# The Pensions Regulator Defined Benefit Funding Code of Practice Consultation
# Institute for Family Business Response

## 1. Summary


- Family businesses, with their long-term outlook and strong values, are committed to acting responsibly, but also recognise that investment and growth is essential if they are to be sustainable.
- Any future funding rules must always meet the Pensions Regulator's (TPR) stated objective to "minimise any adverse impact on the sustainable growth of an employer".
- A lack of flexibility in funding arrangements has previously led to businesses failing - it is essential that this does not happen in the future. It's also important to recognise that inflexible funding arrangements will take cash away from businesses, which will impact on their ability to retain employees and invest in the business.
- In principle we can see benefits in a twin track compliance approach. Any Fast Track must be sufficiently inclusive to be able to include a large number of family businesses, particularly smaller businesses.


## 2. About the Institute for Family Business

The Institute for Family Business (IFB) is the UK's family business organisation, supporting and promoting the UK family-owned business sector through representation, thought leadership, analysis, events and networking. We work closely with family firms to support them in growing enterprises for generations to come. A central part of our work is to provide educational resources and knowledge-sharing designed to support business owners and those who work in family business. We champion best practice within the family business community and help others to learn from these examples.

## 3. About Family Business

The family business sector in the UK now employs 13.4 million people, generating a quarter of GDP and contributing £182bn in tax. From micro start-ups to worldwide brands the innovation, agility and resourcefulness of family owned firms is second to none. Family businesses are found in all parts of the UK. Growth in the sector brings benefits to the whole UK economy, consumers, the exchequer and the millions who work for family firms

While the majority of family firms in the UK are small or micro businesses, around half of all midsized business and one in five large businesses are family owned. Alongside the large number of growing entrepreneurial first generation family business, many family firms have been operating for hundreds of years and their longevity and enduring success are testament to their innovative and long term outlook.

A long-term outlook is at the heart of family business. Shareholders in family businesses view their role as that of a steward, with an obligation to pass the business on to the next generation in a stronger state than they found it. They feel a sense of responsibility not only to future generations of their own family, but also to the legacy of their forebears, their employees, and the community in which they are based.

Whilst family businesses generate a significant proportion UK GDP, they recognise that success in business is about more than short term financial results. Success is about sustainable value creation. Family businesses

perform better than non-family firms in non-financial metrics such as investing in their employees and in supporting communities. And the best-run family businesses outlast others by a factor of two.

Most family businesses are privately owned and do not have large numbers of disparate and institutional shareholders. On the contrary, shareholders tend to have a close relationship with the family business and play an important role in shaping the culture and values in the business. Family businesses have an in-built natural tendency to approaching corporate stewardship in ways that ensure that the pursuit of good financial performance supports their long term objectives and values, rather than harming them.

While there are many owner-managed businesses in the family business community, ownership and management are not always linked. Because families care about their businesses, they know how important it is to have the best people running those businesses. That means appointments are made based on talent and skill, not family connection. Even in those businesses where family aren't actively involved in management, they still have a very important role to play as active and engaged governors and owners.

The family firm often represents not only a key part of a family's monetary wealth, but their heritage. This is a source of great pride, but also a source of responsibility. Family business owners understand better than any the importance of reputation, how long it takes to build, and how quickly it can be lost. When your name is above the door, responsible behaviour becomes part of the commitment to future generations of your own family.

## 4. Family Business and Defined Benefit Pensions

Family businesses have a long history of acting as responsible employers, and this includes their provision of pensions to their employees. Many firms now have significant pension scheme obligations, and family business owners are committed to ensuring that their business is able to meet these sustainably whilst also investing in growth for the future. Whilst firms may no longer accept new entrants into final salary schemes, those schemes remain a company liability until all beneficiaries of the scheme have passed away.

Family businesses, with their long-term outlook and strong values, are committed to acting responsibly, but also recognise that investment and growth is essential if they are to be sustainable. Any future funding rules must always meet the Pensions Regulator's (TPR) stated objective to "minimise any adverse impact on the sustainable growth of an employer".

Whilst responsible family firms are committed to ensuring that they are able to meet their pension commitments, many businesses feel that the current regime for calculating liabilities does not provide a reasonable representation of the liabilities on their balance sheets. Even where a family business is confident that it is able to meet the requirements of their scheme, the calculated deficit can be high. We welcome this opportunity to share how future changes might impact family firms, and how they can be improved to support employers, and current and future scheme members.

