Guest Editorial

You turn if you want to: Moral hazard and the Pensions Regulator

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Ever since Parliament decided to call into being a separate Pensions Regulator, the pensions landscape in the United Kingdom has changed. The Regulator was given significant powers by Parliament to ensure a number of things. First and foremost, it is supposed to ensure that work-based pension schemes are administered properly. But equally importantly, the Regulator is tasked with ensuring that final salary, defined benefit occupational pension schemes are not left underfunded as a result of corporate shenanigans. Even though the United Kingdom has statutory provisions in place that impose a duty on employers to (help) plug any deficit in their pension scheme, there are various ways in which employers can circumvent this.

The Regulator's moral hazard powers are supposed to put a stop to this. It has recourse to a battery of measures that can be deployed to call wayward employers to account. The Regulator can issue financial support directions as well as contribution notices where, broadly, it has reason to suspect that employers are arranging their affairs in a way which might weaken the employer covenant (the extent of the employer's ability to meet its financial commitment to the scheme).

Not surprisingly, when the new powers were first unveiled, there was considerable anxiety that the Regulator would ride roughshod over normal business activities. Fears were expressed that this would damage corporate confidence. After all, would any company feel comfortable engaging in a corporate acquisition knowing that the Regulator might intervene at the drop of a hat if it felt that the interests of a pension scheme might not be best served?

Of course, the Regulator never set out to be deliberately nasty to employers. Pension schemes, after all, do depend on the ability of their sponsoring employers to fund the stated benefits. Employers are clearly more likely to be able to fund their pension schemes if they can expand their business and make a healthy profit (even though there are not too many businesses around today that are doing that). Anything that might frighten the corporate horses and acts as a fetter on normal business activity can, one might contend, by definition not be in the interest of occupational pension schemes.

In order to avoid creating business uncertainty, the Regulator introduced a clearance procedure. This allows employers (and trustees of occupational pension schemes) to vet any proposed commercial activity by obtaining the Regulator's confirmation that the moral hazard powers will not be used in relation to a particular business proposal. Quite often, in fact, the Regulator has wanted to see evidence of some quid pro quo in the form of increased funding for a pension scheme to compensate for the potential weakening of the scheme's benefit security if, say, a financially healthy sponsoring employer was being sold out of a corporate group.

Most of the time, a clearance application will succeed, provided the employer has managed to obtain the support of the pension scheme trustees. The Regulator does expect the trustees critically to examine what the employer is proposing: they are not supposed to be meekly compliant or simply give the nod to whatever the employer suggests. The codes of practice the Regulator has issued since 2005 have aimed to stiffen the spine of those trustees who might

be tempted to concur too readily with the employer's point of view. Trustees know that they need to convince the Regulator that their scheme is not being sold short. Of course, it would in any event not be trustee-like of them to agree to decisions that might prove injurious to their members' interests. The tried and tested tenets of trust law require trustees to act in the best interests of their beneficiaries. Blithely agreeing to a diminution of members' benefit security would in all likelihood not be regarded by the courts as a proper exercise of trustee powers. The Regulator's presence has served to remind trustees that in doing the right thing by their members, they are only acting with the propriety the law expects of them.

That's all fine and dandy, you might say. But it does sound terribly pre-credit crunch. Has the eclipse of the world's financial system in 2008 and the resulting economic devastation, not to mention the seemingly never-ending eurozone imbroglio, not had any impact on the way the Regulator goes about its duties? After all, in an era of what appears to be economic permafrost, it might seem unwise to heap further costs onto the backs of struggling companies and employers. Sucking cash out of businesses during a recession just to safeguard future pension benefits might well be regarded as a luxury the economy can ill afford at the moment.

In fairness, the Regulator has recognised that desperate times call for desperate measures. Soon after the credit crunch struck, the Regulator made it clear that it would no longer set its face against funding obligations (recovery plans) with decidedly long-term timescales. Where before the recession the Regulator had placed great emphasis on avoiding 'back-end loading' (a term to denote a situation where an employer only has to stump up extra cash for the pension scheme right at the very end of a recovery plan's time span), it now shifted its focus onto the affordability of additional funding payments. This was surely right and only plain common sense when viewed against the backdrop of the worst economic crisis in living memory.

