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MILKING AND DUMPING

The Devices Businesses use to Exploit Surpluses and Shed Deficits in Their Pension Schemes

A Pensions Institute discussion paper for DB trustees, sponsoring employers, advisers, policy-makers and regulators

Keith Wallace

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Milking and Dumping: The Devices Businesses use to Exploit Surpluses and Shed Deficits in Their Pension Schemes

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The Pensions Institute
Cass Business School
106 Bunhill Row
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EC1Y 8TZ
www.pensions-institute.org

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This discussion paper is available here:
www.pensions-institute.org/reports/MilkingAndDumping.pdf

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List of Abbreviations

AWAs*	Approved withdrawal arrangements
Barber	The European requirement for "equal pay" between sexes extended by this case to pension rights
Coloroll	A series of cases, Europe-wide, further interpreting, and enforcing "Barber"
DB	Defined benefit – used of a pension scheme whose promised benefits are defined by reference (normally) to earnings: also called "final salary" or "average earnings" schemes, depending on the rules. The main distinction is with DC – defined contribution, where the ultimate benefit depends on the financial "pot" built up in the member's name
DMRTs*	De minimis restructuring test
DWP	Department for Work & Pensions, the Ministry overseeing pension provision
Employer	In this context, is the legal entity employing the pension scheme member/s
FAAs*	Flexible apportionment arrangements
FT	Financial Times
GAD	Government Actuary's Department
Goode	Report of the Pension Law Review Committee, September 1993 (reforming pension law following the Maxwell thefts)
GMP	Guaranteed minimum pension – the benefits an occupational scheme had to provide to allow workers to be "contracted-out" of SERPS
HMRC	Her Majesty's Revenue & Customs, successor to PSO
IR12	Recorded the basis on which the SFO or PSO would "approve" pension schemes for tax purposes
MFR	Minimum funding requirement – the diluted version of MSR as enacted
MSR	Minimum solvency requirement – recommended by the Goode Report, not enacted
PBGC	Pension Benefit Guaranty Corporation (of the USA)
PPF	Pension Protection Fund
PSO	Pension Schemes Office, successor name to SFO
RAAs*	Regulated apportionment arrangements
RTs*	Restructuring tests
SAAs*	Scheme apportionment arrangements
SERPS	State earnings related pension scheme – an additional component of state-provided pension
SFO	Superannuation Funds Office, the original office in the Inland Revenue handling pension schemes
"Sponsor"	Used to identify the entity (employer) that has set up a pension scheme. Also used loosely to describe the ultimate controller or owner of scheme employers
tPR	The Pensions Regulator
WAs	Withdrawal arrangements

*Mechanisms for addressing or varying an exiting employer's debt, overseen by tPR

Executive summary

This paper gives examples of UK defined benefit pension schemes suffering losses in the 1980s and early 1990s, mostly by fraud or questionable practices (**Table 1**). It gives examples of the means, mostly in the 1990s, by which actuarial surplus was extracted from schemes (**Table 2**). It then indicates techniques by which proprietors of businesses have since then sought to shed or avoid scheme deficits (**Table 3**). It sketches briefly the changing legal bases over employers' contributions and funding obligations, how pension schemes became so large and the responses of Government to schemes exhibiting surplus or deficit.

Table 1

Kinds of fund extraction and exploitation – pre-Goode (1980s – 1990s)
"Investment" in sponsor's shares
"Loans" to sponsor
"Sweetheart" purchase from sponsor
Self-award to controllers of substantial pension benefits

Table 2 – How "surplus" is or was exploited

Theme	Example/Remarks
Contributions	
Employer contribution holidays	
Retroactive contribution holidays	Now tax-discouraged
Employee member contribution holidays	e.g. conferred instead of a pay rise
Employer retroactively obtains funds from scheme under guise of itself requiring reimbursement for retroactive employee contribution holidays	
Employer pockets ongoing employee contributions under similar guise	
Costs	
Employer now causes the scheme to bear administration costs, etc	Now tax-discouraged
Employer "loads" administration cost recovery against scheme	Now tax-discouraged
Retro-active recovery to employer of past administration expense previously borne by employer	Now tax-discouraged

Theme	Example/Remarks
Relieving Payroll	
Scheme receives inwards bulk transfer from other underfunded scheme/s of employer	
Scheme assumes hitherto unfunded pension obligations	
Scheme assumes overseas pension obligations	
Scheme assumes health, death-in-service, accident, redundancy benefits hitherto met from payroll	
"Augmented" benefits used to pay for departure of single or multiple employees ad hoc, thus relieving payroll	
"Augmented" benefits replace bonus and golden hellos	
Aids Balance Sheet	
Promise of generous bulk transfer increases saleability and sale price of divested subsidiary	Because buyer is thus subsidised/benefited, he pays a higher price to employer
Scheme buys employer asset, property or securities on sweetheart terms	Now tax-discouraged Possible breach of Investment Regulations
Scheme makes "investment" loan to (external) buyer of asset from employer	May not be "self-investment"
Scheme makes "investment" in securities of business sold-off by employer	May not be "self-investment"
Scheme enters into sale and leaseback of property in favour of business sold-off by employer	May not be "self-investment"
Inter vivos cash refund	Rare, often precluded by trust deed. Receipt would be "trading receipt" taxable, later subject to 40% standalone charge. Could be available where scheme "overfunded" by very generous GAD surplus valuation criteria.