Since this consultation was published businesses in the UK have been suffering extraordinary levels of disruption and downturn. It is essential that policy across the board reflects this, and that changes support business recovery and growth. Given the significant impact of legacy pension schemes on family businesses, it is vital that the historic issues around pension funding that have had an impact on business investment are addressed, to ensure businesses can invest and recover and support their pension schemes for the long term. A lack of flexibility in funding arrangements has previously led to businesses failing - it is essential that this

does not happen in the future. It's also important to recognise that inflexible funding arrangements will take cash away from businesses, which will impact on their ability to retain employees and invest in the business.

## 5. How Family Businesses Operate

Many of the family businesses and advisers we speak to say that they often feel the way in which they operate, and the reasons they do things, are not well understand by regulators and as a consequence their actions are viewed with suspicion.

The role of dividends in family businesses is one such area. Family businesses tend to fund future investment through reinvesting profits back into the business, rather than taking on outside debt or equity investment. As a result, family firms do not generally pay high dividends. For family members, the long-term sustainability of the business is their key objective, rather than short term financial gain.

However, that does not mean that dividends do not play an important role in continuing to engage the family owners. If family members are not able to receive dividend payments, it creates an incentive for family owners to divest themselves of their shares in their family business to receive the lump sum benefit rather than a small, sustainable income. This would impact on the long-term stability of the UK family business sector, undermining the long termism and stability of the sector.

Close shareholdings of responsible and engaged owners makes a business more secure in the long term. Not only do the shareholders uphold strong values, but it enables the business to pursue long term strategies, informed by engaged and insightful owners. This enables investment decisions to be made for the long-term benefit of the firm, and the UK economy as a whole.

Planning for a transfer of ownership between generations is an essential part of ensuring a family firm will continue to thrive for many years to come. Succession can take many forms, as families and businesses develop a process which is most suitable to their unique circumstances.

In many instances this will see owners gradually phase their withdrawal from the business as the next generation become more involved in the firm, as they perhaps step back from day to day management, or when they retire from the business entirely. In these circumstances' shareholders may be 'exiting' from some of their share, but still intend to remain a shareholder in the business. There are familial reasons and those of heritage to remain a shareholder, as well as financial reasons.

There are other reasons why a shareholder may choose to divest of some of their shareholding whilst still retaining a significant share of the business. For example, a family member may need to realise some of the value of their shares, but still intend to remain involved in the firm. It is perfectly feasible and reasonable for a major shareholder to reduce their shareholding in the family business without wishing to bring in a third party.

It is imperative that families, shareholders and businesses are allowed to manage the delicate issue of phasing succession – or the exit of disengaged family members - in the business in a way that best reflects the long term needs of the business, and that they are not penalised unfairly in comparison to other ownership models for doing this. It is also essential that any rules on ownership changes, notifiable events, etc do not act as a barrier to the smooth and efficient transfer of ownership in family firms. Doing so would undermine the long-term sustainability of the business.

## 6. Proposed Regulatory Approach

*Question 1 - Twin-track compliance*
*Do you think twin-track compliance is a good way of introducing objectivity into a scheme-specific regime? What are your views on the proposals set out above? If you disagree, what do you propose instead?*

In principle we can see benefits in a twin track compliance approach. It is likely that those schemes which take the Fast Track route will be well funded, with low risk assets, and be in a position to pay high contributions. This means that those which will face higher administration costs, through higher regulatory involvement, will be schemes that are less funded. This is likely to therefore put a higher financial burden on those with fewer resources.

The Fast Track must be sufficiently inclusive to be able to include a large number of family businesses, particularly smaller businesses. If it does not this will lead to a significant burden on businesses to respond but will also lead to too many companies requiring input from the regulator to apply bespoke rules.

If there are significant numbers of schemes applying bespoke rules we would discourage the use of a sampling approach to those that take the bespoke route. Sampling would lead to a perception that pension regulation is a lottery, and would be backward looking making people uneasy that what they had already done would be judged to be not good enough. This would also damage the relationship between businesses and the regulator.

