JOHN RALFE CONSULTING

Work and Pensions Select Committee Inquiry into the Pensions Regulator and the Pension Protection Fund

Evidence submitted by John Ralfe

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Over the last 15 years, he has written over 70 articles and letters for the Financial Times on all aspects of pensions, including pension regulation.

Until 2002 he was Head of Corporate Finance at Boots and instrumental in moving the £2.4bn Boots Pension Fund to 100% AAA long dated sterling bonds.

He was a consultant to the Accounting Standards Board on FRS17 and the International Accounting Standards Board on share options and worked with Harvard Business School to develop Boots Pensions as a Case Study.

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Appendices with John Ralfe's Financial Times articles on BHS, Trinity Mirror, Trafalgar House, Polestar, UK Coal & Kodak

1 Introduction

1.1 I welcome the invitation to submit evidence to help the WPSC in its Inquiry into the circumstances of BHS's two pension schemes entering the Pension Protection Fund assessment period, and the broader issues of UK pension regulation, especially the role of the PPF and the Pensions Regulator.

1.2 This evidence represents my views on the issues of UK pension regulation, which I have followed closely, and written and debated about for almost 20 years. I support my analysis, wherever possible, and the appendices include some of my Financial Times articles with details of particular regulatory failings. Some comments, however, are no more than my personal impressions.

2 Summary

2.1 In looking at pension regulation, we should remember that the Labour government did not set up the PPF and the Pensions Regulator from a position of strength, as part of an overall pension strategy. Rather the June 2003 announcement was a response to the **pressing political problem of people who had lost their company pensions marching on Whitehall.**

2.2 The **legal funding requirements in the Pensions Act 2004 are weak**; companies are not required to make up funding shortfalls over set periods against a tough and transparent funding standard. Rather the Act emphasises "flexibility", and allows each scheme and employer to agree its own "scheme specific funding standard".

2.3 Meanwhile, the **PPF has been used as a comfort blanket** by employers, trustees and the government.

2.4 I believe that over the last 10 years the combination of "flexible" funding regulations and the PPF safety net has, at best, led to complacency, and at worst, led to "**moral hazard" on a grand scale for both employers and trustees** negotiating deficit contributions.

2.5 Not only is the Pensions Act 2004 weak, but **the Regulator seems to be weak at enforcing the rules.** This may be because its powers are not as strong as is generally thought – it certainly has no powers to "stop" things such as disposals of subsidiaries or large dividend payments - or because it does not want to take action which could tip a company into insolvency, even to reduce the PPF's losses.

2.6 As part of "increased flexibility", the **Regulator has recently scrapped its own guidelines on funding and deficit recovery plans**, put in place shortly after it was set up. I believe this is a dangerous backward step, which seriously weakens UK pension regulation.

2.7 The **Regulator has also allowed high profile companies to put other creditors ahead of the pension scheme** - Trinity Mirror and Premier Foods - breaking the fundamental regulatory principle that the pension scheme should not be subordinated to other unsecured creditors (see appendices).

2.8 The **Regulator has bent its rules in company restructurings** to prevent pension schemes with large deficits – Trafalgar House, UK Coal and Kodak - falling into the PPF (see appendices). These not only call into question the Regulator's consistency and appetite to make tough decisions, but in one case, Polestar – significantly increased the PPF's eventual losses. It appears that the Regulator has failed some key decisions by "kicking the can down the road". I estimate **the losses currently "off the PPF's books" via these deals are £800m to £1bn.**

2.9 I believe the **current "DIY" statutory funding objective should be replaced with tougher pension funding standards**, enforced by the Pensions Regulator. Pension deficits should be measured in a strict rule-based way, with prescribed deficit recovery periods for all schemes

2.10 The **Regulator should become more interventionist** with companies with high risk pension schemes, well before they become insolvent.

2.11 The Regulator is one of a handful of public bodies not subject to FOI. I believe **the law should be changed and the Regulator should be subject to FOI**, to make it more transparent and accountable, with a "public interest" argument for releasing details of decisions.

2.12 The PPF applies consistent and rational rules in determining the levy it charges all pension schemes. It now includes asset allocation in assessing a scheme's risk which I, and others, argued for since it was set up. But the **PPF cannot charge enough overall to meet the corporate credit risks** it is taking.

2.13 However good the PPF's levy charging structure, the extent of its losses are almost entirely out of its control, and **the PPF relies on the Regulator to take action to protect it from losses.**

3 The PPF creates "moral hazard" for employers and trustees; the Pensions Act 2004 is too weak to deal with it

3.1 Setting up the PPF lifeboat to pay compensation to pension scheme member created "moral hazard"; without strict legal funding requirements, each individual company has an incentive to fund its own scheme to the minimum, whilst wanting other companies to have well-funded schemes so it does not pay for their failure.

3.2 To avoid this moral hazard, it was crucial for the new Pensions Act to set out a tough and transparent funding standard to measure pension scheme deficits, and to require companies to plug deficits over set periods, and for this to be enforced by a new Pensions Regulator with strong powers.

3.3 But the legal funding requirements in the Pensions Act 2004 are weak; companies are not required to make up funding shortfalls over set periods against a tough and transparent funding standard. Rather the Act emphasised "flexibility" over prescription, and allows each scheme and employer to agree its own "scheme specific funding standard". In practice, schemes have a wide range of funding assumptions – a discount rate of gilts flat, gilts plus 1.5 per cent, or a corporate bond rate, have all been accepted by the Regulator.

3.4 Equally the Pensions Act 2004 has no mandatory period to plug deficits, and many different lengths of recovery plans have been accepted by the Regulator, including 23 years for BHS at the 2012 valuation.

