Protecting Defined Benefit Pension Schemes – A Stronger Pensions Regulator
R3 Response
August 2018

ABOUT R3

1. R3 is the trade association for the UK's insolvency, restructuring, advisory, and turnaround professionals. We represent licensed insolvency practitioners, lawyers, turnaround and restructuring experts, students, and others in the profession.

2. Our members work across the spectrum of the profession, from the global legal and accountancy firms through to smaller, local practices. Our members have direct experience of insolvencies and their impact on the UK economy and insolvent companies' stakeholders.

3. The insolvency, restructuring and turnaround profession is a vital part of the UK economy. The profession rescues businesses and jobs, creates the confidence to trade and lend by returning money fairly to creditors after insolvencies, investigates and disrupts fraud, and helps indebted individuals get back on their feet.

4. As we wrote in our response to the Government's March 2018 White Paper on Defined Benefit pensions, the insolvency and restructuring profession plays a key role in resolving the future of a financially distressed or insolvent company's pension scheme. When appointed as an office holder in an insolvency procedure, an insolvency practitioner will become responsible for the insolvent company and it is their duty to inform the Pensions Regulator whether the company has a pension scheme, and to realise the company's assets before distributing any realisations to creditors in accordance with the statutory 'order of priority' for post-insolvency repayments. Pension scheme deficits are (usually) an unsecured debt, which rank alongside tax and trading debts. As advisors to struggling but still solvent companies, members of the profession also have a role in approaching TPR to discuss restructuring of pension schemes outside of an insolvency procedure.

5. We have focused our response to this consultation on those questions and themes where we can provide answers based on our members' expertise.

6. R3 would be very happy to meet the Department for Work and Pensions officials to discuss the points raised below in greater detail. If you would like to meet us or if you have any other queries, please contact R3's Public Affairs and Policy Officer, James Jeffreys, at james.jeffreys@r3.org.uk or on 020 7566 4220.

OVERVIEW

7. R3 welcomes the opportunity to respond to this consultation. As we wrote in our response to the Government's White Paper on this issue, government action on defined benefits pensions is needed.

8. At the heart of this consultation is the question of whether the proposals strike the right balance between improved regulations on business and protecting pensions. There is a risk that these proposals would not do this.

9. Fundamentally, the proposals in this consultation may discourage company directors from seeking expert, regulated advice about what to do with their company, either when it is facing insolvency, or when a director wishes to be proactive and restructure their company to avoid financial problems in the longer-term.

10. As explained below, early advice can lead to early action, either to avoid financial problems entirely, or to at least maximise what can be repaid to an insolvent company's creditors – including a pension scheme. Failure to seek early advice will be likely to result in a failure to take early action – and this will lead to worse outcomes for all creditors and stakeholders.

11. As we have noted previously, R3 supports early engagement with the Pensions Regulator (TPR or 'the regulator') as this increases the chances of finding a solution to a company's financial difficulties which works for the company, its pension scheme, its employees, and its other stakeholders. In particular, reforms to the process of agreeing a Regulated Apportionment Arrangement (RAA) would be welcomed by R3 and its members. However, while the proposals in this consultation could be described as promoting 'early engagement', the type of early engagement envisaged by the consultation may not be entirely beneficial.

12. The Government should reconsider the planned scope of an extended notifiable events and 'declaration of intent' framework, particularly in insolvency situations. Many of the proposed new compliance requirements would be of little material benefit, but may make it harder to maximise creditor returns. Some of the outlined requirements and the consequences of compliance are vague, exacerbating any negative impact they may have.

CORPORATE TRANSACTION OVERSIGHT – NOTIFIABLE EVENTS FRAMEWORK

- *We have set out a number of proposed changes to the existing Notifiable Events Framework. Do these proposals strike the right balance between improved regulations on business and protecting pensions? b. Alternatively, are there any other significant business events which you think should be captured?*

- *Have we captured the right criteria for a significant change in the make-up of a board of directors?*

- *We are proposing to bring forward or specify more clearly the timing of reporting notification of certain events (as described above), for instance to the point at which Heads of Terms are agreed for some transactions. Is this appropriate or is there a better time/event to pin the reporting notification to?*

- *What is the likely impact (either direct or indirect) on business of sponsoring employers being required to report earlier? How could the framework be modified to ensure that any adverse impact is mitigated?*

- *Are there any additional changes that could further improve the design of the framework for sponsoring employers, trustees and the Regulator?*

13. R3's primary concern with the proposals in this consultation is with the recommendation that a 'sponsoring employer taking independent pre-appointment insolvency/restructuring advice' becomes a notifiable event.