## 7. Employer Covenant

*Question 2 - Insolvency risk and reliance on covenant*
*Do you think the risk of member benefit reductions on insolvency is an acceptable part of the existing regime and that trustees should be able to place some reliance (whether implicit or explicit) on the employer covenant? To what extent do you think this should be the case? Do you think this risk is well understood by scheme members?*

Yes, the employer covenant should be taken into account. Strong businesses will likely also have lower reserves in their scheme than a weaker business, because the trustees have greater confidence they can return to the business for additional funds if necessary. This principle should also be included in future regimes.

*Question 4 - Covenant assessment*
*a. Should a holistic approach to assessing employer covenant be retained (but with further guidance to assist trustees), or should we seek to define a more prescribed, formulaic approach?*
*b. If the former (holistic approach), what amendments/clarifications to our existing guidance on covenant do you consider may be necessary? Do you agree with the ones suggested above? Is the structure and content of our existing employer covenant guidance helpful and accessible to trustees? If not, what would make it better?*
*c. If the latter (formulaic approach), what do you think of the proposed RACF approach? How would you propose that covenant could be explicitly defined in a clear, consistent and measurable manner? What other metric(s) may be appropriate?*

*d. Alternatively, would it be appropriate to require employer covenant to be assessed in a prescribed (formulaic) way for Fast Track purposes, and only allow for a more holistic approach under the Bespoke framework?*

The assessment of employer covenants must be holistic, not relying solely on financial metrics. These must be able to factor in how family firms work, what makes them stable and successful. This should include considerations such as age of business, business values, age of directors, approach to sustainability, etc. Formulaic approaches should be avoided as they encourage decision making based on the formula/regulations, rather than the best approach. It goes against the spirit of the scheme specific approach. A holistic approach gives visibility of real-world operation, culture, values, etc. In the current regime the covenant is measured holistically – this must be maintained.

It is not appropriate to take an approach which prioritises a few years level of cash flow. Family businesses are more likely that others to own assets outright, including their own premises. This gives them strength and stability. Focusing only on profit misses the true strength of family businesses.

When considering funding, trustees and businesses must weigh the needs of many different stakeholders. Assets and cash are divided between these. If the regulator focuses on short term cashflows, focus will be put on providing that to the scheme and placing other assets elsewhere. This will encourage businesses to change structures to suit funding guidance, rather than the long-term best interests of the business.

*Question 5 - Reliance on indirect covenant*
*Do you think that the strength of the wider commercial group should be factored into the sponsoring employer's assessment? If so, how, and to what degree?*

If a holistic approach is being taken, it is reasonable to consider the wider group.

## 8. General Principles

*Question 7 - Low dependency LTO*
*Should all DB schemes have a low level of dependency on the employer by the time they are significantly mature? If not, what do you think would be an appropriate expectation to ensure trustees manage the runoff phase for their scheme effectively and efficiently?*
*Question 8 - Timing of the LTO*
*What factors should influence the timing of reaching the LTO? Do you think that the timing should be linked to maturity?*
*Question 9 - High resilience to risk at the LTO*
*Do you think that the investment portfolio should be highly resilient to risk when schemes reach their LTO? If not, what do you suggest?*
*Question 10 - Risk-taking for immature schemes*
*Is it reasonable for less mature schemes, which would have more time to reach low dependency funding, to assume and take relatively more investment risk than a mature scheme?*
*Question 11 - Journey planning*
*What are your views of the rationale above for the journey plan? Do you think there is there a better way for trustees to evidence that their TPs have been set consistently with the LTO?*

Trustees and employers understand the unique circumstances of their schemes and associated businesses, and therefore are best placed to agree long term objectives for funding of individual schemes. It is neither necessary nor helpful for the regulator to override the long-term strategies of schemes.

It is not, therefore, appropriate to say all schemes should have a low level of dependency on the employer by the time they are significantly mature. Taking this approach is essentially moving to a scenario where all schemes have the same strategy, rather than taking a scheme specific approach. It is up to schemes and sponsors to agree what is appropriate for their situation, especially as there is no evidence that schemes of a certain maturity should be funded to a certain level. It should not be assumed that a mature scheme cannot be funded by an employer, as there is no reason it cannot be.

The legislation's intention is to support trustees and sponsors to agree a scheme specific approach. Setting an LTO in the way described would not be scheme specific. Having a specific target set by the regulator, this would not be scheme specific. The intention should be to ensure all schemes have a plan. It should not be prescribed what that plan is. Doing so would hamper trustees and employers in creating a sustainable plan which supports the scheme, as well as the long-term future of the business and its employees.