3.5 Deficit recovery plans can include not only employer cash contributions, but also the expected long-term higher returns from holding equities.

3.6 The PPF also creates "moral hazard" for trustees in negotiating deficit contributions. Trustees should press for higher employer contributions to an underfunded scheme, but have little incentive to do so, as PPF compensation for their members is fixed, regardless of the extent of scheme underfunding. PPF compensation is identical whether a scheme is 29 per cent or 99 per cent funded against the PPF yardstick.

3.7 Higher company contributions reduce the PPF loss if the employer goes bust, but does nothing for members, unless it takes funding over the PPF level of compensation, which is unlikely.

3.8 The worse the funding level, the weaker the incentive for trustees to be tough, especially if this risks pushing the company into insolvency. Some trustees are themselves members of the pension scheme so may not want to rock the boat, especially if they are near to retirement age

3.9 Since the PPF is funded by a levy on all pension schemes, the losers from weak funding are the shareholders of the strongest companies, which will ultimately pay for the PPF's losses. The winners are the bank creditors of companies that go bust. Lower deficit contributions amount to a "tax" on the shareholders of stronger companies, paid to the bank creditors of the weakest companies.

3.10 I believe that over the last 10 years the combination of "flexible" funding regulations and the PPF lifeboat has led, at best, to complacency, and at worst, to moral hazard on a grand scale for both employers and trustees negotiating deficit contributions.

4 The Regulator has recently weakened its own funding guidelines

4.1 Not only is the Pensions Act 2004 itself weak, but the Regulator's own funding guidelines, separate from the Act, have recently been weakened.

4.2 As early as May 2006 the Regulator had a number of helpful guidelines for valuations and recovery plans; these required that the value of liabilities should be no be weaker than the accounting value, using a corporate bond rate, the recovery plan should be no more than 10 years and the cash contributions should not be "back-ended". [1] Failing to follow these guidelines could trigger an investigation by the Regulator, which, in practice, made companies and trustees think long and hard

4.3 In 2013, however, as part of "increased flexibility" the Regulator scrapped these triggers altogether. [2] I believe that scrapping these triggers on funding valuations and recovery plans is a dangerous backward step, which seriously weakens UK pension regulation.

5 The Regulator has bent its own rules; Trinity Mirror & Premier Foods

5.1 The Regulator has also allowed companies to put other creditors ahead of the pension scheme, breaking a fundamental regulatory principle that the pension scheme should not be subordinated to other unsecured creditors.

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[1] http://www.thepensionsregulator.gov.uk/docs/funding-statement.pdf especially section 3

[2] http://www.thepensionsregulator.gov.uk/docs/DB-annual-funding-statement-2013.pdf

5.2 In 2012 Trinity Mirror cut its £100m agreed pension deficit contributions over 3 years to just £30m, to allow it to repay US bond holders.

5.3 It appears Trinity Mirror chose not to seek pre-clearance from the Regulator and in response to the announcement the Regulator issued an apparently tough statement: *"We will scrutinise any reduction in contributions or other actions that increase risks to the scheme, and are prepared to take strong action where necessary."*

It is not clear if the Regulator took any action, but I have not been able to find any disclosures in Trinity Mirror's subsequent accounts.

5.4 In 2012 Premier Foods was allowed to stop £82m of deficit contributions and used all £130m of asset disposal proceeds to pay down bank debt, effectively putting the pension scheme behind other unsecured creditors.

6 The Regulator has bent its own rules; Trafalgar House

6.1 There have also been several examples of the Regulator bending its own rules over company restructurings to prevent pension schemes with large deficits, falling into the PPF. These not only call into question the Regulator's consistency and appetite to make tough decisions, but certainly in one case have increased the PPF's eventual losses.

6.2 In 2006, shortly after it was set up, the Regulator gave pre-clearance for a transaction for Trafalgar House Pensions, with 25,000 members, and a £300m deficit as of March 2014.

6.3 The Regulator allowed it to become a "zombie scheme", with no employer standing behind it to make cash contributions to plug the deficit. Its legal sponsor is the pension trustee company, itself owned by the scheme, with no income or cash flow.

6.4 Having the pension trustee company as the legal sponsor creates a minefield, as the trustee company directors have a head-on conflict of interest as both directors of the sponsoring company and trustees of the pension scheme.

6.5 To plug the substantial deficit, the trustees are betting on investment outperformance in high-risk assets, 60 per cent of assets are in equities, private equity, hedge funds and property.

6.6 Despite the absence of a real sponsor, Trafalgar House is still eligible for the PPF, creating a situation of "heads we win, tails the PPF loses".

6.7 Trafalgar House was the first real test of the new regulator's powers and I said at the time that, "*We've returned to the bad old days. Kvaerner [the former owner] has turned its back on a huge pension deficit*." [3]

6.8 In 2006 the architect, and public face of Trafalgar House was Baroness Altmann the current pensions minister; she was an advisor to Trafalgar House in 2006, and a trustee between 2007 and 2010 and again from 2014 until just after she was appointed as a Minister.

This conflict may make it difficult for the Minister to take a dis-interested view of pension regulation.

[3] http://www.telegraph.co.uk/finance/2937793/A-dangerous-pensions-precedent.html

7 The Regulator has bent its own rules; Polestar

7.1 In December 2006 the Regulator approved a second “zombie” deal for the printing group, Polestar, backed by private equity.

7.2 As with Trafalgar House, the trustee company became the legal sponsor, with a plan to plug its deficit through high-risk investment bets. This deal faltered, however, and in 2011, the trustees wound up the scheme after the Regulator told them to “crystallise the position” and warned it would use its powers if they did not.