Table 3 – Shedding or sidestepping a deficit 1990s - to date

Value shedding from scheme-participating employer	Remarks
Large, excessive dividends	
Interest-free loans granted to non-scheme affiliates	
High interest-bearing loans received likewise	
"Commissions" payable likewise	
"Management fees" payable likewise	
Supplier rebates diverted likewise	
Tax surrenders for nil consideration likewise	
Transfer pricing prejudice intra-group	
Creation of "central" purchasing or sales to cream off margin likewise	
Retrospective imposition of these	
Assumption of intellectual property centrally	
Customer business/links diverted	
Incremental/new business or products diverted	
Buying time	
Maintaining token employee, or token ongoing accrual	Postpones trigger point for debt
Shifting liability	
Introducing, or increasing the employee member numbers in, a service company	Employees' services are made available to a non-scheme participating operating entity. This service company is, or can be, assetless. Thus the contractually liable party will not have the funds to meet any emerging deficit.

Introduction

1. In December 2015, the Pensions Institute published *The Greatest Good for the Greatest Number.*[1] This report highlighted the acute pressure faced by many private-sector defined benefit (DB) schemes and their trustees as they strive to meet their long-term liabilities. It estimated that up to 1,000 DB schemes are at "serious" risk of falling into the Pension Protection Fund (PPF). Of this, 600 scheme sponsors are expected to become insolvent in the next 5 – 10 years and the scheme members may only receive PPF compensation. The remaining 400 sponsoring employers might initially survive, but may eventually fail if they are not able to mitigate their pension obligations.

2. Within months, the names of three of those 1,000 schemes became well known to the public: British Steel, Austin Reed and BHS. But the profile they present masks similar, if less immediately severe, issues for many other schemes and their sponsors.

3. These events prompted me to highlight some other cases of "milking and dumping" that have been previously used to extract pension assets and shed pension liabilities. I focus on two related phenomena affecting UK DB pension schemes over the last 50 years, namely

   - Reductions or losses caused to scheme funds through the diversion of assets or utilisation of scheme surplus; and
   - As deficits emerged - and their repair became more assertively enforced - activities having the effect of the employer shedding or sidestepping that deficit.

Disclosures and limitations

4. While some of the activities described here were manifestly criminal, unlawful or breaches of trust, others were and are entirely lawful and may even, in the eyes of other interested stakeholders, have been commendable. The reader should be careful not to infer impropriety or guilt directly or by association.

5. This paper draws on my observations from 50 years of legal and trustee services to pension schemes. These are entirely personal views and not to be attributed to any entity with which I have or have had connections. There are a very small number of UK "industry-wide" schemes - which have had more than their fair share of troubles. Their special features are excluded from consideration.

6. My thanks are due to Debbie Harrison and Robin Ellison of the Pension Institute for their helpful review and comments: errors and infelicities, of course, are mine alone.

1 http://www.pensions-institute.org/reports/GreatestGood.pdf

Scheme of the paper

7. The subjects are only comprehensible if one has had a fair picture of what has gone on before. For the archaeologist, each layer of the dig requires a grasp of the entire stratigraphy of the site, and this principle applies here, too.

8. There are five core themes:

    - The obligation to fund, at all, pace, ongoing and at wind-up
    - The nature of “surplus” and “deficit”
    - How pension schemes became so large
    - How surplus emerged and was exploited
    - How deficits emerged and were shed.

The obligation to fund, at all, pace, ongoing and at wind-up

9. "Tax approval": the key legal framework could be said to start in 1921. From then on, until 1995, a British pension scheme had to be set up in a form acceptable to the tax authorities.[2] An "employer" had to be identified and to apply, and was required to commit to contribute to the scheme.[3] So long as he actually contributed, the pace and timing of contributions was entirely at the choice of the employer.[4] Over time, various provisions operated to require "full funding" of segments of the promised benefits (where the scheme was used to replicate or substitute state-derived benefits (SERPS and GMPs) these elements were prioritised and the subject of regular adequacy certifications).

> *"…the employer must contribute…the amount and timing…are matters for him"*
> *Inland Revenue "Notes on Approval" IR12 (1979)*

10. The Goode Report (1992-3), which followed the Maxwell thefts,[5] recommended that the employer make good any funding shortfall below 90% within three months. The "minimum solvency requirement" was to be based on individual transfer values for active and deferred members and annuity buy-outs for pensioners. A five-year transitional period was recommended.

11. This "minimum solvency requirement" was significantly diluted by the Government on implementation.[6] Two more funding dilutions followed.[7] The consequence was that schemes exhibiting "100% MFR" funding proved on windup to be around 50% funded on an annuity buy-out basis.

12. Until the Goode Report, the only legal obligation to contribute was that, if any, arising under a pension trust's own wording, this might be as to an ongoing basis – such as following each periodic valuation, but also at scheme windup or at the exit of each participating employer. With the introduction of MFR came some statutory obligation to fund to the – very weak – basis that MFR mandated. "Debt on employer" machinery was introduced by statute.[8] PPF levies are credit- and solvency-based, thus providing an additional indirect encouragement to fuller funding.

