two actuaries from the same firm working for different parties only have to be seen out drinking together and the walls disappear." Accountant

"In some cases the company is using a separate actuary for everything – but it is important to avoid extra costs. In the case of sensitive issues the company must use a separate firm – it is no good going to a different partner in the same firm." Trustee

In cases where advice from separate firms is necessary, respondents said that the existing actuarial firm should continue to serve the trustees and that it would be the corporate sponsor who would seek a separate view.

Conflicts of interest in the legal, accounting and actuarial professions

The accounting, legal and actuarial profession all have codes of conduct that outline how members and member firms should deal with actual and potential conflicts of interest.

The Law Society's Code of Conduct states that law firms should not act if there is a conflict of interests which it defines as the case where *"you owe separate duties to act in the best interests of two or more clients in relation to the same or related matters and those duties conflict, or there is a significant risk that those duties may conflict."*

The Auditing Practices Board notes the existence of a "self interest threat" to objectivity where the firm has economic dependence on a client. In particular *"where substantial fees are regularly generated from the provision of non-audit services, and the fees from non-audit services are significantly greater than the annual audit fee, the audit firm has regard to the possibility that there may be perceived to be a loss of independence."* The provision of non-audit services to audit clients has declined substantially in recent years in light of this potential conflict.

Some respondents thought that a 'self interest threat' could arise from an actuarial firm obtaining greater fees from the corporate sponsor than from the trustees.

"Part of it [the issue of separate advisers] comes down to money, even if different partners are involved. If the trustees are paying £30,000 for basic actuarial advice and the company is paying the same firm £500,000 for full pensions accounting, the firm's interests are clear." Pensions manager

The Actuarial Profession's Professional Conduct Standards give guidance on conflicts of interest.

"If there is or might appear to be a conflict of interest between two or more clients of a member or of the member's firm, or a conflict between a client and the member or the member's firm, the member must consider the nature and extent of the conflict and whether it is such as to make it improper for the member to give advice to one or more of the clients involved in the conflict."

The standard requires any conflict to be disclosed when advice is given to a client and for the member to not disclose within his or her firm any information he or she has reason to believe may harm the interests of a client.

4.4 *Cost of separate advisers: issues for SMEs*

Most respondents said that the best practice of using separate advisers unravels when it comes to smaller companies, which are likely to stick to a single adviser due to cost rather than desire.

> "The big schemes can afford two actuaries, but the smaller ones can't. The cost will be much higher than just two separate actuarial fees because the actuaries will have to negotiate with each other – it will become defensive actuarial work." Pensions lawyer

> "For SMEs most of the advice should be shared. They simply can't afford a separate adviser and it's better that one actuary does all the work – it provides more joined up thinking." Consultant to SMEs

> "There isn't a cost-effective way for SMEs to pay for two advisers. They find it hard enough to pay for one actuary, let alone the PPF levy and a second actuary. In practice directors of SMEs won't bother getting separate actuarial advice and will try to argue their own corner." Consultant

> "The trend [towards separate advisers] will be less marked for smaller employers – they'll simply take less notice of the Act." Trustee

4.5 *Trustees and asset managers: A closer dialogue in future*

Most respondents said that the actuarial and investment consultants generally did a good job. However, outside of the consultancy sector many providers of services to pension funds felt that the near-monopoly consultants have over investment strategy and the appointment of asset managers is likely to be eroded. The greater pressure on trustees to understand and engage with complex investment strategies in future may make them bolder in questioning their investment adviser and in talking directly to banks and asset managers. Understandable the most vocal respondents in this section are asset managers but a minority of consultants openly acknowledged that they expect a closer dialogue between trustees and asset managers in future.

Respondents noted that many trustees already engage in direct dialogue with asset managers and they anticipated that this trend would grow, albeit at a slow pace, and that this may dilute the consultants' control over the investment strategy.

> "Trustees and employers feel that they have to liaise with too many parties and that advisers are insufficiently accountable for the implementation of the advice they give." Asset manager

> "We have always wanted to avoid the situation where the consultant acts as gatekeeper to the scheme and that status is finally being eroded." Asset manager

> "Asset managers are already approaching trustees directly – they are rebadging their services. Manager of managers already incorporates a consultancy element." Consultant

> "The rationale of the managers is that if they can forge a strong relationship with the funds it might help them to either get on the short list for upcoming

mandates – even if the scheme investment consultant would not normally put them up for such a mandate – and it might give them a head start when it comes to the beauty parade. Managers might also believe that direct contact with funds will allow them to circumvent the whole beauty parade process but I think this is unlikely." Asset manager

"Investment consultancy is being broken up post Myners, so that actuarial and investment are separate. Within investment, asset allocation and manager selection are also being separated. Once the asset allocation is decided the manager can go direct to the trustees. Where asset managers get involved in asset allocation they may be conflicted – for example, they get much higher fees on the active equity portfolio than on passive and on fixed interest." Consultant

"Most asset managers would like to form some sort of direct relationship with the pension funds that they are targeting, while at the same time recognise the need to remain on good terms with the consultants to these schemes." Asset manager

4.6 *Asset managers and consultants need to address changing relationship*

In some cases, it was clear that the asset managers and consultants do not always see eye-to-eye. Some respondents also noted that as investment becomes more liability focused investment banks would have a greater role to play and were taking on actuaries to provide a broader service to pension schemes.