7.3 In 2013 the PPF estimated that this action had increased its losses from £60m to £166m, when it entered the PPF.

7.4 The regulator’s S89 report on Polestar in 2011 concluded *that “under any reasonable scenario the scheme could never expect to pay the benefits promised to its membership [and] in the absence of an employer that could make payments to the scheme, the PPF was . . . exposed to a growing deficit”.* [4]

7.5 It added: *“The regulator would not expect any scheme to take excessive investment risk, unsupported by the employer covenant, and to the detriment of younger scheme members and the PPF.”*

8 The Regulator has bent its own rules; ANOther

8.1 I have established under an FOI request that there is a third scheme in the same position as Trafalgar House and Polestar, but I have been unable to identify it.

[4] http://www.thepensionsregulator.gov.uk/docs/section-89-polestar.pdf

9 The Regulator has bent its own rules; UK Coal

9.1 A restructuring in 2012 split UK Coal into two companies; one owning mines, responsible for making pension deficit payments owned by an employee benefit trust, and another owning 30,000 acres of brownfield development land, with no pension liability. The pension schemes bought 75 per cent of the property company for £30m, with the other 25 per cent owned by a publicly quoted company.

9.2 Following a fire at one of the mines, UK Coal restructured a second time so it could continue to operate, owned by an employee benefit trust, and the PPF received a series of "debt instruments". [5]

10 The Regulator has bent its own rules; Kodak

10.1 In 2013, the Regulator approved a deal allowing Eastman Kodak to reach an agreement with its UK pension plan, helping it to emerge from Chapter 11 bankruptcy. The UK pension plan agreed to buy two of Kodak's businesses for $650m and withdraw its £1.9bn legal claim against Eastman Kodak.[6]

10.2 A new Kodak UK pension plan was formed – like Trafalgar House, Polestar and AN Other, a zombie scheme with no corporate sponsor standing behind it to make deficit contributions. The ex-Kodak businesses will, it is hoped generate enough cash to plug the deficit.

10.3 The new plan will be eligible to enter the PPF at some point in the future.

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[5] http://www.thepensionsregulator.gov.uk/docs/section-89-ukcml.pdf

[6] http://www.thepensionsregulator.gov.uk/docs/section-89-report-kodak.pdf

11 The Regulator's decision making is not transparent and is not subject to FOI

11.1 In each of these cases we would expect the employer to enter administration, with the corporate assets being sold as going concern or piecemeal. The PPF, as its largest unsecured creditor, would receive the lion's share of the proceeds of administration to offset its loss.

11.2 The Regulator did not explain why this approach, which has been applied to hundreds of other companies was not used; what the criteria are for the rules to be bent; how these different structures minimised the present value of likely PPF losses and how it has been monitoring the consequences of these decisions.

11.3 As a practical matter, this lack of clarity and consistency makes it impossible for companies and advisors to draw any conclusions about what solutions may be acceptable to the Regulator.

11.4 Transparency of outcome and decision-making process is crucial to maintain the Regulator's independence and integrity and to avoid what looks like smoke and mirrors. The Pensions Regulator is one of a handful of public bodies not subject to the Freedom of Information Act.

11.5 Furthermore, the Pensions Act 2004 makes it a criminal offence for the Regulator to disclose *"information obtained by the regulator in the exercise of its functions which relates to the business or other affairs of any person"* [7]

[7] http://www.legislation.gov.uk/ukpga/2004/35/section/82

11.6 "Who regulates the Regulator?" is a version of the ancient question, "Who guards the Guardians?" Although the Pensions Regulator is, quite rightly, independent it also needs to be accountable. In 2006 several MPs asked Parliamentary questions on the Regulator's decision over Trafalgar House, including: " *To ask the Secretary of State for Work and Pensions what measures are in place to ensure transparency in the process used by the pensions regulator for taking decisions; and to whom the pensions regulator is accountable for his decisions".* [8]

11.7 The Minister's reply was unhelpful. *"Any information concerning decisions taken by the pensions regulator needs to respect both legislative prohibitions and the confidentiality of information exchanged between the parties and the regulator. The regulator has published a number of documents containing guidance as to its approach on its website. The regulator is accountable to the Secretary of State for Work and Pensions and thus ultimately to Parliament."*

11.8 The Minister's description of accountability is, unfortunately, circular. If the Regulator is *"accountable to Parliament",* then why is it impossible for MPs to obtain any information on the Regulator's decision?

11.9 The law should be changed to de-criminalise providing information and to make the Regulator subject to FOI, to make it more transparent and accountable, with a "public interest" argument for releasing details of decisions.

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[8] Keith Vaz, MP for Leicester; Hansard 16 May 2006: Column 919W**.** ***[73213]***

12 The PPF levy is applied consistently, but is too low overall

12.1 The PPF is funded by a levy on all companies with defined benefit schemes, taking into account: scheme funding, sponsor strength and the extent to which assets and liabilities are mismatched, so schemes with equities pay more.

12.2 The method of charging has become more refined over the years, and in particular, asset and liability mis-match is now included, which I, and others, had pressed for as soon as the PPF was set up.

12.3 But the real overall economic charge for the risk the PPF is running is higher than it is charging. Furthermore, it had no initial capital to absorb unexpected losses and its losses are geared – it is directly hit by any change in the value of liabilities, assets or sponsor recovery rates, so its net position can change rapidly.

12.4 Within the overall charge, less risky companies are subsidising more risky ones.

12.5 For many higher quality companies, borrowing to inject cash or a bank guarantee, may be cheaper than paying the PPF's risk-based levy, encouraging them to make deficit contributions to reduce their PPF ley.