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2 Superannuation Funds Office, later Pension Schemes Office (PSO), later HMRC.

3 See, e.g., 5.1 I.R. 12 (1979) Notes on Approval – "It is a condition of approval of a scheme that the employer must contribute to it and the Inland Revenue will not exercise their discretion to approve a scheme if the employer's contributions appear to be mere token contributions of insignificant amounts…In considering whether a particular level of contribution is acceptable the Superannuation Funds Office will take account of all the circumstances, including the employer's contributions to any other scheme relating to the same employee or employees. Subject to this and to the consideration that contributions must be in reasonable amount and not excessive in relation to the benefits to be provided…the amount and timing of the employer's contributions are matters for him".

4 Midland engineers were notorious for smoothing results by stop-start employer contributions: they flattered a lean year and reduced profit in a fat one.

5 Report of the Pension Law Review Committee, Volume 1 Chapter 4.4 recommended that funded schemes have a minimum solvency requirement within a band of 90%–100%.

6 Pensions Act 1995 and its new name - Minimum Funding Requirement (MFR) indicated the change it had undergone.

7 Effective 15 June 1998 changes to the formula reduced MFR liabilities by up to 19%. Effective 7 March 2002 MFR liabilities were reduced by up to 8%.

8 Originally in the Social Security Act 1990, it was not brought into force until 1997.

13. When a statutory regime for arriving at a valuation and "schedule of contributions" was introduced, there was considerable doubt whether this "trumped" and displaced each scheme's own trust deed machinery. After some time of doubt, consensus held that the deed machinery was unaffected and could run in tandem; in practice, schemes follow the statutory path.

The nature of "surplus" and "deficit"

14. There is no certainty at all about the cost to a pension scheme of providing an income stream of benefits extending for the next 90 or so years. A "surplus" is therefore merely the difference between computed values of assets and liabilities at any given moment, and on the assumptions adopted. Valuations are highly sensitive to the assumptions used. Typical bases of valuation were "ongoing" and "discontinuance" (or windup or buy out). With the introduction of the PPF, a new valuation measure entered the galaxy, the PPF or section 179 percentage – the ability of the scheme to fund benefits at the (reduced level) that the PPF would pay were the scheme to be entered into that fund.[9] Another measure was prescribed in the context of taxable pensions surplus; and employers had and have latitude in valuing the pension-associated liability for the purposes of their own balance sheets.

15. The existence of "surplus", it follows, can only truly be verified at the point of complete scheme windup.

"Surplus" is therefore merely the difference between computed values of assets and liabilities at any given moment, and on the assumptions adopted"

16. "Deficit" is the converse of surplus.

17. In an ongoing scheme, periodic valuations disclose surplus or deficit, the object being that each is to be remedied over future time. But following Goode, trustees were required to formulate and agree with the employer a "recovery plan" and "schedule of contributions" payment schedule and a target restoration date. With each (normally three yearly) valuation, these items were renegotiated and readopted.

18. The legal nature of the trustees' deficit debt from the employer is therefore:

- A "right", contractual or statutory,[10] under the prevailing schedule of contributions to the payments there stipulated, extending normally to a similar process following the next three yearly valuation.
- Statutory rights to exit "debts on employer" on employer exit, scheme windup or insolvency (but subject to a variety of modifications and easements.)[11]
- Any additional contractual contribution rights (ongoing and exit) as may be available (over those above) under the trust instrument.

19. The **legal** feature of this structure is that in an ongoing scheme the deficit "claim", in the most part, is not contractual at all – nor statutory. It could

9 See the PPF website for the construction of the (reduced) benefits that it is obliged to pay.
10 s.59(2) Pensions Act 1995 categorises a contribution as "a debt due from the employer" where it has not been paid in accordance with the schedule of contributions within "the prescribed period" "if not a debt apart from this subsection". Hence contributions not yet due are not statutory debts. The "schedule of contributions" is a statutory process to which the trustees must conform: that does not mean it has contractual force.
11 See "Multi-employer schemes and employer departures" guidance from tPR explaining SAAs (scheme apportionment arrangements), FAAs (flexible apportioned arrangements), AWAs (approved withdrawal arrangements, RAAs (regulated apportionment arrangements), WAs (withdrawal arrangements), RTs (restructuring test) and DMRTs (de minimis restructuring test).

become contractual or statutory on future events. It is accorded no priority in any insolvency. In so far as it is an "asset" in the hands of the trustees, it is economically undiversifiable (unlike other creditors, trustees cannot call in or otherwise exit the debt). Being undiversifiable and contingent, it is also accorded no priority and can, conversely, be freely demoted or deprioritised by the employer. In practice, neither insurance nor hedging is available to guard against default and failure.