*Question 12 - Relevance of investments for funding*
*Do you agree that the actual investments and investment strategy are a relevant factor for scheme funding?*
*Question 13 - Broad consistency between investment and funding strategy*
*a. Should the investment strategy be broadly consistent with the level of current and future investment risk assumed in the funding strategy? If not, why not?*
*b. If it is not broadly consistent, for instance where trustees want to take additional investment risk (than that assumed in the TPs), should trustees have to demonstrate that the investment risk taken can be managed appropriately? If not, why not and what would you suggest?*
*Question 14 - Liquidity and quality at maturity*
*Do you think that security, quality, and liquidity become more important as a scheme becomes significantly mature? In particular, do you think that the scheme's asset allocation at significant maturity should have a high level of liquidity and a high average credit quality?*

Given the objective to establish a scheme specific approach we believe it should be the responsibility of trustees and companies to agree how investments are taken into account in scheme funding approaches. It is the role of the trustees and businesses to discuss whether the funding strategy is consistent with the investment strategy.

We do not believe that the regulator would have the capacity to assess the needs of each scheme individually, and any one size fits all framework would not be appropriate. Imposing rules on investments would harm the ability of family businesses to invest appropriately and effectively.

*Question 15 - Covenant visibility*
*a. Do you think it is prudent for reliance on employer covenant to be reduced beyond the period over which there is reasonable visibility? If not, why not?*
*b. How much visibility do you think most trustees can have over the employer covenant? In the absence of evidence to the contrary, do you think it is reasonable for most schemes to assume there is reduced visibility beyond 3-5 years?*

As we said in our answer to question 4, it is not appropriate to take an approach which prioritises a few years level of cash flow. Family businesses are more likely that others to own assets outright, including their own premises. For these long-standing businesses this can include a wide range of unusual assets like manufacturing sites, mills, distilleries, etc. This gives them strength and stability. Focusing only on profit misses the true strength of family businesses. Ignoring assets in this context is inappropriate.

*Question 16 - Use of additional support*
*Should additional support, such as contingent assets and guarantees, be allowed in scheme's funding arrangements provided they are sufficient for the risk being supported, appropriately valued, legally enforceable and realisable at their necessary valued when required?*

Yes, additional support should be allowed. Furthermore, trustees and companies should have flexibility to take into account arrangements between parties without having to prove legal enforceability. Requiring them to do so in all cases would require businesses spending significant sums in legal fees, and would not be proportionate to the situation.

*Question 17 - Appropriateness of RPs and affordability as key factor*
*a. Should employer affordability be the key factor to determine the appropriateness of a RP? If not, what should it be?*
*b. Is it reasonable to require schemes with a stronger employer covenant (and a resulting reduction in prudence in the assumed TPs and size of deficits) to have a commensurately shorter RP?*

Affordability, which allows for sustainable business growth, should be the key factor of a recovery plan. We think it's appropriate that recovery plans are set to take account of what is reasonable for other stakeholders, employees, and sustainable growth. This will mean recovery plans take into account the individual circumstances of the business, the sector it operates in, its future growth plans, etc.

## 9. Equitability

*Question 43 – Equitability*
*What are your views on the concept of 'equitability' in respect of how a scheme is treated compared with other stakeholders? Should any requirements be qualitative (in line with the commentary above) or should trustees also be expected to consider a specific metric? If so, what might be an appropriate measure of equitability (for example, comparing the ratio of DRCs to dividends, or the size of scheme deficit to the 'stake' of other stakeholders) and how could this reflect a scheme's superior creditor status over shareholders?*

It is essential when considering whether a scheme is being treated equitably with other stakeholders, that the definition of equitability is not based solely on financial metrics. Trustees and companies should consider the specific scheme and business circumstances and agree what is equitable. This should not be defined by the regulator. This would be impractical in family businesses particularly because of the challenges around valuing stakes in family businesses. Valuing family businesses is challenging because the businesses are closely held, no sale is planned, no sale has ever taken place and the shares themselves have little value. Schemes should be treated equitably, but that should not be judged solely on a financial basis where simple ratios are bound to fail in the complex real world of family business.

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