One might have thought that the economic recession would have led to a swelling chorus

of voices arguing for the panoply of moral hazard powers to be abandoned altogether. The reason that this has not really happened probably has something to do with the fact that the Regulator has only used those powers sparingly. Since their inception, only few contribution notices have been issued and almost no financial support directions. But right at the end of 2011, the Regulator did issue another financial support direction. This time, unusually, it even decided to issue such a direction in respect of events that occurred as long as 10 years ago. Clearly, any company or employer engaged in corporate activity would have to sit up and take notice of that. It simply meant that the Regulator's arm can reach back into the distant past – could this lead to new uncertainty?

The financial support direction the Regulator issued to ITV plc in respect of the Box Clever Group Pension Scheme has reaffirmed how serious the Regulator is about combating the dangers of leaving pension schemes at risk of serious underfunding. The Box Clever Group Pension Scheme had been left badly exposed as the result of the financial activities of its sponsoring employer, Box Clever. Box Clever had been set up as a joint venture between Granada and Thorn in 2000. As part of the deal, Box Clever acquired the consumer rental businesses from Granada and Thorn and paid some £500m in dividends to Granada. Granada subsequently merged with Carlton Communications to form ITV.

Box Clever had had to borrow £860m to fund the costs of the business acquisition and the dividend payment but was unable to repay this money and was forced into administration in 2003. The pension scheme was left underfunded to the tune of some £62m. The fact that considerable value had been stripped out of the business had obviously had an impact on the funding position of the pension scheme.

The Regulator argued that ITV and its subsidiaries had derived a great deal of benefit from the joint venture structure they had set up as it had allowed them to extract full value from the business. ITV, even though it never formally participated in the Box Clever Group Pension

Scheme, was sufficiently closely associated with the scheme for it to be reasonable for a financial support direction to be issued to them.

Most interesting of all, however, was the Regulator's insistence that it was not unreasonable to issue a financial support direction in respect of events that had occurred some significant time ago. Although there is no statutory time limit on the events in respect of which a financial support direction can be issued, the maximum limit for contribution notices is 6 years. It therefore seemed reasonable to assume that the Regulator would adhere to this with regard to financial support directions as well. In issuing a financial support direction to ITV, the Regulator made it clear that Parliament, in passing the relevant statutory provisions, had clearly intended for moral hazard to be combated no matter when it occurred. The Regulator put it rather nicely by saying that, were certain events effectively to become time-barred from being made the subject of a financial support direction, the risk of encouraging employers to use delaying tactics when negotiating solutions to pension shortfalls with trustees would simply be too great. After all, if employers were to suspect that the Regulator might regard distant events as simply being too remote to serve as a basis for regulatory intervention, the very moral hazard that is meant to be resisted might well start to carry less risk. Employers might simply feel encouraged to try and kick funding negotiations into the long grass in the hope that the possibility of regulatory action would simply disappear with time.

What does this mean? One can safely say that the latest developments show that the Regulator

is serious about using its moral hazard powers, even in times of economic uncertainty. What is more, it will not flinch from peering into the (relatively) distant past to uncover evidence of moral hazard. Where it believes it to be right, the Regulator will force employers to provide additional funding into their pension schemes. Rather than stand accused of being the dog that didn't bark in the night, the Regulator is prepared to face down criticisms that it is being unfashionably astringent or acting unreasonably in hauling employers before the beak in respect of events that happened many years ago.

ITV has decided to appeal the financial support direction on the grounds that it was wholly unreasonable for them to be made liable in respect of a pension scheme in which they never participated and whose deficit they did not create. We have clearly not heard the last of this story.

Ever since the Regulator commenced its duties in early 2005, there has been scepticism about the efficacy and desirability of having a regulatory panjandrum whose writ seemingly runs into every nook and cranny of the UK pensions system. Hopes have been expressed in certain quarters that the Regulator might take a backseat or at least be more circumspect in intervening in corporate activity. Recent events have shown, however, that, like the famous lady, the Regulator is simply not for turning.

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