The deficit "claim"

- *not fully – or at all? – contractual*
- *not immediately statutory*
- *undiversifiable, unexitable*
- *contingent*
- *has no insolvency priority*
- *can be demoted or deprioritised by sponsor*
- *difficult/impossible to hedge or insure against*

How pension schemes become so large – Non-annuitisation and asset gathering

20. This is not a foolish question and has received insufficient attention. Large schemes amplify any ensuing deficit or surplus. They also increase the exposure leverage where the more traditional industries begin to shrink in workforce terms. Increasing beneficiary numbers are one factor – private sector schemes pensioners rose from 200,000 (1953) to 3,000,000 (1991).[12]

21. At an early stage, provision was made for additional employers to participate in a tax approved pension scheme. A degree of "association" had to be shown for permission to be given. 100% subsidiaries clearly qualified, but business is linked by joint ventures of common shareholders who could also obtain permission; equally "association" was extended to entire industries that wished to set up a single scheme to embrace workers who might regularly move between employers, but remain in the same trade. Since the (tax approved) object was to provide a secure pension at retirement, the tax approval rules for associated employers required a partial wind-up, and annuitisation of benefits, at the point of exit of each participating employer.[13]

22. This requirement made economic sense but, over time, the habit of sectional wind-up and annuitisation slipped – either through oversight or by intention of the scheme trustees or managers. It is to be supposed that the tax authorities noted this development, possibly giving consent if asked; at any rate I can recall no articulation of any dissent at this practice. This "non-annuitisation for exited employers sections" resulted in trustees investing and managing ever larger funds, often for a shrinking number of participating employers and a top-heavy beneficiary mix with pensioners and deferred pensioners outweighing, in number and liability proportion, an increasingly modest tail of active members.

23. The then prevailing actuarial criteria, and benign investment experience of the 1980s and 1990s, often resulted in such group schemes exhibiting actuarial surpluses. Hence, omission to annuitise exited sections became understandable and defensible, though it may have been the opposite of what trust deeds actually directed.

24. Pension scheme managers were happy to see their empires grow, asset managers encouraged the growth of funds under their mandate and finance directors saw large pension funds as containing the seeds of future exploitable surplus. The pace of corporate activity and restructure, with segments of businesses tactically and strategically changing hands with increasing frequency, contributed to the growth of funds' size and the addition of increasing numbers deferreds and pensioners who had arrived through corporate activity never having had the least connection, while in work, with the sponsor. (Indeed such beneficiaries regularly learnt well after the event that they had been "bulk transferred" to another pension scheme without knowing about it at the time).

12 Table 4 Appendix 4 Goode Report, GAD estimates.

13 See, e.g., I.R. 12(1979) Part 16 permitting multiple employers and subsidiaries. On exit of an employer "…This usually involves the segregation of an appropriate proportion of the scheme assets and the application thereto of the winding-up rule (see paragraphs 15.3-15.6)" (16.5). "As [the proportion of the scheme] is ceasing to exist, benefits must be secured either by… transfer payments to other schemes or by purchase … of … annuities" (15.5).

25. The upshot is that the combination of growing scheme availability, increasing membership, business consolidation and a disinclination to "annuitise" caused scheme funds – and the capacity to exhibit surplus and deficit – to increase exponentially over the years from 1970.

How surplus emerged and was exploited

26. Assumptions and funding: many schemes started as life office models with the entire package – deed, rules, booklet, contribution calculation and investment medium – being provided by a life insurer. The assumptions were stringent, funding was conservative and the investment medium (i.e., bonds) seen as low risk with correspondingly pedestrian returns.

27. As schemes grew in size, and employer familiarity increased, these schemes abandoned the life office tie, engaging their own investment managers and actuaries. Investment return expectations increased and actuarial assumptions tended to weaken. This strategy was presented to the employer as a "cheaper" means of providing the promised benefits, the advisors duly taking the credit.

Factors facilitating surplus emergence 1970s–1990s

- *move from life office models to "self-administered"*
- *weaker actuarial assumptions*
- *more "aggressive" investment expectations*
- *discontinuance/workforce shrinkage creates windfall profit (poor vesting/ indexation for deferreds)*
- *inflation*
- *equity markets*

28. Windfall truncation gains – until 1975 there was no statutory protection for early leavers. If a worker was not actually in post on his scheme retirement date, there was no statutory call for the scheme to pay any pension at all. "Vesting" of benefits for adults after 5 years' service was then introduced, the qualifying criteria being bought down over time. Even so, the "preserved" deferred pension was not much protected against future wage or price inflation. The happy result ensued that if the workforce was reduced, or the mill closed, the scheme's funding level improved, with a windfall discontinuance profit just when it was needed. This "elegant" result insulated employers and trustees from potential strain.

29. However, as increasing protection was introduced for early leavers in terms of vesting and indexation, and transitional protections ran down, workforce shrinkage ceased to advantage or insulate the scheme.

30. The economic factors assisting surplus emergence are well known; inflation spiked at high levels in the 1970s and equity markets produced highly attractive returns from the mid 1950s.

Surplus exploitation and fund extraction

31. It may be helpful for future reference to tabulate reported instances of surplus exploitation and fund extraction from my own archive (Table 4). This table suggests – possibly erroneously – an accelerating experience of value loss to the early 90s, but this could credibly be attributed to the emergence of surplus, increasing scheme size and the almost complete absence before Goode of any prudential regulation. On the limited data available, it is not practicable to sub-categorise these instances into classes such as: crime, breach of trust, regulatory infraction or proper business judgement.