"Asset managers don't necessarily understand the liabilities and commitments – only the actuary can bring that information to the table. The investment consultant is independent and has no interest in which managers are appointed." Consultant

"Consultants say asset managers cannot be impartial but many of the consultants now offer a manager of managers service so this point must also apply to them." Asset manager

"We will certainly see more of the banks in this arena – they pose the greatest threat to consultants, as they are hiring actuaries to offer competing services." Consultant

"Investment banks represent the biggest competition to consultants and will become more influential over the next five years, offering swaps and derivative solutions to pension scheme problems. A lot of asset managers are also taking on actuaries and building their resources so they can offer asset-liability modelling, manager of managers solutions, and liability-driven investment." Asset manager

Section 5: Clearance procedures

The Regulator's Clearance procedures are likely to favour trustees but may create problems for employers.

The Pensions Regulator runs a clearance procedure whereby companies that engage in corporate finance transactions that could be construed as counter to the interests of the pension scheme members – for example transferring assets that could be used to fund the scheme – can apply for a ruling from the Regulator. The purpose of the ruling is to confirm the Regulator's opinion that the transaction is for bona fide purposes and is not detrimental to the strength of the covenant and the position of trustees as unsecured creditors. In the absence of this clearance, companies could find transactions challenged after the fact and parties to them may become liable to support pension schemes in deficit.

What the Act says:

38 Contribution notices where avoidance of employer debt

The Regulator may issue a notice to a person stating that the person is under a liability to pay the sum specified in the contribution notice either to the trustees of the scheme or to the Board of the PPF, where the PPF has already assumed responsibility for the scheme.

The Regulator may issue a contribution notice to a person only if the Regulator is of the opinion that the person was party to an act or a failure to act the purpose of which was to prevent the recovery of all or part of the pension debt that would otherwise become due from the employer. The person has to have been in the relevant period either the employer in relation to the scheme or a person connected with, or an associate of, the employer.

42 Section 38 contribution notice: clearance statements

An application may be made to the Regulator for the issue of a clearance statement. A clearance statement is a statement made by the Regulator that, in its opinion in the circumstances described in the application, the applicant would not be for the purposes of Section 38 a party to an act or failure to act and that it would not be reasonable to impose a liability on the applicant under a contribution notice.

Where an application is made for clearance, the Regulator may request further information from the applicant and may invite the applicant to modify the circumstances described.

A clearance statement binds the Regulator in relation to the exercise of the power to issue a contribution notice unless the circumstances that give rise to the exercise of the power to issue a contribution notice are materially different to the circumstances described in the application.

5.1 *FRS17 funding appears to be a prerequisite for clearance*

Full funding on an FRS17 was widely considered to be the key benchmark the Regulator is using at present to determine clearance applications. Respondents said this raised serious concerns about the Regulator's power to use clearance as a means to secure an immediate improvement to scheme funding.

> "The Regulator seems to be taking FRS17 solvency as the basis for negotiation. If a scheme falls below this then the Regulator will use clearance as an opportunity to force the employer to improve scheme funding." Pensions lawyer

> "It seems that if there is a deficit on an FRS17 basis then the Regulator is very interested in the situation and keen to have the scheme looking better after clearance than before. If there is an FRS17 surplus the Regulator is less interested." Insurance company

> "It looks like getting to 100% funding on FRS17 will get the Regulator off your back." Pensions manager

> "The Regulator is using FRS17 as a pragmatic proxy for PPF funding at present – if you've got this it is likely to give you clearance and if you haven't you'll have to get there first. In due course it will move to the PPF funding level and in most cases this will be higher than FRS17. This will make it difficult for trustees when they look at prudent funding for SFO – will they assume that FRS 17 or PPF funding is adequate in general if it is adequate for clearance?" Consultant

> "The Regulator seems to be adopting FRS17 as a de facto minimum funding rate and this is very questionable. FRS17 is a corporate accounting standard and a single line in the sand – it was never designed as a de facto minimum." Consultant

5.2 *Clearance opportunities for trustees*

The clearance procedures are regarded as a major change for trustees and one that is, on balance, positive for them and for scheme members in that trustees can usually use the process to secure additional funds for the scheme.

> "The first question the Regulator will ask is about conflicts – clearance asks if there are conflicts and it asks if trustees support the corporate activity." Consultant

> "Clearance is a powerful tool with which to enter discussions about restructuring at an early stage. Historically trustees would never have been involved in M&A discussions, so this is a huge change in corporate dynamics." Investment bank

> "[The clearance procedures] will help trustees to help members, particularly in getting money into the scheme that might not otherwise have been contributed by the employer. Employers will have to 'buy off' trustees now before corporate action." Consultant

> "I think the Regulator has said that in the first 50 cases to come for clearance, they have improved the position of the trustees in 48 of them." Insurance company

5.3 *Trustees' greater involvement in corporate activity*

Involvement in the clearance procedure does bring complexity for the trustees, in terms of analysing the situation and negotiating their position with the company.

