By email

DBConsultation@thepensionsregulator.gsi.gov.uk

MACFARLANES

7 February 2014

Dear Sirs

Response to the Pensions Regulator's Consultation on Regulating Defined Benefit Pension Schemes

1.1 We refer to the Pensions Regulator's current Consultation Paper titled Regulating Defined Benefit Pension Schemes (the "**Consultation**") and the associated draft documentation, being:

1.1.1 the draft Code of Practice on Scheme Funding;

1.1.2 the draft DB Regulatory Strategy; and

1.1.3 the draft DB Funding Policy.

1.2 We are a firm of lawyers whose clients include companies and pension schemes. We welcome the opportunity to respond to the Consultation.

2 Overview

2.1 We welcome the new objective requiring the Regulator "to minimise any adverse impact on the sustainable growth of employers" in respect of its duties in relation to scheme funding that is contained in the Pensions Bill 2013.

2.2 It has always been the case, as well noted by the Regulator, that scheme members are best served by having a well-run scheme supported by a strong sponsoring employer. It is often not in members' interests for the sponsoring employer to be prevented from making important investment in its business by a requirement to make pension contributions. Recognition of this has always been consistent with the Regulator's original objectives of protecting scheme members.

2.3 The new objective supports this and goes beyond. As per the Government's response to the consultation on the new objective and the press release issued by the Department for Work and Pensions dated 30 March 2013 regarding the new objective, the new objective is provided to "support economic private-sector led growth". It is intended to "ensure an employer's need for sustainable growth is considered during scheme funding negotiations and is properly reflected in trustees' dealings with the employer". The clear intention of the Government in introducing the new objective was that the growth of the employer's business should not be assessed solely by reference to any direct or indirect benefit to the pension scheme but should be given separate consideration. This is akin to the consideration required to be given by

Macfarlanes LLP is a limited liability partnership registered in England with number OC334406. It is authorised and regulated by the Solicitors Regulation Authority.
Its registered office and principal place of business are at 20 Cursitor Street, London EC4A 1LT.

The word 'partner' is used to refer to a member of Macfarlanes LLP. A list of members is open for inspection at the above address.

directors of companies to the interests of employees (and other matters) under s.172 of the Companies Act 2006, even while pursuing the success of the company.

2.4 There are a number of statements in the draft documents which refer helpfully to the need to consider employers' need to invest in the sustainable growth of their businesses. It is recognised that it is in the interests of all parties that employers should be able to do so as, where such investment is successful, employer covenant will be improved in the long term. It is to be welcomed that the draft documents accept that sustainable growth will have a different meaning depending on the employer.

2.5 However, in the draft code, the recognition of employers' need to invest comes with a number of caveats and additional obligations for trustees. The draft code requires trustees to check the investment decisions made by employers. It suggests that the trustees' involvement in respect of the investment process is required throughout: they are asked to assess whether the investment is necessary and whether it is in fact an investment for sustainable growth, they must then monitor this investment and have contingency plans in place both in the event that the investment is not made and in the event that it is successful in which case they are advised to ensure that they secure some of the upside. Indeed, trustees are even directed to assess whether the funding for the investment is appropriate: for example, whether an investment would be better funded by undertaking an equity fundraising.

2.6 Trustees and employers will be concerned at the judgements that the trustees are being asked to make in relation to business decisions that are properly made by employers, acting by their directors and in accordance with the duties of such directors. We note that such judgements will need to be made by trustees on an on-going basis as they are called upon to assess whether any of the contingency plans are required or should be triggered. Such additional responsibilities will require the trustees to take substantial further advice, increasing their costs. We would consider it inappropriate for trustees to take such an active role in reviewing the business decisions of employers.

2.7 These business decisions that will be required to be scrutinised by trustees in accordance with the draft code are also, we note, likely to be scrutinised by the Regulator. This is because the balanced funding objective (the "**BFO**") does not take into account the employer's need for sustainable growth. The draft code suggests that the Regulator is likely to intervene if the agreed funding levels are lower than the BFO. In cases where allowances for sustainable growth have been given and result in lower agreed funding levels, intervention by the Regulator may be assumed. This would seem to negate the concession to the employer's sustainable growth by making it a trigger for Regulator intervention.

2.8 The integrated approach to risk management that is evident throughout the draft documents is particularly clear in the approach to investment strategy outlined in the draft code of practice which clearly integrates investment risk with the employer covenant. We understand the reason for the Code requiring trustees to take a low risk approach to investment unless the employer's covenant can support underwriting a riskier approach. Such an approach protects the Pension Protection Fund as the risk of deficit increases are minimised prior to employer insolvency events. However, we consider that there should be some further flexibility in this area.

