

BBS investment update

THE PENSIONS REGULATOR AND EMPLOYER-RELATED INVESTMENTS

SUMMARY OF UPDATE

- The Regulator has issued a statement setting out the issues that need to be considered by trustees, sponsors and advisors in relation to employer-related investment ('ERI') regulations.
- The statement pays particular attention to 'non-cash' funding arrangements, where the Regulator is concerned about the potential for breaches of the regulations. In particular, the Regulator suggests that specialist legal advice should be taken regarding the risk of such arrangements breaching the regulations.
- Where such a risk exists, the Regulator suggests that a regulation-proof 'underpin' arrangement be included in the funding agreement. This would come into effect if the original arrangement were to be subsequently deemed invalid. The Regulator expects to be notified of any such arrangements and also requires that members be informed, for instance via the summary funding statement.
- The Regulator's statement clarifies the need for trustees to assess and monitor the potential for breaches of the regulations, where they invest via pooled funds.
- The statement also sets out the issues the Regulator would consider in determining whether to use its powers in relation to any breach of the regulations.
- Whilst BBS is broadly supportive of the statement, we are concerned that the Regulator's guidance on funding arrangements will burden pension schemes with additional cost and complexity.

BACKGROUND

A BBS Investment Update was issued in September, which discussed changes to the regulations concerning employer-related investments ('ERIs') that came into force on 23 September 2010 ('the regulations'). Our previous update can be viewed at:

<http://www.bbs-actuaries.co.uk/publications/publications/employer-related-investments>

In summary, the regulations prohibit an investment of more than 5% of the current market value of an occupational pension scheme's assets in ERIs. The regulations also specifically prohibit investment in 'employer-related loans'. Breaches of the regulations could lead to civil penalties and criminal prosecutions against trustees, employers and their advisers. Any assets breaching the regulations may not be taken into account in statutory funding valuations.

On 10 November 2010, the Pensions Regulator issued a statement setting out its views on the issues trustees, employers and their advisers need to consider in relation to these regulations and how it expects to act in fulfilling its own duties in enforcing compliance.



THE REGULATOR'S STATEMENT

In its statement, the Regulator focuses on three areas:

- The potential for breaching ERI regulations in non-cash funding arrangements.
- Issues to consider where ERIs may be entered into through a collective investment scheme, such as a pooled fund.
- The Regulator's approach to the use of its powers in relation to ERIs.

Each of these areas is considered in the sections below.

(a) Funding arrangements that do not involve payment of unconditional cash contributions

Recent years have seen the introduction of new and innovative methods by which employers attempt to support pension schemes, where employers either do not have the wherewithal or the appetite to fund with unconditional cash contributions.

Such methods might include legally enforceable agreements that provide additional security contingent on particular eventualities, such as insolvency of the sponsor, sale of its assets or the failure to meet a target level of funding by a given date. Security can take various forms including charges over assets of the company or deferred cash held in escrow. These arrangements can be complex, involving a variety of legal structures.

The Regulator has suggested that the use of certain 'non-cash' funding mechanisms may potentially risk breaching employer-related investment regulations, although it notes that this has yet to be tested in the courts.

Where trustees and employers are considering such funding mechanisms, the Regulator expects them to take legal advice on whether the proposals may risk breaching the ERI regulations. If there is such a risk and the funding mechanism is not approved by a court, the Regulator would expect trustees to recognise the possibility that the arrangement might be deemed to be invalid under the regulations at a later date. In light of this, the Regulator would expect trustees to negotiate, at outset, an alternative 'underpin' funding arrangement that would take effect if the existing agreement were subsequently invalidated. This underpin arrangement would generally be expected to be in the form of cash contributions or another arrangement of equal financial value.

The Regulator also expects to be informed of any non-cash funding mechanism as part of submissions made in relation to the valuation agreement. The statement also suggests that members should be informed of the arrangement in a 'clear and transparent manner', for instance via the summary funding statement.

(b) Collective Investment Schemes

As noted in our previous update, one of the more contentious changes made to the regulations in September, was the removal of the exemption for 'Collective Investment Schemes'. These include a range of investment vehicles, where trustees pool their assets with those of other investors and delegate responsibility for selecting investments to the fund manager.



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The Regulator recognises that, for most schemes, it is unlikely that they will breach the regulations via pooled investment vehicles. However, the Regulator does expect trustees to consider and identify the possibility of breaching the regulations in their own cases and to monitor how this risk changes over time.

For instance, a pension scheme whose parent is a publicly quoted company may hold 100% of its investments in a pooled arrangement. In reviewing the terms of the pooled arrangement the trustees may note that it is precluded from holding more than 5% of its assets in the shares or bonds of a particular company. The trustees could therefore take comfort that their investments would be unlikely to breach the regulations. However, the trustees may also seek additional reassurance by asking their fund manager to regularly report on the level of any investment made in their sponsoring employer and its associated companies, to protect against the possibility that the manager might breach its own guidelines.

(c) The Regulator's approach to enforcement

In considering whether it will use powers in respect of any breach of the regulations, the Regulator has stated it will take account of the following:

- In respect of funding mechanisms, whether:
 - The mechanism demonstrably provides better security for members than alternative arrangements;
 - It is underpinned by an 'employer-related investment proof' alternative funding approach;
 - It replaces or complements unconditional cash contributions.
- For more general cases, whether:
 - The investment reduces risk to the scheme;
 - The investment reduces the risk of a call on the Pension Protection Fund;
 - The trustees are acting prudently and have sought appropriate advice;
 - There are concerns about conflicts of interest within the trustee board;
 - There are previous similar or related breaches;
 - The breach was the result of a genuine mistake or misunderstanding;
 - The breach was unintentional and corrected within a reasonable time-frame.

Ultimately, the Regulator will attempt to act proportionately and appropriately depending on the specifics of each case.

It is noteworthy that the Regulator will, as a matter of course, also consider whether any material breach should be escalated to a criminal prosecution.



BBS investment update (continued)

BBS VIEW

The Regulator's statement is helpful, although BBS is concerned that the views expressed on non-cash funding arrangements could lead to further complexity and cost for clients seeking to put additional security in place for their schemes.

In particular, the expectation of specialist legal advice on the potential for an arrangement to breach regulations and the requirement to put a backstop 'underpin' arrangement in place where there is the risk of a breach may serve as a disincentive to consider arrangements that might be otherwise be beneficial to schemes over the longer term.

As discussed in our previous update on this subject, we take the view that consideration of the employer-related investment regulations naturally falls within trustees' internal controls framework and should form part of regular reviews of risk registers.

Please contact your usual BBS consultant if you have any queries on this update.

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Note: This update is intended to provide a summary of the issues surrounding the Pension Regulator's statement on employer-related investments dated November 2010. It is not intended to be a source of advice or provide comprehensive coverage of the issues that might be relevant for particular cases.