12.6 But if underfunding shrinks through higher contributions, the levy rate must increase just to raise the same amount. Applying an ever higher percentage rate on an ever narrower base of weaker companies is, eventually, self-defeating. Because the PPF's losses are paid for by levies on all other company pension schemes there is a limit to how far the levies can be increased.

12.7 .If very high losses mean the PPF cannot, in practice, raise levies to cover losses, so the PPF is effectively bust, it can reduce compensation paid to all members to balance its books. This would involve no annual inflation pension increases (inflation protection is already less generous than most schemes), followed by reducing pensions in payment.

12.8 Although the government does not guarantee the PPF the political firestorm if pension benefits had to be cut would, I believe, lead to the government stepping in.

13 How can pension regulation be improved?

13.1 I believe the government should replace the current "DIY" statutory funding objective with tougher pension funding standards and that the Pensions Regulator should enforce the new rules consistently and transparently. Pension deficits should be measured in a strict rule-based way, with prescribed deficit recovery periods for all schemes.

13.2 Fortunately, there is no need to reinvent the pensions wheel. The PPF S179 valuation already requires all pension schemes to calculate a deficit based on the value of their assets and liabilities smoothed over five years, using daily average values.

13.3 The PPF also rightly takes investment risk – a scheme's asset and liability mis-match – into account, by "stress testing" smoothed pension liabilities and assets. Stress testing smoothed liabilities assumes a fall in interest rates, increasing their value. Stress testing smoothed assets assumes an increase in the value of bonds, reflecting the fall in interest rates, and a fall in the value of equities.

13.4 Along with the credit score of the sponsoring company, the smoothed and stress-tested deficit is used to assess the risk-based PPF levy each scheme must pay.

13.5 Under the new funding rules I recommend all schemes would be required to hold a minimum value of assets equal to their smoothed and stress-tested value of PPF liabilities.

13.6 Against this minimum standard, companies would be required to put in extra cash over, say, 10 years, with, say, 5 years to reach 90 per cent if they are below it, with no "ifs or buts". There would be no reliance on expected "equity outperformance" to plug deficits.

13.7 This would be similar to the much maligned Minimum Funding Requirement, abolished by the Pensions Act 2004 - its only fault was to be too weak when it was introduced in 1997 and was then further weakened by the government in the name of increased flexibility.

13.8 Since this s179 deficit is already produced each year by all schemes, it can be used immediately, with no extra compliance costs. Most importantly, it would also bring valuable consistency between the deficit calculations required by the PPF and the Pensions Regulator, which are just two sides of the same regulatory coin.

13.9 Trustees could, if they wished, spend the time and money to produce a valuation on a stronger basis than this, and try to negotiate faster deficit contributions, but it would be irrelevant in calculating the regulatory deficit and legal minimum deficit contributions.

14 What would tougher pension funding do to the real economy?

14.1 Many lobbyists argue that tougher pension funding, requiring companies to better fund their schemes, as I outline above, would be negative for the UK real economy.

14.2 In 2012 the UK chancellor announced a consultation on "smoothing" the value of pension scheme assets and liabilities used to calculate deficits for regulatory purposes. He said he was *"determined to ensure that defined-benefit pensions regulation does not act as a brake on investment and growth".* [9]

14.3 But the claim that higher deficit contributions "crowd out" investment and growth in the real economy is based on faulty economics. It ignores what happens to the deficit contributions and suggests they disappear down a rathole, never to be seen again.

14.4 Deficit contributions, including those to the local government scheme, was about £45bn for the three years to 2015. Rather than disappearing down a rathole this was invested by individual schemes in capital market securities, equities or bonds, or held as cash on deposit, then lent to other companies.

14.5 Pension contributions are a zero sum game – they do not reduce the total supply of capital in the economy available for investment to fuel growth. Pension contributions from one company will find their way, through banking and capital market intermediation, to other companies with the best opportunities for productive investment and hiring.

[9] https://www.gov.uk/government/consultations/pensions-and-growth-smoothing-of-assets

Appendices Detailed articles

http://www.ft.com/cms/s/0/d939416e-0d3e-11e6-b41f-0beb7e589515.html#

FTMoney Comment April 30th 2016 John Ralfe

"BHS has lessons for the state of pension regulation"

The fate of 20,000 members of BHS's two pension schemes is likely to be a long-running saga, involving superyachts and a lifeboat.

The troubled retailer entered administration this week, and its pension schemes are now in the lifeboat of the Pension Protection Fund (PPF), set up to pay compensation to members of bust schemes.

The BHS schemes are now unsecured creditors in the insolvency process, with a whopping £571m claim against BHS's corporate assets — the largest by a long way — but, as most assets are secured, they will receive virtually nothing.

The Pensions Regulator quickly announced it was "undertaking an investigation" and will start the process which could (eventually) lead to a claim of up to £571m against Taveta Investments, a company controlled by Lady Tina Green and her immediate family, which sold BHS for £1 in March 2015 to a newly formed company with no track record.

Although we should not rush to judgment, BHS does look like a return to the bad old days when companies could walk away from underfunded pension schemes, with the new twist of being able to dump them into the PPF.

Companies planning to sell a subsidiary with a pension scheme can get pre-clearance from the regulator, which may require a one-off cash contribution. Since the regulator has announced an investigation, it seems that Taveta chose not to obtain pre-clearance.

When a parent company sells a subsidiary whose pension scheme ends up in the PPF, the strength of the regulator's case against the parent depends on the precise level of financial support it gave. If a parent guarantees all its subsidiary's liabilities as long as it remains a subsidiary, the regulator can argue that, by selling it, the parent has avoided its pension obligations.