14. While R3 supports the Pensions Regulator's ('the regulator') desire to have improved awareness of the financial health and history of a pension scheme sponsor, this proposal could have unintended consequences. Rather than improve the regulator's knowledge of scheme sponsors' activities, it could make 'surprise' and serious scheme sponsor failures more likely.

15. There are two potential problems with the proposal: 'independent pre-appointment insolvency/restructuring advice' covers a gamut of interactions between a company and advisors, so, in many cases, notification would be a disproportionate requirement; a requirement to notify the regulator about advice may also deter directors from seeking advice in the first place.

16. In addition to these primary concerns, it is also unclear what will happen once a notification is made. Resolving this question may help ameliorate the above two problems.

Defining Advice

17. Defining what 'pre-appointment insolvency/restructuring advice' should be notified to the regulator is very important. The proposal in the consultation, however, appears to be unworkably wide.

18. 'Restructuring advice' could cover all manner of interactions, including some which are relatively 'harmless' as far as the regulator is concerned: an independent business review (suggested as a notifiable event in the consultation) may, for example, be part of the process of a financially healthy company finding a new secured lender.

19. There are also plenty of different ways advice may be received by a company, from advice in formal meetings with advisors, to informal chats, or to the aforementioned independent business review.

20. The requirement to notify the regulator about any advice could add a compliance burden to companies which is either unnecessary (where a company is healthy) or distracting (where a company *is* receiving advice because of impending insolvency).

21. A vague definition of the advice about which the regulator needs to be notified could also create confusion, inconsistency, and delay to notifications. The threat of significant sanctions for non-compliance combined with a lack of clarity over the type of advice which should prompt a notification would see directors take a 'safety first' approach to seeking advice, and they may avoid seeking advice which may not actually need to be notified to the regulator.

22. Actions which trigger notifications to the regulator should be clearly defined; but the Government must also take care not to create loopholes or opportunities for avoidance. For example, a requirement for the regulator to be notified about advice received from an insolvency practitioner could lead to companies seeking advice from unregulated advisors instead.

An Incentive Not to Seek Advice

23. A perennial problem for the insolvency and restructuring profession is that businesses (and individuals) do not seek advice early enough to maximise the chances of rescue or a 'solvent' resolution to their financial problems.

24. A number of factors explain why companies delay seeking advice, including (but not limited to): directors may simply be unaware of their options or the true state of a company's finances; directors are overly optimistic and believe that they can resolve a company's problems themselves; directors may be worried that speaking to an insolvency practitioner or restructuring expert may see them lose control of a company; they may be worried about the personal consequences of corporate insolvency (disqualification or potentially personal financial troubles); they may also be worried about how a company's entry into an insolvency procedure might be perceived by colleagues, contacts, or friends and family; and they may be worried that, if the market was to become aware of the fact they had sought advice, the public reputation of their company may be damaged.

25. As we noted in our response to the Government's White Paper on this issue, "in the profession's experience, the sooner a company restructures, the greater the chance that it will be able to fulfil its financial obligations. Failure to take action early often leads to financial positions deteriorating, destroying value for creditors – including a company's pension scheme."

26. As such, the insolvency and restructuring profession will support policies which encourage companies to seek advice on restructuring and insolvency at the earliest possible opportunity. Unfortunately, the proposals in this consultation may do the opposite: they would encourage companies to delay or avoid seeking advice.

27. As above, companies in financial distress are often unwilling to publicise their situation – both internally and externally. Even with commitments from the regulator to keep notifications confidential, companies may be unwilling to take steps which may result in intervention from the regulator, both because they would not want their difficulties to become public knowledge (and regulatory action would potentially be difficult to keep quiet), and because regulatory intervention would add complexity to an already difficult, fast-moving, and unpredictable situation, and could potentially make resolving financial difficulties harder and more costly.

28. For these reasons, a requirement to notify the regulator about simply seeking advice would mean that companies may become unwilling to seek external advice at an optimum, early point. This would reduce the chances of business rescue and potentially increase the number of notifications being made at the last possible moment – the opposite of what the Government is seeking to achieve.

What Happens to the Notifications?

29. It is not clear from the consultation exactly what will happen with a notification once it is received. The Government must make clear whether an individual notification would be enough to trigger intervention from the regulator, what form any intervention would take, and the threshold there would be for regulator intervention.

30. Clarity – and reassurance – that sending a notification to the regulator would not immediately trigger action by the regulator may make companies more comfortable with the idea of notifying the regulator of the fact they have sought advice (and thus may not discourage companies from seeking restructuring or insolvency advice).

