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SHOULD THE PENSIONS REGULATOR HAVE A NEW OBJECTIVE?

PENSIONS

The DWP is consulting on a proposed new objective for the Pensions Regulator **"to consider the long-term affordability of deficit recovery plans to sponsoring employers"**.

The driver for the proposal, as referred to in the Autumn Statement, is concern that "the cost of funding defined benefit liabilities is diverting funds away from business investment and ultimately, economic growth".

The DWP's aim in this consultation, which is issued together with a consultation on smoothing assets and liabilities in scheme funding valuations, appears to be one of dampening the funding requirement for defined benefit schemes to enable employers to retain more cash for investment and jobs.

WHAT ARE THE PENSIONS REGULATOR'S CURRENT OBJECTIVES?

With regard to defined benefit pension schemes, the Pensions Regulator's current objectives are:

- to protect the benefits of members;
- to reduce the risk of compensation being payable by the Pension Protection Fund (the PPF); and
- to promote good administration of schemes.

In addition, when exercising any of its powers, it is required to have regard to the interests of the generality of the members and to other persons who are directly affected.

Having regard to the interests of other parties does not however mean giving them equal priority, and the objectives of protecting defined benefit members and the PPF therefore trump the interests of employers and other employees.

WHAT HAS THIS MEANT FOR SCHEME FUNDING AND SPONSORING EMPLOYERS?

The Pensions Regulator does not set scheme funding but works to influence trustees and employers in agreeing valuation assumptions and funding plans.

In practice, the Pensions Regulator's objectives of protecting members' benefits and the PPF and the absence of any wider or counter-balancing objectives has led to growth in the value attributed to defined benefit pension liabilities and the shifting of the burden of funding them onto the employer and away from the investment strategy. The Pensions Regulator has also pressed trustees hard to secure additional funding or third party guarantees and other assets where cash is unavailable often suggesting a switch in assumptions and investment strategy if additional security is not provided.

Current objectives of the Pensions Regulator:

- To protect members
- To protect the PPF

Also

- Duty to have regard to interests of directly affected parties

New objective:

- To consider long-term affordability of deficit recovery plans to employers

Alternative new objectives:

- To protect the long-term affordability of deficit recovery plans to employers or
- To balance the interests of members, the PPF and sponsoring employers

The unofficial rule is that **if the employer can afford to pay, it should pay. If it can't afford to pay, then it should pay more**.

This is built on the premise that trustees should avoid investment risk (and every other kind of risk) if the employer is not able to underwrite all downside risk of the investment strategy throughout the recovery period. This is notwithstanding that these schemes were set up on the basis that investment returns would part fund the benefits and enable the employees to receive pensions that could not otherwise be afforded.

The notion that trustees should not hold any risk that is not underwritten by an employer with sufficient financial strength does not derive from legislation but from the Pensions Regulator's objectives of protecting the members and the PPF.

WHAT WOULD THE NEW OBJECTIVE MEAN IN PRACTICE?

The proposed new objective - "to consider the long-term affordability of deficit recovery plans to sponsoring employers" - is not an objective.

"To protect the long-term affordability of deficit recovery plans to sponsoring employers" could be an objective. To consider it, is not.

The Pensions Regulator already has a duty to have regard to the interests of other directly affected parties such as the sponsoring employers which seems very similar to the new proposed objective. In practice, this duty carries little weight.

Also, the Pensions Regulator currently does have regard to the long-term affordability of deficit recovery plans and encourages trustees to do so. Concern over long-term affordability is the reason for preferring short recovery plans where these are affordable.

The issue of affordability is already included in the Pensions Regulator's Code of Practice on Funding Defined Benefits which supplements the legislation and has approval from Parliament. The Code states that the employer's financial strength and prospects should inform decisions on the valuation assumptions and the recovery plan and that in setting the recovery plan, "trustees should aim for any shortfall to be eliminated as quickly as the employer can reasonably afford". No distinction is made between long-term and short-term affordability.

Recently, the Pensions Regulator has focused on those schemes which it considers cannot, even in the long term, clear the deficit (nick-named "zombie schemes"). In some cases, it has put pressure on trustees to wind-up pension schemes in the knowledge that this would result in insolvency for the employer.

In fact, the unofficial rule has an additional part: **if the employer can't pay even in the long term then the scheme should be wound up now even if that means a business insolvency**.

Given the existing approach on long-term affordability, it is not clear that an 'objective' to "consider the long-term affordability of deficit recovery plans to sponsoring employers" would contribute meaningfully to stemming the diversion of funds away from business investment and economic growth. The Pensions Regulator does already consider this, albeit only with the interests of the members and PPF in mind.

ARE THERE OTHER OPTIONS WHICH WOULD ENSURE THAT THE PENSIONS REGULATOR CARRIES OUT ITS FUNCTIONS IN A WAY WHICH APPROPRIATELY BALANCES PROTECTION OF MEMBERS, THE PPF AND SPONSORING EMPLOYERS?

This is the final question asked by the DWP in its consultation.

A new objective to "**protect** the long-term affordability of deficit recovery plans to sponsoring employers" might be more useful in restoring the balance.

Alternatively, to match the question, the Pensions Regulator could be given a new objective of "carrying out its functions so as to balance the interests of members, the PPF and the sponsoring employers".

This would not define the balance or what is appropriate but would at least require the Pensions Regulator to have genuine regard to the interests of employers and employees instead of always being in opposition to or careless of their interests.

It would also realign the Pensions Regulator's duties with trustees' current duties to invest the assets of the scheme for the purposes of the scheme and in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole rather than purely to avoid downside risk for the members and the PPF.

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