The regulator used this argument last year, where a parent had guaranteed a subsidiary's pension scheme but then sold the subsidiary for £1, and the guarantee fell away. The regulator made a claim for the full buy-out deficit against the former parent.

Taveta did not guarantee BHS's liabilities, but it did provide what BHS's accounts from 2011 to 2014 (the last accounts before BHS was sold) described as "continued financial support". Crucially, this allowed BHS's directors to prepare accounts on a "going concern basis".

Establishing the precise nature and extent of Taveta's "continued financial support" for BHS will be important if the regulator is to enforce a claim. Sir Philip Green has been reported to have offered £80m to help pay down the BHS pension deficit.

The regulator will start by getting all documents on the sale from Taveta, BHS and the new owners, as well as documents explaining Taveta's "continued financial support". Depending on what it finds, it could then issue a "warning notice", take representations and hold oral hearings, and then issue a "contribution notice" to Taveta to pay a specific amount.

Each of these steps will take several months and a contribution notice can be appealed, all the way to the Supreme Court.

Although any BHS claim could take years, the regulator will be prepared to spend as much time and money as it takes, because this is a test case to reinforce the principles of pension regulation. Furthermore, the amounts at stake are so huge for the PPF — its loss of around £300m, before any money recovered from Taveta, is one of its biggest ever.

The PPF's losses are paid for by levies on all other company pension schemes. If very high losses mean the PPF cannot, in practice, raise levies to cover losses, making the PPF itself effectively bust, it can reduce the compensation paid to all members to balance its books — a nuclear option. There is no government guarantee.

So what does BHS tell us about the state of pension scheme regulation? The Labour government's announcement of the PPF in 2003 was not part of an overall pension strategy, but a sticking plaster for the pressing political problem of people losing their company pensions and marching on Whitehall.

Furthermore, the legal funding requirements of the Pensions Act 2004 are weak. Rather than requiring companies to make up funding shortfalls over set periods against a tough and transparent funding standard, it has just an elastic "scheme-specific funding standard".

The combination of "flexible" funding regulations and the PPF lifeboat have set up moral hazard on a grand scale for trustees and employers negotiating deficit contributions.

The Pension Regulator seems to have given up its job of regulating defined benefit pensions. It recently quietly dropped its guidelines which triggered an investigation into a scheme's valuation and recovery plan, it has interpreted its rules flexibly to keep large schemes out of the PPF — including Trafalgar House, UK Coal and Kodak — and it has allowed companies including Trinity Mirror to extend their deficit contribution schedules.

Rather than continuing to muddle through, the government should introduce tougher pension funding standards and the Pensions Regulator should enforce them in a transparent way, otherwise we are storing up bigger problems for the future.

Even with PPF compensation, the 20,000 BHS pension scheme members will lose out, receiving an average of 20 per cent less than their pensions promise (because of the PPF's compensation cap, long serving senior staff with a pension of £50,000 for example would lose around 40 per cent). As BHS slashes prices to lure shoppers, spare a thought for those who will have an unwelcome discount applied to their pensions.

http://www.ft.com/cms/s/0/789bd5ec-74bd-11e1-ab8b-00144feab49a.html#axzz47QxVliOu

Financial Times FTfm March 26th 2012 John Ralfe

"Newspaper puts creditors before pensions"

"Trinity Mirror is trying to drive a coach-and-horses through the fundamental regulatory principle"

Trinity Mirror, the ailing newspaper publisher, has just announced an agreement with its pension scheme trustees to reduce deficit contributions over the next three years from the £100m agreed in its recovery plans, to just £30m.

This reduction in pension contributions, plus new bank facilities to replace those maturing in 2013, will allow the company to repay £168m of US$ private placements from 2013 to 2015 – which puts the unsecured bond holders ahead of the pension schemes.

It appears Trinity Mirror chose not to seek clearance from The Pensions Regulator to approve the reduced deficit contributions; in response to the announcement the Regulator issued an unusually tough statement: "We will scrutinise any reduction in contributions or other actions that increase risks to the scheme, and are prepared to take strong action where necessary."

What "strong action" should the Regulator take?

With £1.7bn of IAS19 (the international accounting rule for employee benefits) liabilities at January 2012, Trinity Mirror's several pension schemes, including the scheme raided by Robert Maxwell 20 years ago, dwarf the company, which has a market cap of less than £100m. The £300m IAS19 deficit for those schemes in deficit is three times the market cap.

Many hard pressed companies have extended their pension scheme recovery plans, as part of rescheduling borrowings, which have been approved by the Pensions Regulator. But this is different – it is the first known case of a company agreeing to pay unsecured creditors at the expense of its pension schemes.

Trinity Mirror is trying to drive a coach-and-horses through the fundamental regulatory principle that the pension scheme should not be subordinated to other unsecured creditors.

The Regulator has the power to force a company to make contributions – a power not used so far – and it should start the lengthy legal process to ensure the full £100m pension payments are made, as long as Trinity Mirror's other unsecured creditors are being paid on schedule.

The Regulator should do this despite the serious implications for the company, its pension scheme members and the Pension Protection Fund. Both sides know that if the company does make the full £100m deficit contributions it may lead to a default on its borrowings, which may, in turn, lead to administration.

If this happened the loss to the PPF, before any recovery of corporate assets, would be around £300m, making it one of the PPF's biggest hits.

But not enforcing contributions would create a precedent for other companies to push their pension schemes behind unsecured creditors, fatally damaging the already tarnished reputation of the Regulator.

It is not clear if the Regulator already has wide legal powers, but chooses not to use them, or if its powers need to be strengthened.