31. That said, if it is clear that notification of advice will trigger an intervention, companies may delay or avoid advice. That would be bad for business rescue – and bad for UK pension schemes.

Timing of Notifications

32. The proposed change to the timing of the notification of potential transactions may be meaningless in some insolvency scenarios, particularly pre-pack administrations.

33. A pre-pack administration is where the sale of a company's business or assets is negotiated prior to the appointment of an administrator and completed shortly afterwards. Most creditors will find out about a pre-pack sale after it has taken place. The speed and discretion provided by a pre-pack can be vital for maximising creditor returns in insolvencies: they help protect the value of a company's business and assets in many circumstances, while there are frequently funding obstacles to more 'transparent' alternative rescue procedures, such as a trading administration. Without the right protection, the publicity of a company's financial problems can undermine its brand value, while there is a risk that the company could lose key staff, customers or suppliers as a result of uncertainty. A declining business value means declining returns to creditors. There is also the risk that, should a company be open about its financial problems ahead of an insolvency procedure, it exposes itself to the risk of a hostile creditor action, such as a winding-up petition, where creditors seek to exert pressure to secure payment priority.

34. The consultation proposes that the regulator be notified of the impending sale of a controlling interest in the sponsoring employer, the sale of the sponsoring employer's business or assets, or the granting of security in priority to scheme debt when the Heads of Terms agreement is first put in place. The current requirement is that notification of these events occurs as 'soon as reasonably practicable' after they have taken place. While this change may make a material difference in 'typical' business circumstances, it may lead to just an extra 24 or 48 hours' notification if a company is rapidly approaching insolvency (or is already insolvent) and has to agree a business sale or loan in a very short space of time. In insolvency situations, an accelerated sale may be necessary to protect the value of the business (and, by extension, protect the value of what can be repaid to creditors – including any pension scheme).

35. There are two potential issues: the earlier notification may not be early enough for the regulator to take any meaningful action should it wish to, while any regulatory intervention in this period may make business rescue more difficult. Some in the profession report that dealing with the regulator can sometimes be time-consuming, so adding this factor to the difficulties facing an insolvent company may not be conducive to business rescue. Even if the regulator does not intend to take immediate action as a result of a notification, the time taken to comply with notification requirements could be better spent elsewhere.

36. An additional handful of days' notice for the regulator may also be considered superfluous: the regulator already has extensive 'look back' powers available to it, and it may impose a contribution notice on a 'relevant person' in relation to an act or failure to act in the

previous six years. It's not clear, therefore, what meaningful difference marginally earlier notification in an insolvency scenario would make to the regulator given that its existing powers would presumably already allow it to take action to rectify any problems anyway.

37. While an employer's pension scheme is often an important unsecured creditor in an insolvency procedure, the Government must remember that a scheme is one of several unsecured creditors a company will have, including other companies with their own pension schemes. The insolvency of one company can have a serious negative financial impact on another: recent R3 research found that over a quarter (26%) of UK companies had suffered a hit to their finances following the insolvency of a customer, supplier or debtor in the six months to April 2018[1]. Rescuing a business is often the best way to maximise returns to the creditor body as a whole and to minimise the negative knock-on effects of corporate insolvency: a rescued business can recover and continue to meet its obligations (or, at least, be in a position to make a better contribution towards any obligations than a liquidated company could). Any additional obstacles to business rescue – such as new, but potentially unnecessary, compliance requirements to benefit one unsecured creditor – could make rescue harder to achieve, leading to worse outcomes for all creditors, including both a company's business creditors and its own pension scheme.

38. In an insolvency, it is the role of the insolvency practitioner to provide assurance to creditors that their interests are being taken into account. The insolvency practitioner is responsible to the creditor body as a whole, not to one creditor, and not to the debtor. This assurance is particularly useful in a pre-pack administration, where events can be necessarily fast-moving and where transparency is necessarily limited. While we understand the regulator's wish for more visibility in situations like these, the regulator can rely on the insolvency practitioner to seek to ensure that its interests have been considered and that the pension scheme's position will not be unfairly prejudiced in an insolvency procedure. Any insolvency practitioner who fails to do this can – and should – face regulatory action by the profession's regulators. Insolvency practitioners will contact the regulator in insolvencies once they have been appointed as an office holder.

