NAPF

Securing the future of pensions

Non-economic Regulators: Duty to Have Regard to Growth

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About the NAPF

The NAPF is the leading voice of workplace pensions in the UK, speaking for 1,300 pension schemes with some 16 million members and assets of around £900 billion. NAPF members also include over 400 businesses providing essential services to the pensions sector

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Executive Summary

The NAPF supports the Government's aims to promote growth and support employers and has welcomed the new statutory objective for the Pensions Regulator (TPR), announced at Budget, to support scheme funding arrangements that are compatible with sustainable growth for the sponsoring employer. This is the appropriate response to the challenging economic conditions faced by pension schemes and their sponsoring employers and clarifies the trade-offs that trustees are expected to make through their negotiations with employers around scheme funding and deficit recovery plans. The NAPF is actively engaging with HMT, DWP and TPR on this issue ahead of the wording for the new objective being published alongside the forthcoming pensions bill.

However, the NAPF believes that overlaying a second, broader growth objective or duty onto TPR would be far more contentious. A broader objective or duty could create additional conflicts between pension scheme members, trustees, and employers. The NAPF would be particularly concerned if, for example, a sector-specific approach to funding negotiations was encouraged, or if decisions around pension fund investment (for example, to encourage investment in projects of strategic importance to the UK) could be impacted. This would fundamentally alter the way that TPR interacts with those running pension schemes, and the way that trustees discharge their fiduciary duties to their members, and may require pensions trust law and supporting guidance to be completely reviewed. It is also not clear how a broader objective would impact on TPR's wider functions around auto-enrolment and it's regulation of Defined Contribution (DC) workplace pension schemes but here too any difference in treatment of employers because of size or the economic importance of the sector in which they operate would be unacceptable.

The consultation document appears to assume no additional cost from a new duty or objective. However, if TPR is required to have regard to the impact of its actions on growth, it will have to review its current regulatory behaviours and approach and demonstrate how it is giving regard to the new duty or objective in practice. Given that a new, more targeted, statutory objective for TPR is already being legislated for this is likely to only create additional burdens. The true cost (and benefits) of this additional duty objective needs to be very carefully considered.

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Introduction

1. On 8 March 2013, the Department for Business Innovation and Skills (BIS) launched a consultation on applying a new growth duty to all non-economic regulators[1]. The Government then made it known in the Budget 2013[2] that it was "attracted, subject to the results of that consultation, to applying such a new duty to TPR".

2. The NAPF is responding to this consultation purely with reference to TPR and offers no opinion on the relevance of a growth objective for the non-economic regulators listed in Annex A of the BIS consultation document.

3. TPR is not a non-economic regulator but the current consultation being undertaken by BIS poses the specific question of whether the growth consideration requirement should apply to TPR in addition to the non-economic regulators. NAPF aims to promote an environment where well-funded pension schemes can deliver benefits to members over the longer-term by ensuring pension provision is seen as sustainable by sponsoring employers. The NAPF has argued that the current economic environment and the policy of Quantitative Easing undertaken by the Bank of England has exacerbated funding pressures on defined benefit (DB) pension schemes and their employers. This is because they have been implicitly encouraged by TPR to use a discount rate pegged to gilt yields to calculate the net present value of their future liabilities and their technical provisions, and so their funding position is particularly sensitive to the downward movements in gilt yields that have been observed.

4. The higher deficits and more challenging deficit recovery plans in the short term that result from lower discount rates run the risk of diverting cash away from investment and jobs and locking it away in the pension scheme. In some cases this leads to more investment in gilts as DB schemes seek to hedge themselves against any further future movements in gilt yields and gilts based discount rates. The NAPF's view is that, whilst it may be in the interests of trustees and scheme members in the short term to secure more contributions into the scheme, this runs counter to the wider aims of the Government's aims and the Bank of England's QE programme to support economic growth and encourage investors to increase investment in the UK economy. It also risks employers reacting to the volatility by reviewing their scheme arrangements and closing their DB schemes to new or existing members where they might otherwise have felt able to run these arrangements on.

5. Consequently, in October 2012 the NAPF proposed in its paper "DB Funding – a call for action"[3] that trustees and sponsoring employers should be able to use the full flexibility of the current legislation to calculate a prudent discount rate. To facilitate this the NAPF proposed that TPR should be given an additional statutory objective to more fully take into consideration the long term economic prospects of employers and the sustainability of the pension scheme.