Either way, the Regulator should become more interventionist with companies in financial difficulties, well before they become insolvent. Much of its energies have been given over to maximising corporate recoveries in insolvency, such as Nortel and Lehman Brothers, but this is too late.

“If you are in a hole, stop digging”. When a company is in financial difficulties, the Regulator should require it to stop new accruals, to provide annual pension increases only in line with the PPF’s increases and provide only 90 per cent of pensions for those retiring.

If the company did subsequently become insolvent this would ensure that the pension promises are no greater than if it had entered the PPF at the earlier stage. On the asset side the Regulator should be able to enforce a conservative asset allocation in line with PPF asset allocation, reducing future asset losses.

Finally, and most important, the moral hazard faced by trustees should be recognised and the Regulator or PPF, not trustees, should negotiate with the company on behalf of the pension scheme.

When a scheme is underfunded against the PPF measure trustees have little incentive to negotiate hard. Any extra cash they obtain does not benefit members, who always receive the PPF level of compensation, but does reduce the potential loss to the PPF.

Equally, agreeing to waive deficit payments does not damage members, but does increase the potential loss to the PPF.

The Trinity Mirror case will work itself out in the coming months. The Pensions Regulator and politicians should be clear that it is a defining test for the Regulator. If it is not able to enforce contributions, we should all ask what is the point of the Regulator?

Financial Times FTfm Viewpoint

June 8th 2015 John Ralfe

"Zombie scheme haunts Pension Protection Fund"

Ros Altmann, the new UK pensions minister

http://www.ft.com/cms/s/0/48a14fae-085b-11e5-85de-00144feabdc0.html#axzz3cLn6n41f

Should the new chief executive of the UK pensions regulator take a tougher line on approving the restructuring of company pension schemes?

The regulator's approvals of controversial restructurings such as UK Coal in 2012 and Kodak in 2013, certainly allowed the Pension Protection Fund, the pensions lifeboat, to avoid large hits, but only by bending the regulator's own rules. They are nothing, however, compared with the extraordinary Trafalgar House Pension Trust deal in 2006, which is still unfinished business for the regulator.

Like many UK schemes, Trafalgar House, with 25,000 members, is in deficit to the tune of £300m as of March 2014, with assets of £1.6bn and liabilities of £1.9bn. But unlike other plans, it is a "zombie scheme". No employer is standing behind it making cash contributions to plug the deficit. Its legal sponsor is the pension trustee company, itself owned by the scheme, with no income or cash flow.

To plug the deficit, the trustees are betting on investment outperformance in high-risk assets. Although 40 per cent of assets are in bonds and swaps to match liabilities, 60 per cent are in equities, private equity, hedge funds and property. The trustees aim to plug the deficit by 2024 by making an average annual return of gilts plus an astonishing 6 per cent.

The regulator's 2006 approval allowed the sponsor — the rump of the engineering group, Trafalgar House, bought by Kvaerner, the Norway-based engineering company, and then sold to a management buyout — to abandon its pension obligations, subject to paying just £101m into the scheme by 2012.

This was £200m less than the deficit as calculated by FRS17 accounting rules.

This 2006 deal was the first real test of the new regulator's powers and it seemed to take us back to the bad old days, when a company could just walk away from its pension scheme. It prompted hard questions in parliament.

The trustees' 2006 plan was to clear the deficit through asset outperformance by 2014, but actual performance has been poor. The scheme would have done better simply holding all of its assets in passive long-dated index-linked gilts. Meanwhile, in the eight years from 2006 to 2014 it has paid more than £100m in fees to investment managers.

Despite the absence of a real sponsor, Trafalgar House is still eligible for the Pension Protection Fund. When it does inevitably enter the PPF, its deficit will be paid by other companies through a higher levy. To add insult to injury, its 2014 PPF levy is just £200,000, down from £1.2m in 2012.

In 2006 the architect and public face of this game of "heads we win, tails the PPF loses" was Ros Altmann, the new UK pensions minister; she was a Trafalgar House trustee between 2007 and 2010 and again from 2014.

In 2006, the regulator also approved a "zombie" deal for Polestar, the printing group. The trustee company became the sponsor and planned to plug its deficit through high-risk investment bets. In 2011, however, the trustees wound up the scheme after the regulator told them to "crystallise the position" and warned the trustee company it would use its powers to wind up the scheme if they did not.

The regulator's report on Polestar concluded that "under any reasonable scenario the scheme could never expect to pay the benefits promised to its membership [and] in the absence of an employer that could make payments to the scheme, the PPF was . . . exposed to a growing deficit".

It added: "The regulator would not expect any scheme to take excessive investment risk, unsupported by the employer covenant, and to the detriment of younger scheme members and the PPF."

All of this applies verbatim to Trafalgar House. It is inconceivable it will be able to pay its pension promises, it has no sponsoring employer, it is taking huge investment risk and the eventual hit to the PPF is increasing.

As with Polestar, the regulator should tell the trustees to "crystallise the position" and warn them it will wind it up if it does not. If the pensions regulator chooses not to do this, it should produce a detailed public explanation of why it is prepared to let this extraordinary arrangement continue.

http://www.ft.com/cms/s/0/e43b2d74-8450-11e0-afcb-00144feabdc0.html#axzz47QxVliOu

Financial Times FTfm May 23rd 2011

"Regulating the Pensions Regulator" John Ralfe

"The Regulator can become transparent and accountable only if the law is changed"

The Chairman of Polestar Pension Scheme, which had £370m assets at March 2010, recently sent a letter to the 8,500 members explaining that Polestar Limited is being sold to a US private equity firm, and that the trustees have been forced to accept a huge reduction in the agreed deficit payments from the company.