Table 4 – Examples of surplus exploitation and fund extraction

Names/Date(s)	Issue/Device	Source/s
Hillsdown 1983 – 1995	£18.4m abstracted by new proprietor from FMC scheme by (invalid) rule change. FMC members told of scheme "merger" but not of surplus abstraction	Ombudsman, High Court, Independent 12.09.96
Hill Kestrel 1985	Apparent theft of entire £1.4m scheme	Various
Aveling Barford 1986 - 92	Loan to sponsor £1m. £4m "abstracted" – "reinvested" or paid to controllers as commissions etc.	FT 18.3.92. Perpetrators jailed 5.8.92
Melton Medes 1986 – 92	Loans to sponsors (£5m): part "repayment" by issue of related shares	Various
Fergabrook 1987	Loan to sponsor (£1.7m from £4m fund)	The Lawyer 13.12.93
Farr 1988 – 90	One third of fund (£1m) in sponsor's shares. Remaining £2m encashed and invested in sponsor's shares "apparently without the knowledge of all trustees"	FT 22.3.91
Lewis's 1988 – 91	Loan to sponsor. "Sweetheart" sale to fund by sponsor £2.4m	FT 19.3.91 & 9.12.91
Coloroll 1989 – 90	Extra benefits self-awarded. Over-value self-sale	Ombudsman Determination 1994
R.J. Shrubb 1989 – 90	Actuaries/administrators siphoned off difference between interest earned from 500 schemes and interest as reported to clients	FT 13.8.90

Names/Date(s)	Issue/Device	Source/s
QA 1989 – 92	Privatised health services firm takes transfer value from NHS. Insufficient contributions follow. Three senior executives take augmented pensions, causing severe strain/shortfall	Independent and Guardian, both 4.11.92
Universal Computers Group/ Ferrari Holdings 1990	Fees, dividends, interest free loan	FT 4.3.1993
BT 1990	Unauthorised pension contribution holiday - settled in court for £40m.	Daily Telegraph 27.02.1990 and later case
Greenup & Thompson 1984, 1990	Two loans to employer: trustees personally liable	Ombudsman 08.07.2008
LEP 1991	£10.5m loss partly through buying sponsor's shares. Sweetheart property sale by trustee to scheme £12.5m	Independent 13.4.94
Harland Simon 1992	Invested £500,000 in connected company. Principal took £960,000 transfer from failing fund. "Reimbursement to pension fund" reported of £5.1m	FT 1.12.1992
Belling 1992	Loan to sponsor	Pensions Management 1995 Professional Pensions 29.5.97
Peak Design 1991	Disappearance of £1m from £1.1m scheme	Daily Telegraph 20.3.92
JL, Charlesworth, GMS, Dando, Wild Barfield (Messrs Spiers & Shaw)	Extraction from purchased companies' schemes, transfer to own scheme, self-award of benefits	August 1994

Names/Date(s)	Issue/Device	Source/s
Water Industry Scheme Early 1990s	39,000 deferreds and pensioners transferred to separate scheme on water privatisation. National Audit Office reports new £812m fund got “the poorest assets and the problems”. £400m said to be “missing” – likely to be investment and actuarial shortfall	Independent 11.3.98 National Audit Office report 1998
Asheridge 1990s	Loan to company, purchase of Florida properties for directors not registered in trustees’ names	Ombudsman 14.08.2008 - Went v Asheridge Trustees
Teampace 1991	Alleged management self-preference (i.e., self-award of extra pension benefits by controlling senior management), low contribution	
Maxwell 1991	Theft (£450m) from about 13 schemes, via “common investment fund” set up for all of them controlled by Robert Maxwell.	
Blackwood Hodge 1991	Surplus exploitation in numerous ways post purported scheme merger following takeover.	[1997] B.C.C. 434 Blackwood Hodge Plc. Exploitation routes pleaded in Petition. Action by disadvantaged preference shareholders failed on court finding scheme “merger” invalid.

32. The shock of the Maxwell thefts, the resultant scrutiny coupled with the measures recommended by the Goode Report (and enacted) account for the apparent reduction in the more blatant activities from the early 1990s. These Goode Report measures included:

- self-investment restrictions
- clarity of investment responsibilities
- adviser loyalty regime
- "whistle-blowing" duties
- fuller disclosures to members

– and there can be no doubt but that these dramatically increased asset security thereafter.

33. Table 5 offers thematic examples of – mostly legitimate – surplus exploitation by employers in the 1980s and 1990s. By now assets were more secure, but attention focussed on making use of scheme surplus.

Table 5 – How "surplus" is exploited

Theme	Example/Remarks
Contributions	
Employer contribution holidays	
Retroactive contribution holidays	Now tax-discouraged
Employee contribution holidays	e.g. conferred instead of a pay rise
Employer retroactively obtains funds from scheme under guise of itself requiring reimbursement for retroactive employee contribution holidays	
Employer pockets ongoing employee contributions under similar guise	
Costs	
Employer now has scheme bear administration costs, etc	Now tax-discouraged
Employer "loads" administration cost recovery against scheme	Now tax-discouraged
Retro-active recovery to employer of past administration expense previously borne by employer	Now tax-discouraged