CORPORATE TRANSACTION OVERSIGHT – DECLARATION OF INTENT

- *We have set out a number of proposed transactions which would trigger a Declaration of Intent. Do these proposals strike the right balance between improved regulations on business and protecting pensions? Alternatively, are there any other significant business transactions which you think should be captured?*

- *Is there any further information which could be included in a Declaration of Intent to improve understanding of the proposals to strengthen the position of the pension scheme?*

- *At which point in the transaction process should sponsoring employers a) engage with trustees and b) issue a Declaration of Intent to them?*

- *What would be the impact (both direct and indirect) of our proposals on businesses, for example on transactions or administration costs of notification?*

[1] Research undertaken by BDRC. Questions were put to 1,200 UK businesses via BDRC's monthly Business Opinion Omnibus. Online interviews with a nationally representative sample of senior financial decision makers across the UK, weighted by size, region and sector. Fieldwork dates 29 March to 18 April 2018.

- *What more could we do to increase trustees' involvement in negotiations to ensure there is due consideration of the potential transactional risks to pension schemes?*

39. As above, R3 recognises the regulator's desire for more visibility of changes to a company's financial position, but this extra visibility may not make a material difference in some insolvency or distressed company situations.

40. As noted, some insolvencies can be fast-moving, and there can be little time between the need for a sale to be identified and the sale being completed. Additional compliance steps, such as 'a declaration of intent' may not make a difference to the outcome but the need to spend time to consider and complete notifications may not be helpful.

41. Indeed, a declaration of intent may duplicate the work already carried out by an insolvency practitioner ahead of an insolvency. Insolvency practitioners will work with employers to ensure that the impact of a planned sale on a company (and its pension scheme) has been taken into consideration.

IMPROVED REGULATOR POWERS

- *What are the likely effects and impacts on business and trustees of the introduction of this proposed new system of penalties?*

- *Are there other behaviours that should attract sanctions? If so, what are they?*

- *We have proposed a new civil penalty (up to a maximum £1m) for example to take action for non-compliance with providing a declaration of intent. Will this deter wrongdoing? If not, what would be a suitable deterrent?*

- *We have proposed a new criminal offence for wilful or reckless behaviour in relation to a pension scheme, and for failures to comply with Contribution Notices and the Notifiable Events Framework. Do you agree with these proposals? Will this deter wrongdoing? If not, what would be a suitable deterrent?*

- *If yes, should the maximum penalty for these offences be a) Unlimited fines? b) Custodial sentence and/or fine for the worst offenders – do you have views on the appropriate maximum term?*

- *What more can we do to support the Pensions Regulator in enforcing legal requirements in an effective and proportionate way?*

42. Compounding some of the issues with the proposed new compliance requirements outlined in the consultation are the proposed new penalties for non-compliance.

43. While the strength of the proposed new sanctions should discourage compliance failures, it would also encourage cautious directors to avoid coming into contact the compliance regime in the first place by encouraging them to not seek advice when there is an opportunity to do so. As above, this would damage the chances of business rescue in distressed business situations.

44. Similarly, a £1m fine for non-compliance with the requirement to provide a declaration of intent may be problematic in some insolvency situations. As outlined above, a marginally

earlier declaration of intent may be practically meaningless in some situations and unnecessarily adds to the compliance burden in a difficult situation. A £1m fine for non-compliance in these scenarios is excessive. Moreover, the inclusion of 'associated persons' within this part of the sanctions regime may make insolvency practitioners very wary about offering support to distressed businesses facing a sudden financial shock or where there is little time available to rescue a business (for fear they may be found liable for any non-compliance with the declaration of intent framework). This would have a negative impact on business rescue – and a consequentially negative impact on returns to creditors, including pension schemes.

CONTRIBUTION NOTICES

- *We have set out a number of proposed changes to the way Contribution Notices function. A) Do these proposals strike the right balance between improved regulations on business and protecting pensions? b) Alternatively, what else could we do to improve the way Contribution Notices work?*

- *What would be the most appropriate way of protecting the value of the Contribution Notice through uprating? What are the likely impacts of this?*

- *What could be the impacts of changing the date at which the cap was calculated to a date closer to the final determination?*

45. It may be reasonable that, as it is proposed that the regulator has the power to increase the value of a contribution notice in some situations, the target of the contribution notice should have a mechanism for requesting a decrease in the value of the notice where (in those same situations) it can be shown the value of the notice is too high.

OTHER

- As above, insolvency practitioners are required to notify the regulator when a scheme sponsor has entered an insolvency procedure. In R3 members' experience, details of an employer's pension scheme are not always readily available: directors may be uncooperative or simply poor at record keeping. As a result, the insolvency practitioner may be unaware of the existence of a scheme or unable to provide the correct information to the regulator. The profession would appreciate support from the regulator in identifying any schemes linked to an employer (so that insolvency practitioners do not have to rely on directors for key information). Such assistance would help the regulator to have greater confidence that it will receive prompt notification on an insolvency practitioner's appointment.