Please reply to:

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The Hundred Group
of Finance Directors

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The Pensions Regulator Policy Team
Pensions Protection and Stewardship Division
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Dear Sir or Madam,

Pensions and Growth: Whether to introduce a new statutory objective for the Pensions Regulator

I am writing on behalf of the Pensions Committee of the Hundred Group of Finance Directors with regard to the above-named call for evidence. I am responding by separate cover to the call for evidence on whether to smooth assets and liabilities in scheme funding valuations.

The Hundred Group represents the views of the finance directors of FTSE 100 and several large UK private companies. Our member companies represent almost 90% of the market capitalisation of the FTSE 100, collectively employing over 7% of the UK workforce and in 2011 paid, or generated, taxes equivalent to 13% of total UK Government receipts. Our overall aim is to promote the competitiveness of the UK for UK businesses, particularly in the areas of tax, reporting, pensions, regulation, capital markets and corporate governance. While this letter expresses the views of The Hundred Group of Finance Directors as a whole, they are not necessarily those of our individual members or their respective employers.

Overall, we believe that there is considerable merit in creating a new statutory objective for the Pensions Regulator to consider the perspective of the employer to redress a perceived imbalance in its current objectives. Care will, however, be needed in framing the objective and in ensuring that the Pensions Regulator has the necessary tools at its disposal to demonstrate that it has considered affordability to the employer.

Q6. What would be the advantages of a new statutory objective for the Pensions Regulator to consider the long term affordability of deficit recovery plans to sponsoring employers?

The Pensions Regulator currently has two objectives which are of relevance in funding discussions, namely to protect members' benefits and to reduce the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund (PPF). (It should be noted that the interests of members and the PPF will usually, but not always, be aligned; for example, once a scheme is funded above the level of PPF compensation, then there may be a divergence of interests.)

The explicit focus on members and the PPF and the absence of any mention of the employer sponsoring the scheme arguably creates an imbalance, both when the Pensions Regulator is formulating its strategy for regulating the funding of defined benefit schemes and when it is intervening in specific funding negotiations. If the Pensions Regulator solely follows these two objectives, then the legislation should lead it to seek to maximise pension scheme funds in order to minimise the risks to member benefits and the PPF.

This is particularly the case given that the Pensions Regulator also does not have a statutory objective to consider the long term sustainability of defined benefit pension schemes. Its responsibility is to protect members' accrued benefits, not to safeguard defined benefit provision for the future. The legislative framework on its own is therefore indifferent to the continuing viability of both pension scheme and sponsoring employer; the Pensions Regulator has the power both to reduce or remove future accrual in a scheme and to impose a recovery plan that makes an employer insolvent.

In practice, however, the Pensions Regulator has indicated that it does take into account the perspective of the employer. Its statement in April 2012 indicated that 'recovery plans should usually be based on what is reasonably affordable without compromising the employer's long term ability to support the scheme' and that, 'in the vast majority of situations, a strong and ongoing sponsoring employer is the best support for a scheme'. At least in terms of its published statements, therefore, the Pensions Regulator appears to be operating with an implicit objective of considering the affordability of recovery plans for the employer.

Making this an explicit objective could help by clarifying the Pensions Regulator's position and by giving employers an opportunity to challenge decisions made by the Pensions Regulator. At present, all they can point to are the Pensions Regulator's own statements not to a statutory objective. This would effectively level the playing field between members and the PPF on one hand, and the employer on the other hand.

Q7. What would be the disadvantages in creating this further statutory objective for the Pensions Regulator?

One possible disadvantage is that this further statutory objective could create a conflict for the Pensions Regulator given that members' and employers' interests are likely to be opposed in difficult funding negotiations. However, as suggested above, this conflict is already implicit in the Pensions Regulator's published statements. The tension between the interests of members and employers is at the heart of funding discussions (and the reasons why trustees and employers have to reach agreement on the assumptions under most scheme rules). We do not therefore feel that this would be a real objection to introducing a new statutory objective for the Pensions Regulator.