Theme	Example/Remarks
Relieving Payroll	
Scheme receives inwards bulk transfer from other underfunded scheme/s of employer	
Scheme assumes hitherto unfunded pension obligations	
Scheme assumes overseas pension obligations	
Scheme assumes health, death-in-service, accident, redundancy benefits hitherto met from payroll	
"Augmented" benefits buys departure of single or multiple employees ad hoc, thus relieving payroll	
"Augmented" benefits replace bonus and golden hellos	
Aids Balance Sheet	
Promise of generous bulk transfer increases saleability and sale price of divested subsidiary	Because buyer is thus subsidised/benefited he pays a higher price to employer
Scheme buys employer asset, property or securities on sweetheart terms	Now tax-discouraged Possible breach of Investment Regulations
Scheme makes "investment" loan to (external) buyer of asset from employer	May not be "self-investment"
Scheme makes "investment" in securities of business sold-off by employer	May not be "self-investment"
Scheme enters into sale and leaseback of property in favour of business sold-off by employer	May not be "self-investment"
Inter vivos cash refund	Rare, often precluded by trust deed. Receipt would be "trading receipt" taxable, later subject to 40% standalone charge. Could be available where scheme "overfunded" by very generous GAD surplus valuation criteria.

34. In many ways, pension schemes pre-Maxwell were an "open goal" for surplus exploitation and fund extraction. A laissez faire regime, set up with responsible, long-term, paternalistic employers in mind, had extended into smaller, short-term, insecure and weakly governanced businesses. Unsurprisingly, losses resulted.

35. The Goode reforms, after Maxwell, successfully controlled the worst (particularly the criminal) abuses. The "exploitation" of emerging surplus, if surplus it really was, could in some instances be defended – or commended – for example, where it extended the overall workforce's benefits, albeit through dipping into the security of existing beneficiaries.

How deficits emerged and were shed

36. Full analysis of the factors contributing to deficit is beyond the scope of this paper, but Table 6 tabulates some salient ones. In my view, the introduction of taxation of dividend income[14] has been a major factor, somewhat overlooked. A loss of one quarter of a long-term future income stream ought to have been immediately recognised as raising the cost of future liabilities by one third. No such adjustment in valuations was observed. Mortality experience was regularly debated and recognised, though with an apparently consistent "undershoot". A third factor was the "Barber ratchet" by which the superior benefits for one sex had to be accorded to the other. It has been convenient to blame investment conditions and bond yields, but these have been only one of a number of causes.

Table 6 – Factors contributing to deficit emergence

Tax on dividends
Longevity recognition
Equalisation hit post-Barber, Coloroll
Fuller vesting protection
Indexation in deferment
Indexation in payment
Tightening actuarial assumptions
Tightening control of other fund-advantaging features (transfers out, bulk transfers, commutation)
Stronger funding requirement
Investment conditions
Fuller employer exit debt provision

37. It has indeed to be questioned whether the "surpluses" from the 1970s onwards, over which so much attention was lavished and negotiation expended, were not merely paper ephemera.

Employer on exit debt

38. As outlined above, the employer contribution obligation, such as it was, derived from the trust deed, as supplemented by statute. Many schemes, having originally been based on life office models contained a simple facility for the employer to cease contributing and wind up – without any further obligations as to any shortfall. Since the life office model was predicated on the yearly purchase of pension annuities (often individual – the "brick-by-brick" contract) from the life office, this provision was entirely symmetrical with expectations. But as schemes became self-administered, moving away from the life office model, the absence of any windup deficit repair machinery became a serious omission.

14 1993 and 1997 Tory and Labour budgets.

39. Statute thereafter intruded, seeing frequent twists and turns along the way as politicians responded, in turn, to pressure from short-changed beneficiaries on the one hand, and to the complaints from business, on the other, that full funding demands were stultifying their ability to protect jobs, produce goods, and contribute to the country's prosperity.

40. As surpluses turned to deficits around the turn of the millennium, the Damoclean nature of the overhang became increasingly recognised by employers. Psychologically, the perceived gravity was increased by the move in accounting standards as to how the pension liability should be disclosed in the employer's profit and loss account and balance sheet.[15] Not only did the employer accounting changes focus the attention of management and shareholders on the – now exposed – pension risk but, more importantly for the purposes of this paper, it alerted bankers, other potential extenders of credit and potential acquirers to the same danger as well.

Shedding the exposure

41. In April 1997, after 7 years waiting on the statute book, the statutory debt on an exiting employer was finally imposed. Its basis has been made more stringent over time. The pathetically inadequate MFR ongoing contribution basis was twice eroded (see paragraph 11) but replaced on a more stringent basis in 2004. Pension "risk" was more prominently disclosed in the early 2000s.

42. The inevitable consequence was that every corporate transaction came to include both detailed scrutiny of the extent of this risk and consideration of the routes by which the new proprietor might be insulated from its reach.

43. The pension exposure has proved, to the layman, surprisingly easy to shed or sidestep. To understand how this should be so, it is first necessary to sketch out some basic legal principles.

44. The liable entity to participate in a pension scheme: each employer had to execute a deed of adherence confirming its obligation to contribute. The contract was with those participating employers, and those alone. Sister companies, not having adhered to the scheme, were not liable, nor parents nor controllers.

45. The debt on employer statutory provisions bore on employers of members alone. Hence an incoming proprietor of the business need not (and did not) enter into any contractual tie with the scheme. This remained confined to the participating employers.