How the Polestar scheme ended up in this position reflects badly on the Pensions Regulator and calls into question its ability to make tough decisions.

Polestar prints magazines, ranging from Country Life, through Radio Times to Hello!. It was bought by a private equity firm in the 1990s, but following financial difficulties was restructured in December 2006, with the lending banks taking ownership.

As part of this, the Pensions Regulator issued a “clearance statement” that Polestar could walk away from its pension scheme, in exchange for agreement to pay just £45m, a fraction of the deficit, into the scheme over 12 years, with no further obligation. The pension trustee company, with no assets or cash flow, became the sponsoring company.

Just a few months earlier in 2006, the Regulator had allowed the same arrangement for the £1.5bn Trafalgar House scheme, formerly part of the huge Norwegian company, Kvaerner.

Polestar’s payments did not start until January 2009 and by December 2009, with the company’s continuing financial problems, the trustees agreed to defer £2.5m payments until March 2011, which must have had the blessing of the Pensions Regulator.

Meanwhile, Polestar has continued to struggle, leading to the current sale to the US private equity firm. The trustees were given no choice but to accept the £3.6m payment offered and give up claims to the £35m of the original £45m still owing.

What happens now? Although the scheme does not automatically enter the Pension Protection Fund process, it is only a matter of time. Despite the obvious conflict of interest, the trustees are also directors of the sponsoring company - the pension trustee company - and if they want to avoid the risk of trading insolvently they will trigger entry into the PPF.

How much bigger is the likely PPF loss today than if the scheme had entered the PPF in December 2006?

The March 2007 actuarial valuation shows £760m buy-out liabilities, so assuming PPF compensation is 75 per cent of the full pensions payable, PPF liabilities were around £570m. With £500m assets, if Polestar had entered the PPF in December 2006, the PPF hit would have been around £70m.

Four years on, today's buy-out liabilities will have increased to around £840m, allowing for pensions paid, the unwinding of interest and falls in long-term interest rates, giving PPF liabilities of around £630m.

But, by March 2010 assets had dropped from £500m to just £370m, with pensions paid and investment losses. Assuming the same asset value today means the PPF hit – paid for by levies on pension schemes - has gone from around £70m, if the Polestar scheme had entered the PPF in December 2006, to a whopping £260m.

The Pensions Regulator offered no explanation in 2006 for allowing Polestar and Kvaerner to walk away from their pension schemes, which contradicted the way pension regulation was supposed to operate. The alternative of allowing the two schemes to enter the PPF in an orderly way was the right thing to do in principle in 2006; not doing so, has increased the PPF's loss on Polestar from around £70m to around £260m.

The Regulator should be required to explain why it allowed the Polestar and Kvaerner schemes to become "zombies", relying on ultra-aggressive investment strategies of "double-or-quits", underwritten by the PPF, to plug the deficits. It should explain how it judged this minimised the present value of likely PPF losses and how it has been monitoring the consequences of these decisions.

The Pensions Regulator is one of a handful of public bodies not subject to the Freedom of Information Act and the Pensions Act 2004 makes it a criminal offence for the Regulator to reveal any information on its decisions. The Regulator can become transparent and accountable only if the law is changed to make it subject to the Freedom of Information Act, with a "public interest" argument for releasing details of key decisions.

Financial Times FTfm Opinion

July 15th 2013 John Ralfe

"PPF digs deep in UK Coal deal"

"What political pressure did the PPF face to "save 2,000 jobs" by keeping mines open?"

http://www.ft.com/cms/s/0/56d90f02-ea3b-11e2-913c-00144feabdc0.html#axzz47QxVliOu

Last week, UK Coal, the owner of most of few Britain's remaining coal mines, went into administration. The Pension Protection Fund took on its two pension schemes and 7,000 members, triggering the PPF's largest ever loss.

This follows a complex and costly solvent restructuring, signed as recently as December 2012, that was supposed to put the company and its pension schemes on a sound footing. The restructuring split UK Coal into two separate companies; one owning the mines – responsible for making pension deficit payments and in turn owned by an employee benefit trust – and another owning 30,000 acres of brownfield development land, with no liability for the pension schemes. The pension schemes bought 75 per cent of the property company for £30m, with the other 25 per cent owned by a publicly quoted company.

With the ink barely dry, an underground fire broke out at UK Coal's largest deep mine, Daw Mill, which has now been closed and will be transferred to the Coal Authority quango. However, Daw Mill had already suffered severe production problems, and plans to consult on closure in 2014 had been announced.

The administrator would be expected to sell UK Coal's assets, as a going concern or piecemeal. The PPF, as its largest unsecured creditor, would receive the lion's share of the proceeds to offset its loss.

Instead of this, UK Coal – restructured a second time – will continue to operate, owned by an employee benefit trust, and the PPF will receive a series of “debt instruments” or IOUs, with an unspecified maturity schedule. This is the first time among the 800 schemes the PPF has taken on since it was set up in 2005 that any company sponsor has been allowed to continue operating with the PPF taking its IOUs.

Transparency of outcome and decision-making is crucial to maintain the PPF’s independence and integrity and to avoid what looks like smoke and mirrors. Although the PPF’s press release says that under the IOUs it “will receive regular payments from the new company which are expected, over time, to be materially higher than any sum it would have received had the company become insolvent”, this bland assertion is not good enough. The PPF must answer many questions.

Why, uniquely among hundreds of similar situations, is this the best deal for the PPF, and the companies funding it through the levy, versus simply receiving its share of recoveries from administration?

How much would third-party buyers pay for UK Coal? If these offers are too low, why should it not be liquidated?