A more significant objection may be the difficulty for the Pensions Regulator of fulfilling this objective. How will the Pensions Regulator assess the long-term affordability of deficit recovery plans to sponsoring employers? At present, this is something that trustees are expected to do as part of their negotiations over recovery plans. In some cases, they will have taken independent advice on affordability, in which case the Pensions Regulator has the power to ask to see that advice, but, where no such advice has been received, the Pensions Regulator will either have to discuss with the trustees how they reached their decision or undertake an investigation of their own (or both). Will the statutory objective impose a duty on the Pensions Regulator to carry out an affordability analysis for all funding negotiations, or only when they are intervening in a funding valuation?

Given that there may well be an increased level of challenge from employers where they feel the objective has not been followed, it is important that the Pensions Regulator should be able to demonstrate that they have carried out this objective, and this may involve it carrying out further investigations than currently to demonstrate compliance.

A further potential disadvantage may lie in the difficulty of defining affordability, either in legislation or, more likely, in any statement by the Pensions Regulator as to how it intends to comply with this new objective. It will be important to ensure that affordability is defined to take account of the employers' other business objectives (which may reduce the level of cash available to make 'affordable' contributions in practice). This definition of affordability is key: if companies are required to put more money into pension schemes sooner, then something has to be reduced and that is likely to be investment. An excessively robust approach by the Pensions Regulator to affordability could divert resources from productive companies to passive investments and will slow the creation and preservation of production and jobs in the UK. It is not necessarily in the interests of the country, employees, shareholders or investors (including pension schemes) that, because a company has money, it should use it to pay down pension deficits first. Healthy companies can do this over a longer horizon, as the deficit becomes a smaller liability compared to the size of the company's assets.

Q8. Is the consideration of the long term affordability of deficit recovery plans to sponsoring employers already implicit in the existing objectives and requirements for the Pensions Regulator? If so, is this sufficient?

As noted above in our answer to question 6, we believe that this objective is implicit to the extent that it is mentioned by the Pensions Regulator's own statements. However, we do not believe that it is implicit anywhere in the statutory framework.

That said, we consider that the Pensions Regulator needs a wider objective to consider the UK economy and the health of employers, in general. As commented by many, including t Pension Regulator's Chief Executive in launching the April 2012 funding statement, we consider that the interests of pension scheme members and the PPF are best served by a strong economy with healthy employers. The current objectives could lead to an over emphasis on adding more and more prudence into Technical Provisions, inevitably leading to less cash being available for companies to invest in their future resulting in weaker employers and lower economic growth.

Q9. Are there other options (including legislation) which would ensure that the Pensions Regulator carries out its functions in a way which appropriately balances protection of members, the Pension Protection Fund and sponsoring employers?

As mentioned above, we consider that the Pension Regulator should be given a wider objective to consider the UK economy and the health of employers.

In addition, and as mentioned in our response on smoothing, we consider that the Pensions Regulator should issue a statement that supports reference to a prudent assessment of the expected return on the scheme's assets in setting discount rate assumptions, rather than gilt yields in current conditions. It would also be helpful to obtain greater transparency around the Pension Regulator's approach, principles and internal guidelines to assessing prudence. In particular, greater transparency would help to give trustees and employers a clearer understanding of the review process and acceptable approaches which will also serve to reduce the Pension Regulator's workload.

Finally, we believe that consideration should also be given to an objective to consider the long-term sustainability of defined benefit pension schemes in order to preserve defined benefit accrual for those employers who still wish to provide pensions on this basis. Whilst most large defined benefit schemes are now closed to new members, there are still some that remain open and consideration should be given to having a statutory funding regime that supports them.

I trust that these comments are useful.

Yours sincerely,

Philip Broadley
Chairman
The Hundred Group – Pensions Committee