46. No duty to maintain asset level: there is no legal duty on any person to maintain their assets intact or to any minimum level. A person conscious of an exposure that might turn into a debt some years ahead need not maintain his assets to that or any level.

47. Bankruptcy rules allow the unwinding of certain transactions in a narrow window up to insolvency[16] but the vulnerable period is short. There has been

15 SSAP 24 during the 1990s offered a benign slant on pension exposure. Following FRED 48, FRS 17 and FRS 102, businesses, despite their strident opposition, became obliged to mark the pension liability to market thus bringing the exposure on to a prominent, less subjective basis of disclosure (2001-3).

16 Five years in bankruptcy if insolvent at the time. Two years for administration and liquidators.

no general sanction for asset depletion or dissipation between learning of the possibility of exposure and the point at which any debt becomes an enforceable obligation.[17]

48. Company owes duties to members not creditors: by the same token, a company and its board owe duties to the members (shareholders) and not, generally speaking, to creditors.

49. Subsidiaries owe duties to parent: a subsidiary, likewise, owes duties to its parent and, again, not to creditors. If the parent proposes a transaction by which value may flow from the subsidiary to parent or a sister company, the subsidiary's directors are normally unlikely to incur any exposure in complying – the party to whom they are accountable has asked them to do it. It follows that transfers of assets or liabilities at under- or over- value between subsidiaries are barely susceptible of challenge since there is no loss justiciable by any external party.

50. From these principles, it follows that just as an incoming proprietor can sidestep liability for pensions exposure (confining it to the existing scheme-participating employers) the existing parent of scheme-participating employers may, over time, engineer the transfer of value from those participating employers to other group companies whose assets, not being scheme-participating employers, are thereafter free of the exposure. Table 7 lists examples of such value transfers. These activities do not, of course, reduce or increase the pension deficit itself but do reduce the pool of assets, and often future earning capacity, of those husks that remain, tied to the putative scheme debt.

51. In the face of such value transfers, scheme trustees are fairly helpless. They may, for example, place a lower value on the "employer covenant", thus permitting the adoption of more stringent valuation assumptions, a more protective investment strategy and, in consequence, an accelerated pace of ongoing deficit restoration. But this barely meets the need, the horse has left the stable. Some anti-avoidance powers are available to the regulator[18] but considerable reluctance has been encountered from that party to implementing the provisions available to it.

17 S.423 Insolvency Act 1986 gives "undervalue" victims some limited rights but the hurdle is high. The author is unaware of any reported case where a pension scheme has obtained the reversal under this section of a value-shifting transaction.

18 Contribution notices and financial support directions. Six, only, had been issued by April 2013.

Table 7 – Shedding or sidestepping a deficit

Value transfer from scheme-participating employer	Remarks
Large, excessive dividends	
Interest-free loans granted to non-scheme affiliates	
High interest-bearing loans received likewise	
"Commissions" payable likewise	
"Management fees" payable likewise	
Supplier rebates diverted likewise	
Tax surrenders for nil consideration likewise	
Transfer pricing prejudice intra-group	
Creation of "central" purchasing or sales units to cream off margin likewise	
Retrospective imposition of these	
Assumption of intellectual property centrally	
Customer business/links diverted	
Incremental/new business or products diverted	
Buying time	
Maintaining token employee, or token ongoing accrual	Postpones trigger point for debt
Shifting liability	
Introducing, or increasing the employee numbers in, a service company	A service company is, or can be, assetless. Employees' services are made available to a non-scheme participating operating entity. Thus the contractually liable "employer" is a thing of straw

Suggestions for amelioration and areas for further research

52. The current situation is unsatisfactory, as shown by current concerns such as BHS[19] and Halcrow.[20] Some steps could improve the situation:

- According the pensions debt priority over all other creditors, whether secured or not, on insolvency.[21] If adopted, current and intending creditors would pressure the entity to address the exposure more assiduously.
- Giving the debt priority, as an alternative, just over unsecured creditors: the same consequence, but weaker.
- Relax "non-amendability" rules. These are capricious and unduly restrictive. Many scheme members have joined with benefit-adjustment machinery which may not be used. These mechanisms precisely mirror "market value adjustment" provisions in most life insurance contracts, and the legislature has had no issue with those.
- Simultaneously allow the introduction of "crawling peg" machinery (by which benefits may be scaled upwards or downwards from time to time to accord with the state of funding - akin to a market value adjustment) with the same object.
- Scheme retirement dates to track rises in state pension age, automatically. These three suggestions do not prevent asset shortfall but do allow benefits to align more closely to scheme funds.
- Neutralise the "service company" device.
- Give the regulator fuller powers to obtain contributions from connected parties, plus the staff and encouragement to use them.

19 The Work and Pensions and Business, Innovations and Skills Committees report on BHS published on 25 July 2016 is available here: www.parliament.uk/business/committees/committees-a-z/commons-select/work-and-pensions-committee/news-parliament-2015/bhs-report-published-16-17/

20 The well-known Halcrow construction business was bought by an American entity, CH2M in September 2011. Its scheme (HPS1) had a £600m solvency deficit by the end of 2015. It was proposed that all members be transferred without their consent to a new scheme (HPS2) with a significant reduction in benefits, including statutory minimum increases rather than those in HPS1's Trust Deed. No member of HPS2 would receive less than what the PPF would have provided had HPS1 entered the PPF (a "PPF underpin").