If UK Coal’s operating losses continue, does that not leave the PPF in an impossible position? Could it really insist on payment of its IOUs if this would force a mine to close, with job losses?

Is this a fundamental change in the PPF’s approach? Will we see similar deals with other companies and what criteria will the PPF apply?

What political pressure did the PPF face to “save 2,000 jobs” by keeping the mines open?

The coalition government may not want to see the final end of the British coal industry on its watch, or it may have well-founded strategic reasons to keep some coal production going.

In 2011, UK Coal produced 5 per cent of the UK's electricity, despite the continuous closure of pits since privatisation in 1994 and the move to "clean, green" energy. If so, the government should put these strategic reasons to parliament and the voters to justify nationalisation, rather than parking the problem with the PPF.

How big is the PPF's likely loss? The Pensions Regulator estimated a £540m PPF loss in December 2011, before any corporate recoveries, which will be up to about £600m in June 2013.

The 75 per cent of the property company, which reduces the PPF's loss, was valued at £138m when it was bought by the pension schemes last year, but the company owning the remaining 25 per cent has a market capitalisation of just £11m, suggesting a value nearer £33m.

This puts the PPF's net loss at around £450m to £550m – versus its largest single loss to date of £333m in 2009. This would make UK Coal the PPF's largest loss by a long way.

A single £450m to £550m hit, plus other smaller losses, will require the PPF to increase the annual levy it charges to schemes. Beyond this, it takes the PPF closer to having to reduce payments to its members, which it is allowed to do to balance its books. The resulting political firestorm would inevitably lead to a costly taxpayer bailout.

Financial Times FTfm Talking Head

May 6th 2013 John Ralfe

"Kodak pension deal brings regulator into question"

"Has the Pensions Regulator given up on regulating pensions?"

http://www.ft.com/cms/s/0/ef4a34d0-b315-11e2-b5a5-00144feabdc0.html#axzz47QxVliOu

Last week, the venerable US company, Eastman Kodak, reached an agreement with its UK pension plan, helping it to emerge from Chapter 11 bankruptcy. Under this deal, approved by the UK Pensions Regulator, the UK pension plan will buy two of Kodak's businesses for $650m and withdraw its £1.9bn ($2.8bn) legal claim against Eastman Kodak.

By approving this extraordinary deal, the Pensions Regulator seems to have abandoned rule-based pension regulation, and moved to "regulation by expediency". This approval, combined with others in recent months, prompts the sobering question: has the Pensions Regulator given up on regulating pensions?

Rules operating since the regulator was set up in 2005 suggest that the Kodak UK pension plan would enter the Pension Protection Fund, with its 15,000 members receiving PPF compensation, set at a lower level than the promised pensions.

Meanwhile, the regulator would pursue Kodak UK and Eastman Kodak in the English and US bankruptcy courts for the £1.9bn ($2.8bn) deficit on a buyout basis, especially as the US parent guaranteed Kodak UK's pension obligations. Like all unsecured creditors, the pension plan would receive a share of company assets, which may include equity in a new company, reducing the PPF's net loss.

Rather than this tested and transparent mechanism, a new Kodak UK pension plan will be formed – a zombie with no corporate sponsor standing behind it to make deficit contributions – with around £1bn of assets. The pension plan will not be given the Kodak businesses in exchange for dropping its legal claim, but, adding insult to injury, is paying $650m for them.

The new plan's main asset – 40 per cent of total assets – will be the Kodak businesses, which, it is hoped, will pay cash dividends to the plan.

Individual members can choose to transfer to the new plan, with pensions slightly higher than the PPF compensation, or stick with the existing plan and enter the PPF. The new plan will be eligible to enter the PPF at some point in the future.

To shed much-needed light on this bizarre deal, the regulator should produce a "Section 89" report as soon as possible, to explain why buying two Kodak businesses for $650m, and giving up the £1.9bn claim, was the best deal the regulator could achieve. Eastman Kodak, after all, had guaranteed the UK pension plan.

The regulator should also explain how much more than the $650m purchase price the two businesses are worth, showing how much of the £1.9bn claim has effectively been paid. It should also indicate if the two businesses will be sold to third parties to realise the difference between the purchase price and the real value. (Eastman Kodak has been trying to sell the two businesses and announced plans to sell one of them to Brother only a few weeks ago).

Most importantly, the regulator should also explain why, if this was the best deal, the plan did not simply enter the PPF, with the PPF then buying the two businesses for $650m, which would then become part of its overall assets.

How much would the PPF lose if it took on the Kodak pension plan? With £1bn of assets and £2.9bn of buyout liabilities, the PPF liabilities are around £2bn. Before including the difference between the value of the two businesses bought and the $650m purchase price, this is a £1bn hit for the PPF, its largest single hit by a long way.

The PPF's £1bn surplus at March 2012 would be wiped out by taking on the Kodak pension plan. It would signal the need for hefty increases in pension scheme levies, a possible reduction in compensation payable to claimants, and even call into question the PPF's long-term viability.

The regulator must demonstrate, without any shadow of a doubt, that it approved this deal for genuine reasons, not just as a convenient way to keep the Kodak pension plan out of the PPF.

There were other high-profile examples in 2012 of the regulator allowing companies to put other creditors ahead of the pension scheme, driving a coach and horses through a fundamental regulatory principle.

Trinity Mirror was allowed to stop £70m of agreed pension deficit contributions to repay bond holders. Premier Foods was allowed to stop £82m of deficit contributions and use all £130m of asset disposal proceeds to pay down bank debt. The regulator also approved the split of UK Coal into two companies, with its pension scheme injecting £30m into one of them. This company is now seeking voluntary liquidation, with a £540m hit for the PPF.