> "Clearance helps trustees to think of the bigger picture – that is, the welfare of the company as a whole. In the past they have concentrated on the contribution rate and investment strategy – often in isolation. Now the future of the company and the implications of any corporate deals for the covenant are firmly in their minds." Consultant

> "Initially I thought [the clearance procedures] would be too complicated but now I think they will be a massive help to trustees. They push trustees to adopt a formal approach and to seek professional advice. But there will be a big cost in terms of the need for separate advisers for the trustee and company board, preparing reports, arbitrating etc." Accountant

> "Employers and trustees need to agree protocols for joint management of the Regulator and clearance. Trustees and the company need to decide who will coordinate clearance submission – this could be the accountant or solicitors. Corporate solicitors will be better than pensions solicitors at this because they need to understand the business." Accountant

5.4 *Trustees to be party to sensitive information*

One key issue surrounding clearance is that trustees will be informed of corporate activity at an early stage as the employer seeks their agreement as part of the application for clearance. Respondents stressed that lay trustees must appreciate the sensitive nature of corporate information, including the risks of falling foul of the Financial Services Authority rules on insider trading and market abuse. Many respondents felt that confidentiality agreements were not a guarantee of ensuring information was kept within the trustee group.

> "The Regulator will expect that the company and the trustees will have discussed the issues before the company applies for clearance. Trustees will be dragged into non-public transactions." Pensions manager

> "The employer's biggest concern is confidentiality, as very different parties (trustees and their advisers) will now be involved in early discussions on corporate activity." Investment bank

> "The trustees need to be involved at an early stage in corporate activities but there is a real risk of leakage." Accountant

> "It seems to be manageable but no doubt there will be failures to manage confidentiality from time to time. Bringing trustees in at an early stage in restructuring, for example, is a new development, so we don't really know yet." Pensions lawyer

> "Trustees need to understand their position on confidentiality under the FSA rules as well as under the Pensions Act." Investment bank

> "Trustees will have to sign confidentiality agreements – but there has to be doubt as to whether all lay trustees understand the legal implications." Trustee

"It is clear that in many cases the trustees will become insiders. That has to be a precursor to the discussions, with everyone made aware of the implications." Insurance company

5.5 *Clearance introduces risks for employers*

The clearance procedures are also regarded as a big change to the corporate finance landscape and one that will have major implications for companies and their advisers. The power to issue contribution notices and financial support directions, in effect to 'unpick' transactions that weaken the security of the pension scheme, creates new risks in corporate finance deals.

"This is the big issue for companies. What is new in this Act is that individuals can be held personally liable – they can't hide behind the corporate veil. If the Regulator decides to go after the company they can also go after the directors. MDs and FDs could end up losing their personal capital and their house – and they may not find out they are liable for a non-disclosure for five or ten years – they could be held to account years after an event in which they may not have been involved." Pensions lawyer

"Employers will find life more difficult when doing deals. The debt to the pension scheme has in the past been regarded as 'softer' than any of the other debts. That seems to have been wrong and the new rules mean the pension debt will be properly taken into account in any deal." Trustee

"It's having a big impact around here. Dealing with the pension scheme has turned into a prerequisite in any M&A activity and also in transactions such as share buybacks. Previously, as long as the buyer and seller were happy, everything was ok. Now it gets much more attention." Investment bank

5.6 *Full impact of clearance yet to sink in*

Several respondents expressed concern that a significant minority of companies and their advisers had yet to come to terms with the full significance of the Act on corporate activity.

"Corporate advisers are not necessarily aware of the huge changes that are taking place and the impact these will have on future activity following the Act." Investment bank

"There is a large body of companies out there who are unaware of the [clearance] procedures and of the problems that they can get themselves in." Trustee

5.7 *Employers' initial enthusiasm for clearance waning*

Respondents report mixed reactions to clearance from employers. Companies were keen to have the assurance that they would not be subject to a subsequent contribution notice or financial support direction, but less enthusiastic about the process interfering in their business or requiring accelerated funding for the pension scheme in order to receive the clearance. Some respondents noted that after an initial short period of enthusiasm employers are becoming more reticent to seek clearance.

"After their initial enthusiasm companies are saying they do not want to go down that road [clearance] and are willing to take the risk." Pensions lawyer

"Most of my clients are scared of the Regulator. There's a lot of anxiety over clearance and companies feel vulnerable. They want to know whether there is a downside." Accountant

"Companies don't like the concept of clearance. They fear interference in the way the company runs. In practice its success will depend on the quality of the Regulator's staff." Consultant

"They will perceive clearance as something that gets in the way of doing business, but it is not intended to assist the company, it is intended to help the scheme." Trustee

"Already we are finding that companies prefer taking the risk and are not going for clearance. The price they have to pay for clearance is faster funding than they might otherwise have negotiated [with the trustees] and the whole process could take so long they would lose their competitive advantage in a corporate action." Consultant

"Initially employers were quite keen – they thought clearance gave them a guarantee of safety from further regulatory investigation. Very quickly, however, employers have become wary. We need to see anonymous case studies from the Regulator to find out what led to the acceptance or rejection. We need to know why companies are turned down." Consultant

5.8 *Clearance costs a concern*

There was also concern about the costs of clearance.

"In our experience clearance can cost between £50,000 and £100,000 to cover the legal, actuarial and independent accounting advice. Smaller and medium sized schemes are going to really struggle with that." Pensions lawyer

"Employers will need to decide if they really need clearance – there are costs involved and it is time consuming – but if it turns out after the event that a sell-off or refinancing did need clearance then they will be in big trouble if it wasn't sought." Pensions lawyer

5.9 *Clearance offers no absolute guarantees against future intervention*

Further, there was concern that clearance is not an absolute guarantee of immunity to future action.