6. In Budget 2013 the Government announced a TPR specific growth duty to support scheme funding arrangements that are compatible with sustainable growth for the sponsoring employer and are fully consistent with the 2004 funding legislation. The new statutory objective is expected in the

[1] Non Economic Regulators, Duty to Have Regard to Growth, BIS
[2] Budget 2013, HM Treasury
[3] DB Funding – a call for action, NAPF, 2012

forthcoming pensions bill and is likely to apply from early 2014 once the bill has received Royal Assent.

7. For the avoidance of doubt we have differentiated between the two proposed growth duties for TPR in the remainder of this response by referring to them as the "TPR new statutory objective" (as confirmed in the Budget) and the "broader growth duty" (as proposed in the BIS consultation).

The Role of TPR

8. TPR is currently charged with five statutory objectives:
   - to protect the benefits under occupational pension schemes of, or in respect of, members of such schemes;
   - to protect the benefits under personal pension schemes, where direct payment arrangements exist or the scheme is a stakeholder pension;
   - to reduce the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund;
   - to maximise compliance with the duties of automatic enrolment; and
   - to promote, and to improve the understanding of, the good administration of work-based pension schemes.

9. In performing its regulatory functions, TPR provides codes of practice and guidance on key aspects of pensions regulation, administration and governance. A key function where there is the most potential for conflict with employers and future investment and growth is around the funding regime for DB pension schemes and the negotiations between sponsoring employers, trustees and their advisers. In this area, TPR provides detailed Codes of Practice[4], guidance[5], analysis[6] and engagement to support trustees and employers in their role and to provide clarity about how TPR will exercise its functions in this area.

10. TPR has a number of powers that can be invoked either versus trustees or employers. For example it can prohibit individuals from acting as trustees where it considers them not to be fit and proper, or impose fines or prosecute offences in criminal court. It can also take action to recover unpaid contributions from employers or issue improvement notices to individuals or companies requiring specific action to be taken with a specified time.

11. The role of TPR differs from that of other regulators in that in protecting the benefits under occupational schemes it must carefully balance the views of the scheme's trustees and sponsoring employer on a case by case or 'scheme-specific' basis. The best interests of scheme members may be served in different ways depending upon the particular circumstances of a scheme and its employer.

12. The responsibilities of trustees for UK pension schemes and their fiduciary duties, outlined below, are unique and complex and may be conflicted by a broad growth duty being applied to TPR, to the ultimate detriment of scheme members.

[4] Funding Defined Benefits, TPR, 2006
[5] Pension scheme funding in the current environment, TPR, 2012
[6] The defined benefit regime, Evidence and analysis, TPR 2012

The Role of Pension Fund Trustees

13. The Pensions Regulator describes the key duties of a trustee as follows:
    - Act in line with the trust deed and rules
    - Act prudently, responsibly and honestly.
    - Act in the best interests of your beneficiaries
    - Act impartially.[7]

    Overarching the requirements of TPR are the trustees' duties under trust law, which have developed through Acts of Parliament and case law. The basis of trust law is that trustees hold assets for the benefit of the scheme beneficiaries. When applied to a pension scheme, trust law provides the foundation for how trustees must act in relation to the scheme, otherwise known as the trustees' 'fiduciary' duties. This fiduciary duty means they must act in the best interest of all members and exercise their judgement. They should not agree to any changes which would leave members worse off – unless it would benefit the membership as a whole to a greater extent.

14. It is clear that fulfilment of these duties is unlikely to require any consideration of broader economic growth implications by the trustees and they could find themselves in a position where they have to overrule TPR or, in the extreme, resign their position as their ability to fulfil their fiduciary duty is compromised.

15. Trustees will, however, be concerned with scheme members receiving their accrued benefits in line with the trust deed and part of that will include an interest in the financial wellbeing and ongoing health of the employer and their ability to both support the scheme and provide secure employment to scheme members in future. Hence, we agree with the introduction of TPR's new statutory objective that seeks to clarify the trades-offs trustees need to make when negotiating with the schemes sponsoring employer. Whilst this may support the sustainable growth of the employer it is intended to be restricted to their negotiations around scheme funding. It is not intended to place a wider requirement on them to support and promote economic growth which should not be a primary concern of the trustees and may lead to increased and unnecessary conflict in negotiations with TPR and the employer. We therefore disagree with the application of a broader growth duty to TPR.

The Importance of Employer Growth

16. In fulfilling their duties the trustees must negotiate with the employer in the best interests of all scheme beneficiaries. Scheme members will consist of one or more of the following groups depending on the status of the scheme: active employees still contributing to the scheme; deferred members who have left the scheme; and pensioner members currently in receipt of a pension. Each will have slightly different interests.

