

Written evidence from John Ralfe Consulting (PPF0003)

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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 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.

5.2 In 2012 Trinity Mirror cut its £100m agreed pension deficit

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>

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 disinterested view of pension regulation.

7 The Regulator has bent its own rules; Polestar

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

- 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.

9 The Regulator has bent its own rules; UK Coal

- 9.1** A restructuring in 2012 split UK Coal into two companies; one owning

⁴ <http://www.thepensionsregulator.gov.uk/docs/section-89-polestar.pdf>

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.

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

⁵ <http://www.thepensionsregulator.gov.uk/docs/section-89-ukcml.pdf>

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

- 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
- 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

⁷ <http://www.legislation.gov.uk/ukpga/2004/35/section/82>

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.

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

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

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.

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

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