"Clearance only provides contingent cover on the basis of information provided – and the Regulator asks for a short summary, so companies are strongly discouraged from sending in a huge report. But if they miss anything out or something emerges several years later then clearance is invalid." Pensions lawyer

"If they go for clearance they will be managing a risk but there is no certainty that the risk is eliminated." Pensions lawyer

5.10 *The Regulator can pierce the corporate veil – within the EU*

One of the most important powers of the Regulator is its ability to assess and hold responsible for the problems of a single company, the group as a whole and the parent. However, the Regulator's powers to pursue money owed by a parent or group may be limited by geographical and political boundaries.

"The Regulator will not have any problems where it is clear which is the principal company and in these cases it might be able to secure assets for the trustees from different companies in the group behind the scenes. But it may struggle with complicated structures that involve non-UK companies. It will be difficult to impose contribution notices in these cases." Consultant

"There is a big question over foreign owned companies. In the EU there is the reciprocal cross-border agreement that although not compulsory most countries have signed up to – the 'reciprocal enforcement of judgements convention'. The question though is whether overseas courts will recognise the liability. Is this a civil debt or a regulatory debt? In general foreign courts do not enforce foreign regulatory fines or taxes. The jury is out on whether courts will take any action at all – for example in the US, Japan, China, and Malaysia." Pensions lawyer

"The process is designed to look through corporate structures to see who has accountability. It is important that the Regulator understands the nature of multinationals. In the case of a US parent, the UK company might look quite weak – because that is how US companies run the group, repatriating as much capital as possible to the parent. Trustees also need to understand that if the company is abandoned by a US parent they are in a potentially weak position. The Regulator thinks it can slap financial support directions on the overseas parent. Within the EU that might be possible but it is debatable as to whether this will succeed where the parent is outside of the EU." Consultant

5.10 *Employers likely to contest the Regulator's rulings*

Furthermore, companies are unlikely to accept the Regulator's decisions to apply contribution notices and financial support directions without question.

"Companies will test the Regulator to the limits and will challenge decisions – it could take five years if it goes to the courts, during which time there will be a period of uncertainty. The Regulator has a wide armoury but some companies will try it on. While the Regulator has very effective resources and people at present will it be able to maintain these over the longer-term?" Consultant

Section 6: Pension Protection Fund

There are serious doubts over the longer-term viability of the PPF.

The Act creates the Pension Protection Fund, which is designed to underwrite a proportion of the pension benefits of members of underfunded schemes where the employer becomes insolvent. Existing pensioners effectively receive their benefits in full, while non-retired members receive 90% of their benefits up to a cap, which is currently set at £25,000 per annum.

Respondents generally welcomed the concept of the PPF. Some also noted that it was a politically astute move on the part of the government.

> "The idea of PPF looked good on the front page of the Daily Mail. Somehow it has got to be made to work." Trustee

The scheme members we spoke to also thought the PPF was a valuable protection and one they would, within reason, pay for.

> "It wouldn't be a bad thing, knowing that what I have saved is protected." DB scheme member

> 'It's a belt and braces approach." DB scheme member

> "It does give you confidence." DB scheme member

6.1 *Will the PPF have to cut benefits and/or increase the levy?*

However, most of our professional respondents were sceptical that it could work beyond the short term, at least as currently structured. On this point almost all respondents were concerned that the PPF is too ambitious and must either cut the benefits it offers to scheme members or increase the levy it charges to schemes; probably both. Respondents agreed that the PPF could survive over the short and medium term as it is currently financed but as schemes close, mature, and wind up the 'tax base' for the levy will shrink and the government and taxpayer will be forced to address controversial questions.

> "It's a short-term fix and that's welcome. In the long term the PPF is unstable. It faces a diminishing taxable franchise – that is, the number of available scheme to levy will fall – and a rising liability." Pensions lawyer

> "In the short term the PPF will work, yes – say the next 5-10 years. In the very long term it will have no more DB schemes left to cover, so its role is finite, albeit lasting many decades." Consultant to SMEs

> "The worry I have is that at some stage the PPF will run into funding difficulties. That's not an 'if', it's a given. At this point the PPF will have to increase the levy or reduce benefits, or the government will have to step in. Once the future of the PPF becomes a political issue governments will be reluctant to face it openly and will be inclined to let the problem build up behind the scenes. The situation will get worse and worse until it is too late to save it." Consultant

6.2 *PPF exposed to uncontrollable risk in the event of an economic downturn*

In the longer term, the PPF's viability will depend largely on the state of the economy.

> "Beyond year ten it will start to get tricky – if not before – because it will be swamped. PPF is so dependent on the economy – if we move into a downturn within the next five years then the PPF is going to be in big trouble because a lot of companies will go bust before they've had time to meet the recovery plan. If we go into a recession the PPF will be in danger of collapse – it will be forced into an increasingly unsustainable actuarial position." Consultant to SMEs

> "The PPF is not a sound proposition – it depends on demand and that depends on the economy. This is the real moral hazard – it's beyond the control of politicians, employers and schemes, as well as the Regulator and PPF. Tensions will rapidly emerge between the Regulator's desire for aggressive gung-ho negotiations on the part of trustees with the employer and for trustee prudence in the investment strategy." Consultant

> "The PPF is a political construct. It was not established as a life office and not established as a DB pension fund, but rather something in between. It is a fudge. There is a serious risk that the PPF will get into financial difficulties because it is a fudge. They have tried to balance the demands for protection with the concerns that employers will have to pay for it." Insurance company

Only a small minority of respondents thought there was a long-term future for PPF.