CH2M would "guarantee" a sum of £120m to HPS2 at £5.5m p.a. "De-risking" should ensue by 2043. To what extent, if at all, CH2M had supported, or would support, HPS1, is not publicly known.

The High Court was asked (in a confidential hearing) to approve the trustees' proposal to make the "without member consent" transfer. It declined – though on the ground that the requisite actuarial certificate could not be given. Pollock v Reed [2015] EWHC 3685 (Ch) and Association of Pension Lawyers Presentation 9.5.2016.

21 The Goode Report inclined against this in 1995 – see its paras 4.11.7 and 4.11.8 – but it must be borne in mind that Goode also recommended a much more stringent solvency regime than was enacted. See paras 10-12 of this paper. Under the Goode-suggested regime, deficits, if present, would have been much smaller.

53. The PPF publishes a list of schemes it has accepted. Some of these are "household names" which have reappeared in business under some new corporate cloak, the pension scheme having been dumped on, essentially, continuing DB schemes, and the beneficiaries substantially short-changed. The circumstances on either side of the insolvency of the titular employing company could be illuminating, if investigated with an eye to the ploys in Table 7. Equally, a study of the "notifications" to tPR as to possible pension shedding and of cases of penalties imposed for failure to "notify" against corporate activity thereafter would also be enlightening.[22]

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22 An employer is under obligation to inform tPR of pension shedding events and intentions, Reg. 2(2)(a) S1 2005/900. The avowed purpose is to collect information for the PPF. The scheme trustees have no role in this limited purpose. Failure to notify may incur a civil penalty. No data is publicly available either as to notifications or penalties.

Conclusion and lessons

54. The motivations behind shedding pension liabilities are endemic in a capitalist model, where proprietor profit is supported by the ingenuity of advisers.

55. Government intrusion into occupational pension provision has not been universally commendable. Being "generous with other people's money" – obliging already generous defined benefit schemes to further increase their generosity by conferring indexation – has proved a disaster, not only in cost terms but in the sheer functional impossibility to schemes of investing to match this imposed and volatile liability.

56. Legislation according a pension scheme's deficit priority in insolvency would dramatically alleviate the problem of underfunded schemes. The pressure from other (thus demoted) creditors and stakeholders would quickly produce tangible amelioration.

57. The tPR has been given, by the DWP, irreconcilable objectives: of (being held out as) enforcing aspirations of scheme security, while being mandated to safeguard employment and business viability.[23] In practice, the muddled role saps trustees' negotiating stance and gives them a moral "let out", a sense of helplessness or both. Were there no tPR role here, negotiations between trustees and sponsors might be more acute, but beneficiaries would know clearly where the buck stopped.

58. The PPF, by contrast, has clear objectives and every appearance of achieving them. Where there is some latent moral hazard, though, is in the very existence of the PPF, and the harbour it offers. It affords some lowest common denominator of acceptable benefit. It thus not only reduces the trustees' will to seek more stringent funding, but affords some moral pretext to the proprietor to justify a stance of insufficient contribution.

59. PPF benefits – by their very availability – provide a powerful bludgeon with which to coerce members – "if you don't consent to your benefits being diminished, we'll put you into the PPF" – is the unspoken subtext behind negotiations and member circulars.

60. The exposures and risks facing the PPF were presciently addressed in a 2007 Pensions Institute paper, "Financial risks and the Pension Protection Fund: Can it survive them?".[24] This piece drew attention to the pro-active stance taken by the USA's Pension Benefit Guaranty Corporation (started in 1974) through its Early Warning Program, in which it sought out and started negotiations direct with weaker employers. The PBGC's ability to claim up to 30% of a business's net worth is also significant. Neither currently features in the UK and should do.

23 And by the s. 48 Pensions Act 2014, tPR's objectives now include "to minimize any adverse impact on the sustainable growth of an employer". The effect is to hand the employer a trump card in any deficiency negotiations.

24 David Blake, John Cotter and Kevin Dowd (2007) Financial Risks and the Pension Protection Fund: Can it Survive Them?, Pensions, 12(3):109-130; available at http://www.pensions-institute.org/workingpapers/wp0711.pdf

61. Some of the "moral hazards" it canvassed have not, obviously, come to pass.[25] But others have – "...the PPF should be wary of ...the sale of a subsidiary with an underfunded pension scheme to a financially weak buyer...".[26]

62. This paper illustrates ways by which the "moral hazard" of shedding or dumping is occurring. As time passes, the actions of employers will, in the absence of strong remediation, inevitably exacerbate the trend – to immense loss on the part of pension beneficiaries.

25 It suggested, for example, that weak employers would save on pay rises by offering fuller pension benefits instead, in the knowledge that the PPF might later meet these.

26 Op. cit., p. 122. At the time of writing, precisely this criticism is being voiced in reference to the large BHS pension scheme.

About the author

Keith Wallace is President of TACT - The Association of Corporate Trustees and chairs the Legal Advice Panel of TPAS, The Pensions Advisory Service. This paper is the result of a discussion with David Blake, the director of the Pensions Institute, at the Association of Consulting Actuaries Annual Dinner in April 2016.

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