2.9 In particular, we think this is not a balanced approach since its premise is that the employer is required to bare all of the investment risk, or rather that there should be no investment risk that is not borne by the employer. We do not think this is consistent with the purpose of the investment powers granted to trustees in most occupational defined benefit pension schemes: the purpose was to part fund the benefits from investment returns to make more generous benefits affordable. We do not think the introduction of the statutory guarantee under s.75 of the Pensions Act 1995 changed the trustees' investment duties. We also do not think it is consistent with trustees' investment duties under The Occupational Pension Schemes (Investment) Regulations 2005 (the "**Investment Regulations**") and Article 18 of the EU

Directive on the activities and supervision of institutions for occupational retirement provision (the "**IORP Directive**"). It should be recognised that the purpose of trustee investment powers is to part-fund the scheme benefits, not just to provide security.

2.10 The suggested approach is likely to result in a number of schemes becoming trapped by the combination of limited resources and a low risk investment strategy. This may lead to such schemes being wound up and transferring to the Pension Protection Fund and to section 75 debts becoming due from the employer causing insolvency and potentially destroying value rather than supporting growth.

3 Responses to specific questions

New objective on sustainable growth

3.1 **Is our new objective on sustainable growth adequately reflected in the approach outlined in the draft consultation documents? If not, what more could we do to reflect the new objective?**

No.

We welcome references to the sustainable growth of employers within the draft documents. However, the draft code would suggest that the sustainable growth of the employer is only to be considered by reference to the extent to which it strengthens or weakens the covenant to the scheme. This approach is consistent with the existing objectives of the Regulator and fails to recognise any change arising from the new objective.

To reflect the new objective properly, the code should ensure that the employer's need for sustainable growth is considered in terms of the need of the employer to grow its business for its own benefit and the benefit of its other stakeholders, including employees, even where that need competes with the needs of the members and not only when it supports those needs. The new objective only requires consideration of those needs and not necessarily deferment to those needs but we think the draft code fails to encourage proper consideration of them.

We also consider that the requirement in the draft code for substantial and regular trustee involvement in the employer's investment decisions is not warranted by the new objective and is likely to increase both the time and the cost involved. As such it is more likely to hinder than support growth of the employer's business.

3.2 **Is our interpretation of sustainable growth appropriate**?

No.

Sustainable growth is interpreted too often in the draft code by reference to the benefit to the members and not the value to the employer and its employees. The members' interest would not have required a new objective.

We agree that sustainable growth has different meanings for different employers. In particular, employers in the not-for-profit sector may have a different interpretation of the concept than commercially focused employers. We also agree with the fact that investing for growth for some employers may actually mean investing to maintain a stable level of business. We would note, however, that employers should have a wider discretion than is given under these draft documents to determine for themselves what sustainable growth means in each particular context. The trustees and the Regulator then determine how that is to be considered in the context of scheme funding.

Code of practice

3.3 **Does the practical guidance set out in the revised code reflect your experience of what good practice looks like? If not, why not?**

As noted above, neither employers not trustees in practice will generally wish trustees to be substantially involved with the business decisions of the employers. Trustees may be expected to negotiate with the employer. Trustees may also be expected to work collaboratively with the employer as they support each other to achieve their respective aims, including full funding of scheme benefits in time and the success of the employer's business. Trustees should not however seek to substitute their judgement for that of the appointed directors. Business decisions must be taken by directors of the employer in accordance with company law (or equivalent for other entities) and not, or not principally, by reference to the benefit to the scheme covenant. It is right for the employer to consider the impact on the scheme covenant as an incidental aspect of its business decisions, but rarely as a key driver. The trustees may consider that impact as a key driver of their own decisions in respect of scheme funding while respecting the employer's right to make business decisions for commercial reasons.

We would not expect investment strategy to be wholly dictated by the ratio of the covenant and scheme deficit but by proper consideration of the factors listed in the Investment Regulations and the IORP Directive, together with the covenant, the scheme deficit and the benefit profile. We would expect due consideration to be given to the needs of the employer, including the employer's need to balance the competing interests of members, current and future employees and other stakeholders in accordance with its duties.

3.4 **Is the approach to risk management set out in the code useful? If not, why not?**

Yes but it is misused.

An integrated approach to risk management makes sense. However, risk management should not govern all decisions. It is a tool not a substitute for proper exercise of discretions. The trustees have investment duties and the purpose of those duties is not limited to risk management and should not be used solely or primarily for risk management but to secure full funding of the benefits.

A reasonable and balanced approach to risk is required, not a 'no risk' approach. The provision that more risk may be taken only if adequately covered by the employer does not show balance.

For most businesses, sustainable growth depends on some risk taking. Business investment often requires companies to be at times unable to cover all of their risks or liabilities if they were to crystallise immediately even if they can in the normal course be met as they fall due. The expectation is that all risks will not be fully covered at all times.