> "There is no reason why it cannot work and the comparisons with the US are misleading. We don't have an equivalent of Chapter 11 and so liquidation in the UK is a step taken much less lightly. Also the premiums for the PBGC have to be approved by Congress, so they are not really risk based and they can't be changed easily. A better parallel is the mutual insurance arrangement in place in Germany for the book reserve system. There have been some big corporate failures, but the system has coped without undue difficulty." Trustee

6.3 *PPF levy forces stronger employers to subsidise the weak*

A key issue for many respondents was the effective cross-subsidy from well run schemes to weak or failing ones.

> "Big plcs are very angry because they are picking up the can for disreputable companies – they are now having to pay the levy to bail out the rest." Accountant

> "The PPF is just a mechanism to transfer risk. You can move risk around and you can share it but you can't bring down the total level." Asset manager

> "In theory the PPF can meet its objectives but this is political. The government has effectively given the PPF the power of taxation." Consultant

6.4 *Will larger schemes move offshore?*

Some respondents thought that larger, well-funded schemes would take action to avoid the levy.

> "The PPF is about politics, not pensions but it is still worthwhile. In theory, yes, it can meet its objectives, as it has the power to raise levies. But this is politically unsustainable and will impose an unacceptable cost on ongoing schemes. We will see schemes setting up outside the UK to avoid the levy. This is already being considered. Employers will close the final salary scheme and set up a new scheme for future accrual elsewhere. PPF covers registered UK schemes only – so it would not cover a pan-European scheme established in Ireland, for example, even if it had UK members." Consultant

> "The big multinationals will take their schemes offshore and avoid the levy. The forthcoming European directive says that a pension scheme can be in any EU country and still receive tax relief. No big scheme has moved out of the UK yet but it's going to happen." Pensions lawyer

6.5 *PPF compensation too high?*

The two interrelated issues here are how much the PPF should pay as compensation – and most respondents felt that the cap at £25,000 was too high – and the amount of the levy that schemes of solvent employers pay to fund the PPF. Most respondents thought the total levy would turn out to be significantly higher than the initial indications of £300m per year.

> "The Government is calling it an insurance scheme. During the parliamentary process they were fond of using the word "guarantee" – which is actively misleading. There is a power in the Act for the secretary of state to reduce the benefits if the fund hits financial difficulties." Insurance company

> "The monetary limits will have to come down or the levy be increased substantially." Consultant

> "£25k is too high – it will need at least £500m per annum to meet its liabilities and again it depends so much on the economy as to how pressed it becomes." Consultant to SMEs

What the Act says:

175 Pension Protection Levies

Each year the Board of the Pension Protection Fund must impose a risk-based pension protection levy and a scheme-based pension protection levy in respect of all eligible schemes. The risk-based levy must make up at least 80% of the total amount raised.

A risk-based pension protection levy is assessed by reference to:

- the difference between the value of the scheme assets and its protected liabilities
- the likelihood of an insolvency event occurring to the employer

The Board may also take account of the risks associated with the nature of the scheme's investments when compared to the nature of its liabilities.

A scheme-based pension protection levy is assessed by reference to the amount of the scheme's liabilities to members

The Board may also take account of the number of persons who are members of the scheme and the total amount of pensionable earnings of active members of the scheme.

178 The levy ceiling

The Secretary of State must, before the beginning of each financial year after the initial year for which levies are required to be imposed, specify by order the amount which is to be the levy ceiling for that year. For the first year the Treasury must approve this ceiling. For subsequent years the ceiling amount can be increased in line with aggregate earnings. Increases greater than this require the approval of the Treasury.

The PPF has published an estimate of £300m for the 2006/07 total levy, but more recently has acknowledged that other commentators estimate higher amounts.

6.6 *Concern over PPF investment strategy*

Some respondents noted that it would be ironic if an underfunded PPF were forced to 'bet' on investment returns to meet its financial needs.

> "It depends on the levy ceiling – this needs to be more realistic. Like any pension scheme PPF has two sources of income to pay benefits – the levy and investment returns. There will be serious problems if PPF is forced to depend too heavily on the investment strategy." Investment bank

> "If it doesn't get enough money through the levy it will have to adopt a more aggressive investment strategy – the very position that DB schemes are in regarding the contribution/investment strategy balance." Consultant to SMEs

6.7 *Political debate over levy and benefits ahead*

Having introduced a comparatively low levy and high benefit guarantee it will be hard for the government to make any significant changes without undermining confidence in the PPF. All of the options bring political problems.

> "The government has got to make it work – even if this means providing financial support. Otherwise there will be no confidence in DB at all. This will put the government in a tough position, as it has tried to distance itself from backing DB promises." Consultant to SMEs

> "Although the PPF can reduce benefits marginally, if a significant reduction is necessary it will have to be the Secretary of State for Pensions who takes this step so it will be a high profile political move." Consultant

6.8 *Regulator as gateway to the PPF*

The Regulator has an important role to play in improving pension scheme funding and as a result reducing calls on the PPF.

> "The Regulator is the gateway to PPF, therefore the success or otherwise of the PPF will depend on how that gateway is policed. The Regulator has to get money out of companies before the scheme goes to the PPF." Accountant

> "I'm not convinced about the success of the PPF. It depends on how tough the Regulator is in getting employers to correct deficits on a PPF basis." Investment bank

6.9 *Jobs vs. Pensions*

Where an employer is in a weak financial position, it may be that it is unable to afford to fund the pension scheme deficit. At the extreme, requiring it to make good the deficit could force the employer into insolvency, costing current employees their jobs. The Regulator therefore faces a difficult balancing act between improving scheme funding and avoiding damaging going concern businesses.