17. The on-going consideration of employer growth and on-going financial viability is a key concern for the trustees of DB and DC schemes. Trustees of DB schemes will already review the "employer covenant" which is the employer's legal obligations to the scheme and its ability to meet them. The interests of the scheme beneficiaries and the long term sustainability of the pension scheme will depend upon the solvency of the employer in the longer term. This is why, in the current economic

[7] Trustees duties and powers, TPR website

conditions, we argued for trustees and employers to be able to use the full flexibility of the regulatory framework surrounding discount rate assumptions used for funding valuations.

18. The NAPF therefore supports the idea of TPR's new statutory objective that is expected to apply to the activities around DB scheme funding. The NAPF has responded separately to the DWP Call for Evidence on a new statutory objective for TPR and is actively engaging with discussions with DWP and TPR officials on this issue ahead of the wording of the new objective being published in the forthcoming pensions bill.

19. NAPF believes that TPR's new statutory objective, combined with increased transparency and accountability from TPR to demonstrate how it is altering its behaviour in practice, is a sufficient response to the current challenges being faced. Transparency is important in maintaining the confidence of trustees, their advisers, and employers. For example TPR published some helpful analysis in October 2012[8] on the range of discount rate assumptions that were reported for previous tranches of scheme funding valuations. Providing more context around the circumstances in which these were applied in practice could provide greater reassurance to trustees and employers in their future negotiations. With greater transparency trustees and employers would be able to benchmark their experiences with TPR to ensure that the actions taken were consistent, necessary and reasonable. Introducing a broader growth duty is more contentious and problematic and strays into other areas of TPR's regulatory activities.

20. A broader growth duty that goes beyond a consideration of the financial growth and stability of the employer, specifically when handling scheme funding negotiations, could shift the balance too far towards financial considerations outside of the scheme and away from TPR and trustees' duties to protect scheme member benefits.

21. As already stated the NAPF is particularly concerned that a broader growth consideration would be inconsistent with the trustees' duties, in particular their primary fiduciary duty to act in the best interests of their scheme beneficiaries. More detail is provided on this in the following paragraphs.

The Consequences of a Wider Growth Objective on DB Pension Schemes

22. TPR's preferred outcome for a DB scheme is an **appropriately funded scheme** with a solvent **employer**. The NAPF strongly shares that view.

23. Trustees of DB schemes will already review the "employer covenant" which is the employer's legal obligations to the scheme and its ability to meet them.

24. A wider consideration for UK economic growth could tip the balance of attaining an **appropriately funded scheme** with a **solvent employer** too far in favour of the employer, negatively affecting scheme beneficiaries and directly conflicting with the fiduciary duties of the trustees as governed by

[8] The Defined Benefit Regime, Evidence and analysis, TPR, October 2012

trust law. It would also place additional burdens on trustees in carrying out their duties.

25. For example, one factor on which the trustees and sponsoring employer must agree in their triennial pension scheme valuation is the discount rate to use in calculating the net present value of their future liabilities and their technical provisions.

26. The extent to which the legislative framework prescribes the discount rate to be used is contained in regulation 5 of the Occupational Pension Schemes (Scheme Funding) Regulations 2005 which provides that;

"The rates of interest used to discount future payments of benefits must be chosen 'prudently' taking into account i) the yield on scheme assets held to fund future benefits and the anticipated future investment returns and/or ii) market redemption yields on government or other high quality bonds."[9]

27. The discount rate can have a significant impact on the present value placed on future liabilities and hence the size of a pension scheme's deficit and the financial burden placed on the employer. It can therefore involve a difficult discussion being held between trustees and the sponsoring employer to agree a discount rate that is relevant to the individual circumstances of the pension scheme, their investment strategy and expected returns, and the strength of the employer covenant.

28. There is no legislative definition of "prudently". This creates the potential for considerable flexibility in the funding regime and, in particular, the assumptions that can be used when calculating a scheme's technical provisions.

29. The NAPF supports the use of the full flexibility permitted within the regulations consistent with TPR's new statutory objective. However, this flexibility should be open to all schemes wherever appropriate and should not be impacted by, for example, the strategic importance of an employer to wider economic growth in the UK.

30. If TPR were given an additional requirement to consider the impact on broader economic growth it is possible it may be influenced to allow sponsoring employers in particular sectors more flexibility than others. This in turn could put pressure on trustees of those schemes whose employers are considered strategically important to economic growth to accept less prudent arrangements than they would otherwise have agreed to. It could also potentially create conflict between schemes where the sponsoring employer is a UK registered company versus a multi-national company registered overseas.