Recognising the need for sustainable growth of the employer means recognising that it is unreasonable to expect all down-side risks related to the pension scheme to be at all times covered by contingent assets or unrestricted assets of the employer.

A more appropriate approach to risk management would use the integrated approach proposed in the draft code to assess risk and then determine acceptable levels of risk for the investment and funding strategy having regard to the needs for sustainable growth of the employer and all other matters.

3.5 **Does the revised code provide sufficient practical guidance for trustees in relation to:**

3.5.1 **Working with employers and advisers?**

We think the quantum of practical guidance is sufficient.

However, the guidance lacks balance in that it calls for very high levels of professional advice without sufficient emphasis on proportionality. The result may benefit professional advisers to the detriment of sustainable growth of the employer and even to the detriment of the scheme and covenant.

Paragraph 66 fails to have genuine regard to the conflicting obligations of other parties whose information the trustees seek. Commercial confidentiality and stock exchange requirements are real issues and disregarding them is not practical.

3.5.2 **Assessing and monitoring the employer covenant?**

We broadly agree with the approach. However, we think there is again a lack of guidance on proportionality in paragraph 85.

Paragraphs 87 and 88 look out of place as they address possible negotiation arguments, which might depend on context, rather than practical guidance on covenant assessment.

3.5.3 **Assessing reasonable affordability, including understanding the impact on sustainable growth?**

Subject to the following comments, we think the practical guidance is sufficient and generally helpful and balanced.

We think that the new objective may not be correctly reflected in paragraph 89 because the structure of the sentence suggests that business investment is to be assessed by reference to strengthening employer covenant. We would suggest the sentence should end *"the trustees will need to understand how the investment supports sustainable growth of the employer's business; they will also want to understand the impact on the employer covenant"*.

Paragraphs 101 and 102 placed together suggest that trustees should have contingency plans of the types listed in paragraph 102. However, these are unlikely to be generally available and cannot be treated as universal requirements. The effect of such contingency plans would be to put the employer's business at greater direct risk from the volatility in the scheme (arising from investment markets, inflation and gilt yields etc.). This fails to recognise the need to insulate the employer's business from such market related risks in order to foster sustainable growth.

3.5.4 **Their investment strategy?**

Paragraph 106 fails to recognise the purpose for which investment powers are granted in defined benefit occupational pension schemes, namely to enable the benefits to be part funded from investment returns.

The reference in paragraph 107 "even where not required by law" rather oddly fails to state that trustees are required by law to consult with the employer regarding changes in investment strategy (which should be reflected in the statement of investment principles). This is noted at paragraph 118. In paragraph

115 it seems inappropriate to talk about trustees 'choosing' to accept investment risk given that investment risk is an integral part of an on-going occupational pension scheme and acceptance of the responsibility for exercising investment powers comes with acceptance of the role of trustee. The cross-reference to paragraph 49 seems to derive a judgement about appropriate investment risk from the fact that an employer does as a matter of law underwrite the scheme. We think this is flawed. The employer does underwrite the scheme and its investment risks to the extent of its available resources so it is the case that the investment risk "is" not "should" be supported by the employer covenant. What appears to be suggested, particularly when linked with paragraph 117, is that because the employer does underwrite the scheme, investment risk should not exceed what the employer could make good. That may be desirable but it does not follow from the statutory funding obligations.

It should be recognised that schemes cannot in all cases transfer all of their investment risks to the employer. In which case it is the trustees' duty to manage such investment risk in accordance with the provisions of the scheme, their trust law duties and the Investment Regulations. Understanding the extent to which the employer covenant does cover downside investment risks is a first step not a conclusion.

Technical provisions and recovery plans?

Paragraph 140 is in our view wrong in suggesting that an investment strategy that carries more risk than the employer covenant can support should lead to manipulation of technical provisions. We fail to see any logic to support this approach.

3.5.5 **Any other issue not mentioned above?**

We refer to the Overview section of this letter.

3.5.6 **If not, what further guidance would you find useful**?

3.6 **What, if any, significant administrative cost does the revised code impose on schemes and employers?**

As noted above, there will be a significant increase in trustee costs due to the requirement to assess and monitor employer investment decisions.

Regulatory strategy

3.7 **Does our strategy, focused on 'protecting accrued rights to benefits through adequately funded, supported and well governed DB schemes,' with risks identified and mitigated in a proportionate and balanced way, reflect the proper balance of our objectives?**

No. We think that this strategy as described in paragraph 11 of the draft regulatory strategy would reflect the proper balance of the Regulator's objectives, disregarding the new objective. For the reasons given above, we also consider that in some respects the draft code makes recommendations that are not proportionate and balanced.