We encountered very mixed views over the extent to which the Regulator and the PPF should take jobs into account. All respondents recognised that the Regulator did take jobs into account with approximately half suggesting that jobs should be very secondary to pensions, while the other half felt that they should be of broadly equal weighting because 'jobs' are synonymous with company solvency and without this the scheme would fall into the PPF.

> "The Regulator will face situations where it has to decide whether to impose a level of contributions on the employer that may force the company into insolvency or to let the company continue at a lower contribution rate, knowing that it could still go bust and that this would land the PPF with an even bigger debt." Consultant

> "It's not so much jobs as company solvency. If the company goes bust the scheme falls into the PPF. It's hard to see how the Regulator will balance these two but under the legislation the clear priority is pensions." Pensions lawyer

"This is a very subjective issue. The best outcome could be to dilute pensions and protect jobs." Consultant

"It's difficult – members age 29 will want job security, members age 59 will want pension security." Consultant

"Yes, the Regulator must be interested in saving the employer – it must do all it can to keep the employer in business. This is the only hope of meeting scheme liabilities outside of the PPF." Consultant to SMEs

"There's no doubt that the Regulator is taking account of jobs. However, if this is the right approach, will the Regulator be even-handed or will it be under pressure to underpin companies that are large, high profile and have an active and vocal union?" Consultant

"The Regulator will have to avoid the Siren sound of job protection and ensure that shareholders do pay up when this is required. Otherwise companies will fold and shed liabilities and set up in a new guise – they will buy the assets and re-employ a reduced labour force." Consultant

6.10 *State interference in the market economy?*

Several respondents were concerned about the recent decision of the PPF to accept the pension liabilities of the insolvent insurance broker Heath Lambert in return for 10% of the equity of the new restructured group, Heath Lambert Holdings. The company argued that the deal allowed the business to be recapitalised and without new capital the pension liabilities would have fallen on PPF in any case. Our respondents argued that this is tantamount to state interference in the free market and would distort competition.

"The problem is how to go forward. The Heath Lambert precedent is a major concern. Will the Regulator's action give Heath Lambert a competitive edge – will competitors object?" Investment bank

"The pensions and jobs approach is politically driven and the PPF levy will force schemes to underwrite the jobs of competitors, as in Heath Lambert." Trustee

"The regulation does refer to jobs – the wording is 'having regard for jobs' – but the Regulator says that this is a secondary interest. Having said that, in practice it may act in favour of jobs – the Heath Lambert case being an example. This has set an awkward precedent and competitors of Heath Lambert understandably have complained that they could be at a disadvantage." Pensions lawyer

"Why should a well-funded scheme have to pay a levy to support lesser-funded schemes and to perpetuate jobs in what is possibly a competitor company? This is politically motivated. Savings jobs is a legitimate objective, but should be funded by the taxpayer not by pension schemes." Trustee

"This is an attempt to solve the country's economic problems through pension schemes. The focus clearly should be pensions. Should jobs be protected in uncompetitive companies? This is quasi-state interference with the market economy – similar to what happened with the airlines and steel companies in the US. Pensions have become confused with political and social issues." Consultant

It remains to be seen whether taking equity stakes as a part of recapitalising businesses will be a standard approach for the PPF, or whether the circumstances of Heath Lambert render it a one off.

Section 7: Employer commitment to pensions

Employers feel they have lost control of their DB schemes and will close to future accrual. They will lose their commitment to trust-based pensions.

There was near consensus amongst respondents that the changes introduced by the Act were viewed negatively by corporate sponsors and that closure of DB schemes to future accrual was very much on the agenda. Some noted that this decision would be driven by financial necessity rather than HR policy.

Respondents told us that employers and advisers believe that the legislation has converted what was originally a flexible and voluntary employer promise, where benefits could be reduced if necessary to accommodate economic conditions, to a legal guarantee. Companies that started their DB schemes with good intentions would never have done so if they knew they would be locked in to the guarantees the government now demands.

"Employers already felt they had lost control over advisers and the investment strategy under the 1995 Act, now they feel they have lost control over the contribution rate." Consultant

"Increasingly employers are being forced into an unfair position. They set up schemes in the past on a voluntary basis and between the 1995 and 2004 Acts they have been compelled to cede control of trustee boards to MNTs." Consultant

"Employers certainly regard final salary schemes as risky but then business is all about risk. The biggest problem for employers is that the DB risk is unpredictable – increased risk comes out of the blue due to government changes in legislation and regulation." Consultant

"Employers say they are losing their power to manage pension schemes that they started as a voluntary arrangement – because the government has changed the rules." Accountant

"Legislation has forced them to turn a promise into a guarantee. A promise assumes you will do your best to meet it – a guarantee insists – hence the need to set aside assets now and over a very short period to reach solvency." Trustee

7.1 *Closure will be a response to short recovery periods*

Most respondents regarded the closure of DB schemes to future accrual as an inevitable consequence of the existing deficits and the new rules that require the deficits to be recovered over relatively short time periods.