31. In addition, in a limited number of cases where employers have experienced extreme financial difficulty, it has been possible for sponsoring employers to come to 'compromise agreement' with the Pension Protection Fund to avoid insolvency. In these situations the employer would typically be facing administration and the funds available to the scheme via transfer to the Pension Protection Fund would have been very small. The idea of the compromise agreement is to deliver a result that benefits both the scheme members and the Pension Protection Fund.

32. Compromise agreements are another example where the decisions of TPR could be influenced by a broader growth duty. An example of such an agreement might be for an employer to transfer its pension obligations to the Pension Protection Fund in return for an equity stake in the on-going

[9] Calculation of Technical Provisions Regulation 5 (4)(b)

business being granted to the Pension Protection Fund. The negotiation of such deals is normally undertaken with input from trustees and TPR. A Regulator with a requirement to consider broader economic growth might act more or less favourably towards employers depending on the sector in which they sit which, in turn, might result in additional conflict with the duties of the trustees.

33. **Creating an environment where the sector of the employer could influence the regulation of its pension provision could be incompatible with trust law and the fiduciary duties of trustees. Equally, it could fundamentally alter the way that TPR interacts with trustees and those running pension schemes and may require the legislation and guidance to be fundamentally reviewed.**

34. The NAPF would suggest that, with TPR's new statutory objective already proposed by the Chancellor at Budget 2013, there is already sufficient flexibility to ensure the activities of TPR do not stifle wider economic growth.

35. The consultation paper quotes wording in the Regulatory Enforcement and Sanctions Act 2008 that regulators should "not impose unnecessary burdens and should remove such burdens where proportionate and practicable". This does not currently apply to TPR, but BIS may consider that this type of requirement is more appropriate to the balance of interests TPR needs to consider than a broader growth duty would be.

36. There is also wording in Section 21 of the Legislative and Regulatory Reform Act 2006 that states "action should only be targeted where it is needed". If regulatory action is targeted and needed it should be taken and not influenced by a broader growth duty that has no impact on an individual scheme or its ability to sustain scheme benefits.

The Impact on DB Pension Scheme Investments

37. As part of their scheme funding considerations, trustees must also decide how best to invest their scheme's assets in order to meet the liabilities due to current and future pensioners. The expected return on assets will have a major impact on the scheme deficit (or surplus) and consequently on the additional amount the sponsoring employer will be required to pay into the scheme to address any shortfall.

38. In recent years UK DB pension schemes have undergone a step change in their asset allocation. Schemes are maturing. Only 13% of DB schemes in the private sector remain open to new members and schemes are looking more and more to de-risk and to hedge their future liabilities using lower risk assets.

39. In 2007 the average DB scheme held 55% in equities, 29% in fixed income and 16% in all other assets. By 2012 this had changed to just 35% in equities, 39% in fixed income and 26% in all other assets. The shift out of UK equities has been particularly stark. In 2007 the average DB scheme held 30% in UK equities. By 2012 this had dropped to 10%.[10]

[10] NAPF Annual Survey 2012

40. TPR provides trustees with guidance and training on the principles relating to the suitability of different asset classes to meet the liabilities of the scheme, taking account of the strength of the employer covenant and the trustees' risk profile for the scheme. If TPR were to have a duty to consider the broader growth impact of its actions, it could be more likely to encourage trustees to invest in asset classes that are specifically beneficial to UK growth, such as UK equities or UK corporate debt. Other asset classes, more suited to mature schemes, could also be attractive from a growth perspective, such as infrastructure or social housing. These can be beneficial investments in matching pension liabilities but, due to their illiquid nature, these assets not necessarily suitable for or available to all schemes.

41. Trustees may encounter a conflict of interest when balancing a desire to 'fit' with TPRs duty to aid broader economic growth with their own fiduciary duty to act in the best interests of their members. A broader growth duty could therefore lead to sub-optimal outcomes for the pension scheme and its long-term investment strategy.

The Consequences of a Wider Growth Objective on DC Pension Schemes

42. TPR also regulates trust-based defined contribution (DC) schemes. NAPF supports consistent high standards of regulation and governance of pension schemes and believes that there should be a single regulator for all workplace pension provision.

43. When considering how a growth consideration might affect TPR activity in relation to DC pension provision the NAPF considers the suggestions to be less problematic but, nevertheless, unnecessary.