3.8 **Where risk has already been crystallised, should our focus be on managing the impact of that risk to achieve the fairest and best possible outcomes in the circumstances?**

Yes. In addition to the above, we would suggest that it is important to ensure that the Regulator deals with crystallised risks in a way that is proportionate and does not go further than is necessary in mitigating particular risks.

Funding policy

3.9 **Do you agree with our priorities for the regulation of DB scheme funding?**

Yes, we agree with the set of priorities as set out paragraph 14 of the draft defined benefit funding policy.

3.10 **Is our risk assessment approach, focusing on key areas of covenant, funding, investment and governance risks, useful?**

We have no comment on this particular question.

3.11 **Is our broad approach to segmenting the landscape in order to tailor our policy and operational approach appropriate?**

We would note that where there is segmentation on the basis of employer covenant then there must be sufficient flexibility to allow trustees and employers to agree solutions that do not fall within the expectations of the Regulator.

3.12 **Is our proposed policy focus for the different covenant strengths appropriate?**

As noted above, requiring schemes to take a low risk approach to investment based on the employer's covenant is likely to trap a number of schemes within their existing funding level. Such schemes (in the absence of being able to take investment risk) may ultimately have no other option but to wind up with the section 75 debt becoming due and causing the employer's insolvency. This may be the right outcome in some cases but not all. A rigid policy risks unnecessary value destruction and job losses and fails to have sufficient regard to the Regulator's new objective.

We think this approach also purports to substitute Regulator policy for the trustees' discretion in respect of its investment powers and ignores trust law and the Investment Regulations.

3.13 **We use a broad suite of risk indicators to assess scheme risks in the round. Is this the right approach?**

Although a broad approach is taken, it is clear from the draft funding policy document at paragraph 48 that it will be the BFO that is the main risk indicator. It should be ensured in practice that trustees and employers are given flexibility to depart from the BFO, particularly given that considerations such as the employer's sustainable growth are not taken into account when calculating the BFO.

3.14 **Do you think that our proposed Balanced Funding Outcome indicator is useful to:**

3.14.1 **Measure risk in the system?**

We have no comment on this particular question.

3.14.2 **Inform our approach to prioritising schemes for further investigation?**

We have no comment on this particular question.

3.14.3 **Inform our approach to measuring our impact?**

We have no comment on this particular question.

3.15 **Our policy for targeting our resources where we can have the greatest impact takes account of the level of risk, including scheme size. A greater proportion of interventions will, therefore, be in larger schemes, with smaller schemes generally being regulated through education and other targeted approaches such as portfolio reviews.**

3.15.1 **Is it right that our risk bar for intervention takes account of the level of risk posed by schemes and their size?**

We agree with this approach. It is proportionate to monitor the largest schemes and those with the greatest level of risk as they present a greater risk to the Pension Protection Fund and affect a greater number of members. However, members of smaller schemes also require protection.

3.15.2 **Is education the most effective and proportionate way of regulating across a diverse landscape?**

We agree that education is an important tool. This includes education of trustees, employers and their advisors. Equally important is that policy remains consistent, consistent with applicable law and is accurately reflected in the guidance available.

3.16 **Is proactive engagement an effective way of engaging with schemes and targeting our resources in order to achieve balanced outcomes?**

We do not consider that a strategy of proactive engagement in relation to funding negotiations (as contemplated in paragraph 58 of the draft funding policy) is necessarily proportionate. Although, as we note above, a strategy that focusses on the largest and riskiest schemes is appropriate, it is not appropriate to become actively involved with these schemes unless there is a particular problem. Engaging with a scheme is not necessary if in fact funding negotiations are proceeding relatively smoothly and the Regulator's proactive intervention in such circumstances is unlikely to be helpful. Such intervention may even be unauthorised and could be seen as exceeding the Regulator's powers if it is more than guidance or education. Statute provides for funding negotiations to be between trustees and employers (unless funding is set by trustees alone or with the actuary) and for Regulator intervention only in the event of a failure to agree or comply with regulatory requirements. The Regulator's approach should be to intervene when required (for example when employers and trustees cannot agree on a valuation) or where the risk indicators suggest intervention is necessary.

3.17 **Is our proposed approach to measuring the impact of our regulatory approach appropriate? If not, do you have any suggestions? We are particularly interested in your views on how we should be measuring success against our new objective on sustainable growth?**

We do not have any comments on this particular question.

Any additional comments

3.18 **Are the documents structured and drafted in a way that makes it easy for you to understand the key messages and issues? How could they be improved?**

We do not have any comments on this particular question.

3.19 **Are there any other comments which you would like to make on the proposals contained in these consultation documents?**

Please see our Overview section above.

Yours faithfully

Macfarlanes LLP