> "We are already seeing more companies closing to future accrual as a result of the Act." Consultant

> "Employers want out. They know they have to close their DB schemes and no one can fault them for this." Asset manager

> "Many would like to get out of DB pensions altogether and will do so if they possibly can." Investment bank

While closure to new employees was a relatively easy step for many companies, stopping future accrual for existing members was thought to be a more difficult labour-relations exercise. Nonetheless, most respondents still thought that it would happen in due course.

> "Closure to future accrual has to be the next step. I'm surprised that hasn't happened more already. But, it is understandable that there is some reluctance to take a benefit away from current employees who already have it."
> Insurance company

7.2 *DB scheme management has become a finance rather than HR function*

Some respondents noted that management of the DB scheme was no longer an issue about employee benefits, but rather an exercise in financial risk management.

> "The driving seat on benefits is switching from the HRD to the FD. Closure of DB scheme and the management of the deficit have become technical finance issues and nothing to do with benefits." Consultant

> "Companies no longer see the DB scheme as part of the HR strategy but rather they regard it as a financial liability. These days it's the finance director rather than the HR director who worries about pensions." Consultant

> "Employers see the DB scheme as a debt to be sorted out under regulatory pressure." Investment bank

7.3 *Legacy DB seen as a competitive disadvantage*

Others suggested it was also an issue of competitive advantage within certain industrial sectors. Companies with legacy DB arrangements were thought to be at a disadvantage relative to newer competitors without these liabilities.

> "Companies with DB schemes are looking longingly at competitors that never went there. Think about BA and its low-cost competitors." Consultant

7.4 *Pension guarantees can only be offered at a low level*

A key point raised by several respondents was that the government had failed to understand the fundamental difference between a voluntary pension promise, where discretion could be used to adjust benefits in the light of both positive and adverse economic conditions, and a legal guarantee. If the government wants employers to provide legal guarantees the value of pensions would have to be reduced in future or, alternatively, employers would avoid them altogether by a switch to DC.

"Members may have to accept a lower level of benefits if these are to be guaranteed." Investment bank

"The danger is that solvency requirements that enhance security for existing DB members might perhaps bring an end to DB provision. As companies are forced to improve the funding of existing arrangements, more of them will say 'that's the end'." Pensions manager

"DB schemes face a less certain future under the Pensions Act. The Act strengthens the benefits of members but at the same time weakens the shelf life of the scheme." Consultant

"The Act may make pensions more secure for individuals but if it leads to the destruction of workplace pensions then the collective will suffer." Pensions lawyer

"The Act improves pension security for members if they are in DB. If they are not in DB the Act kills any chance of this ever being offered." Consultant

"There is no point in having the best regulation in the world if there are no schemes left to regulate." Pensions lawyer

7.5 *DB schemes of SMEs will be the first casualty*

The unanimous view of respondents was that smaller companies would not be able to accommodate the requirements of the Act and would be forced to close their DB schemes and to wind up as soon as possible. However, some respondents felt that this was an appropriate response and that DB is no longer an efficient and cost-effective benefit for most SMEs.

"In theory the Act does recognise the needs of smaller companies – there is a proportionality requirement, an overriding caveat that recognises the smaller resources available to SMEs. What we don't know is whether the Regulator will recognise this in practice." Pensions lawyer

"SMEs in particular will have problems with TKU – they shouldn't be in the DB game and it will become necessary to manage their exit from it." Consultant

"The enhanced security conferred by the act comes at a price and this will be too high for many SMEs." Consultant

"There are issues around very small schemes. In some cases people wear three hats, as employer, trustee and member. In these cases the Regulator could well say 'on your own head be it.' But, other small schemes have members who are not the employer or trustees and they could be disadvantaged if the trustees fail to act properly. The case for exemptions is less clear here and if things go wrong the members could legitimately complain that the legal requirements (TKU) were not met." Insurance company

7.6 *Deferred compensation still relevant*

Most respondents acknowledged that, while DB schemes were likely to close to future accrual, employers will find they still need to offer deferred benefits of some sort in order to instil 'loyalty' in key employees.

> "In future it will be important for FDs and HRDs to meet each other half way – for FDs to understand the importance of the benefits package in long-term recruitment and retention policy but HRDs have to understand the financial implications of their strategy." Consultant

> "In the long-term companies will find that they have to retain attractive pension schemes in order to attract the right people. Cash does not encourage loyalty. Pensions are a more subtle retention tool." Consultant

7.7 *DB and other risk sharing suitable only for very large employers*

Larger companies may have the option to maintain a DB scheme but they may also look at risk-sharing alternatives to final salary and at 'flexible benefits' where the annual cash commitment is tightly controlled.

> "Big companies have other options – for example career average or a hybrid DB/DC scheme. The point here is that pensions must remain on the benefits list – large companies have to have a pension scheme as part of their HR strategy. It will not be easy for large high profile companies with a vocal union to close to future accrual and switch to contract DC." Consultant

> "The benefits to an employer of having a DB scheme are unchanged from 10 or 20 years ago, but the risks and costs are much greater now. This could mean the end of DB, but it doesn't necessarily. What is required is more thought on appropriate ways of sharing risk between the employer and the employees." Trustee

7.8 *Rapid scheme restructuring ahead*

Some respondents argued that the tight timetable for deficit recovery implied by the Act would force companies to move quickly to restructure their pension arrangements and as a result some risk-sharing approaches, such as hybrid or cash balance pension schemes, would not be considered.