44. For DB schemes the key concern lies in the ongoing funding of schemes as employers have a long term duty to pay out accrued benefits to the scheme members for as long as the pension scheme remains in existence. This means that the economic stability of the employer may be a concern for trustees for many decades. However in DC schemes the employer pays a pre-determined contribution into the scheme but the size of the member's pension pot is dependent on investment returns and is not guaranteed or promised by the employer. There is less potential for conflict in the discussions between employers and trustees as it is the scheme member, and not the employer, that is bearing the investment, longevity and inflation risks.

45. The main area in which we believe a broader growth duty could impact on the behaviour of TPR is in relation to its duty to regulate auto-enrolment. In October 2012 it became a legal obligation for the largest employers in the UK to enrol eligible employees (based on factors such as age and salary) into a qualifying pension scheme and to pay contributions into that scheme. The introduction of auto-enrolment is happening in stages with the largest employers starting in October 2012 and the smallest employers in April 2017. TPR states it will "be firm but fair to non-compliant employers."[11] The NAPF is concerned that, once again, a broader growth duty could lead TPR to treat non-compliant employers differently depending on their size or the importance of their sector to the broader economy. This would fundamentally undermine the objective of the long-term reforms to improve

[11] TPR website

access to all eligible employees to a workplace pension.

Potential Cost

46. The consultation paper assumes no additional costs will be incurred. However, in order for TPR to have 'considered' or 'had regard to' the economic impact of its actions, it will need to be able to show that it has considered the impact, which will require that it has assessed it.

47. At a minimum this will require an input of time from current TPR staff and a review of TPR processes and practice. A zero cost cannot therefore be assumed (unless the exercise is entirely superfluous and requires no action) and BIS will need to more accurately assess the burden imposed by a broader growth duty.

48. The NAPF's members have also raised concerns about the practical implementation of a wider growth duty, in particular the additional information that may be required from sponsors and trustees in order help TPR to calculate the broader impact.

State Aid

49. In the implementation of a wider growth duty TPR may also be affected by the provisions on State Aid. State Aid refers to "forms of assistance from a public body, or publicly-funded body, given to selected undertakings (any entity which puts goods or services on the given market), which has the potential to distort competition and affect trade between member states of the European Union."

50. The behaviour of TPR, should it be charged with a broader growth duty, could result in certain sectors of the economy being treated more favourably than others and therefore could affect their relative competitiveness among EU member states.

51. As TPR is partially funded by the Department of Work and Pensions BIS will need to consider whether there is potential for a duty to consider wider economic growth to fall foul of the State Aid provisions.

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Consultation questions

Question 1: Should primary legislation be used to introduce a duty for regulators to have regard to growth and the economic impact of their actions?

For the reasons cited above the NAPF does not believe that the TPR should be given a generic duty to have regard to growth and economic impact of its actions.

Question 2: Is there an alternative means by which these objectives, described in paragraphs 2.1 to 2.6 above, could be achieved?

As mentioned in the previous questions TPR will be given an additional objective specific to its unique regulatory duties and limited to consideration of the growth of the sponsoring employer of each pension scheme on a case by case basis.

Question 3: Do you agree that the duty should be complementary to existing duties?
n/a we do not support the wider growth requirement objective for TPR.

Question 4: Should the duty be principles-based, for regulators themselves to interpret and apply to their operations, or should it also specify the manner in which economic growth should be supported?
n/a we do not support the wider growth requirement objective for TPR.

Question 5: Do you think that guidance in how to implement the proposed growth duty would be useful? If yes, please provide examples of what it should cover.
n/a we do not support the wider growth requirement objective for TPR.

Question 6: Do you agree that the measurement and monitoring mechanisms proposed above, allied to those of the revised Regulators' Compliance Code, would be adequate for this purpose? If not, please provide details.
n/a we do not support the wider growth requirement objective for TPR

Question 7: Do you agree that the duty should in principle apply to all non-economic regulators?

n/a we do not support the wider growth requirement objective for TPR

Question 8: Should the Pensions Regulator be included in the scope of the growth duty?

No for reasons outlined elsewhere in this consultation.

Question 9: Do you feel that a growth duty would reduce costs to business and remove or address barriers to growth?

n/a we do not support the wider growth requirement objective for TPR

Question 10: How would you envisage a regulator's actions changing as a result of a growth duty? Please consider this in light of evidence presented above, and/or with reference to other situations where regulator actions impacted a company or industry's ability to grow.

n/a we do not support the wider growth requirement objective for TPR

Where possible, provide a monetary indication of likely impact of a successfully operating growth duty on a company or industry

n/a we do not support the wider growth requirement objective for TPR

Question 11: Is there any evidence that this will add significant burdens to regulators and why?
We have addressed this above in relation to TPR