> "Most companies would have tried to find an alternative – by reducing the accrual rate or raising the normal pension age, for example. PA04 is forcing quick closure and has left no time for restructuring the DB benefits." Pensions lawyer

> "DB is a great way to share very complex and nasty risks that most individuals are not able to deal with. The Act is forcing companies to move quickly and as a result they are going straight to DC, whereas, if they had more time, they

would consider other risk-sharing structures such as career average and cash balance. Most companies have lost the opportunity to explore this middle ground." Asset manager

7.9 *Continued shift to DC inevitable*

Most respondents thought that occupational pension provision would ultimately shift to a DC basis for both new and existing employees. However, several respondents noted that the move to DC had dangers, particularly in terms of possible under provision of pension benefits from low contribution rates.

"In time everyone will be in DC as schemes close to future accrual. Companies will be under pressure to do this, as to run a two-tier workforce makes no sense because DC members will demand higher salaries. It will be easier for employers to switch everyone to DC for future service." Consultant

"Employers will have to move to DC but will do so with the nagging doubt that this is not the right way forwards in the long term. Asset manager

"It's unlikely DC will work – that is, provide sufficient pensions. When these chickens come hope to roost employers will face significant difficulties." Asset manager

7.10 *Occupational DC losing ground*

DC imposes the investment and longevity risk on individual members. The role of the trustee board in occupational DC provides an important element of governance that is absent in contract-based DC, as the NAPF pointed out in its report *'Pensions Scheme Governance – fit for the 21st century?'* (www.napf.co.uk).

Respondents thought that following the Act, many employers that close their DB arrangements will wish to avoid any further implications of trust-based pension arrangements, while those with occupational DC schemes will move to a contract basis. The life offices in the pensions market are already gearing up for this eventuality and several have launched specific DC-to-DC services in addition to their DB-to-DC conversions. The larger 'corporate' independent advisers are doing the same. The apparent attraction of contract DC is that the life office is responsible for the governance, administration, and investment functions. This formally separates pensions and jobs. However, as the NAPF observed, the absence of a body responsible for looking after members' interests means that 'there is no effective mechanism to promote or represent the collective interests of scheme members'.

"Any small or medium sized company starting with a clean sheet will have to think very carefully before going down the route of occupational money purchase." Insurance company

"Contract arrangements are likely to be preferred over occupational money purchase because of the administrative complexity of the latter. Even where the same requirements apply to both forms, in contract schemes the requirements can be dealt with by the provider, which has economies of scale." Insurance company

"Occupational DC schemes are being wound up because the governance is much tougher than for contract DC – for example they need annual audits and trustee requirements. This is a loss to the pension system. Stakeholder schemes and group personal pensions are not capable of being audited – there is no member level information held by the employer, no way of checking the insurance company guarantee that contributions have gone to the right place". Trustee

"Occupational DC was a way of offering something by way of compensation when the DB scheme closed. There is a strong move to contract based schemes and even to cash options (that is pay rather than pension). This is employers on the way out from pension provision." Trustee

Conclusion

Our report aims to reflect the genuine concerns of the many parties to occupational pension schemes in the UK. We have found that those responsible for running the schemes – both sponsors and advisers – are deeply concerned that the Pensions Act 2004 imposes an unacceptable burden on companies that currently provide DB pension schemes. Employers are feeling alienated from policy decisions that have a direct impact on their costs, their risks, and the way they do business.

To proceed with confidence employers need the flexibility to design benefits that are appropriate to their size and financial strength. Employers feel that the Pensions Act 2004, in effect, removes much of the flexibility they need in order to design appropriate employee benefits. The Act raises the risks associated with DB pension provision to a level that exceeds the perceived benefits.

The government has stated in the past that it aims to shift the balance between state and private pension provision from 60:40 to 40:60 by 2050. The possible unintended consequence of the Act is that measures designed to shore up the occupational pensions sector seriously risk undermining it and hastening its demise. This is the Pyrrhic victory of our title.

At present employers have the right to close defined benefit schemes and to switch to defined contribution arrangements that pose many more questions for retirement policy than DB. In our earlier report, 'Delivering DC? Barriers to participation in the company sponsored pensions market' (October 2004), we noted that financial institutions and advisers are withdrawing from the SME sector, particularly where the workforce profile is one of lower to average earners. The earlier report shows that providers and advisers are finding it increasingly uneconomic to market to these companies. This is an important and difficult issue for both the government and the private sector providers.

With the concerns expressed in this second report about the potential demise of DB in all but the largest companies and the inadequate ability of individuals to bear the investment and longevity risk for retirement provision, DC may prove to be a blunt instrument with which to deliver the government's policy objectives.

The Pensions Commission publishes its final report and recommendations later this year and will offer the government guidance on how to improve overall pension provision. The occupational pensions sector is likely to have an important role to play in those improvements. We hope our report has managed to highlight some of the very difficult issues that exist in that area.

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The objectives of the Pensions Institute are to undertake high quality research in all fields related to pensions, to communicate the results of that research to the academic and practitioner community, to establish an international network of pensions researchers from a variety of disciplines, and to provide expert independent advice to the pensions industry and government.

We take a fully multidisciplinary approach. For the first time disciplines such as economics, finance, insurance, and actuarial science through to accounting, corporate governance, law and regulation have been brought together in order to enhance strategic thinking, research and teaching in pensions.

As the first and only UK academic research centre focused entirely on pensions, the Pensions Institute unites some of the world's leading experts in these fields in order to offer an integrated approach to complex problems.

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