

Employer related investments

This statement is aimed at trustees, employers and their advisers who are involved in scheme funding negotiations and decisions about their scheme's investment strategy. It sets out some of the things trustees should consider when they are potentially at risk of breaching the restrictions relating to employer related investments (ERI), and The Pensions Regulator's (the 'regulator') approach in situations where those risks may exist.

We are issuing this statement now because funding arrangements between schemes and their employers are becoming increasingly complex and this has highlighted a risk that some structures could involve potential ERI breaches. In addition, recent amendments to the Occupational Pension Schemes (Investment) Regulations 2005 have resulted in some exemptions from ERI restrictions being removed, and this statement also aims to address the effects of those amendments.

The pragmatic approach that we have set out does not change the existing legislative restrictions, which we recognise are also complex. The type and details of arrangements which may carry a risk of ERI breach can vary greatly and our starting point and focus will be on whether an arrangement is detrimental or beneficial to members and the Pension Protection Fund (PPF).

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**The Pensions
Regulator**

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Background

The ERI restrictions are set out in section 40 of the Pensions Act 1995 and in the Occupational Pension Schemes (Investment) Regulations 2005.

Subject to certain exceptions, not more than 5% of the current market value of scheme assets may at any time be invested in ERI. In addition, some ERI is absolutely prohibited, including an employer related loan or guarantee and ERI transactions at an under value. ERI restrictions not only apply to investments in the employer, but also to investments in parties associated or connected with the employer, and in property used by the employer or its associates.

Breaches of ERI restrictions may attract civil penalties and in some cases will be a criminal offence for which the regulator can instigate criminal proceedings against trustees (and in some cases also employers and advisers). It can also impact on the calculation of the scheme's assets¹.

In addition to ERI considerations, any scheme investment should also comply with legislative and trust law restrictions (including that they are prudent and in the best interests of scheme members).

In many instances it will be straightforward to determine if there has been a breach of the ERI restrictions and whether it is detrimental to the scheme, for instance where existing scheme resources are used for the employer's benefit (such as for a loan or to purchase an asset of the employer's). However, in some situations the application of the ERI restrictions contained in the legislation can be very complex, as can some of the funding structures that trustees and employers are adopting, and parties may find that it is difficult to ascertain with certainty whether an arrangement does involve an ERI breach.

Trustees are required to disclose details of any ERI (whether permitted or in breach) in the annual report, together with details of how and when any breach will be remedied². ERI breaches may also need to be reported to the regulator³.

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¹ Regulation 3(1)(a) of the Occupational Pension Schemes (Scheme Funding) Regulations 2005 provides that any resources of a scheme which are invested in breach of ERI restrictions are to be excluded from the calculation of the scheme's assets for the purpose of a valuation under Part 3 of the Pensions Act 2004.

² Regulations 6(1) of and paragraph 16 of Schedule 3 to the Occupational Pension Schemes (Disclosure of Information) Regulations 1996.

³ See section 70 of the Pensions Act 2004 and our code on reporting breaches of law: www.thepensionsregulator.gov.uk/docs/code-01-reporting-breaches-of-law.pdf for further information.

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Employer related investments and scheme funding

The regulator's view remains that – generally – the best form of support for a scheme is direct and unconditional cash contributions. However, there has been an increase in the use of mechanisms that do not involve only direct and unconditional cash payments from scheme employers to fund schemes. These mechanisms can strengthen the employer covenant, or support to the scheme, by providing the scheme with an enforceable legal arrangement which reduces risks to members. The details of these mechanisms can vary significantly from each other. The regulator's view is that some of these funding mechanisms, including some limited partnership structures, could potentially carry a risk of ERI breach. Whether any of these mechanisms do, in fact, involve ERI breaches has not been tested in the courts.

When employers and trustees are considering the use of such funding mechanisms, we expect them to take specialist legal advice on whether the mechanism might involve ERI and be in breach of the legislative restrictions. Where trustees agree to the use of such a mechanism, and in the absence of a court decision confirming that it does not involve ERI breaches, we expect trustees to recognise the risk that the agreement could, in the future, be proved to be in breach of ERI restrictions and void for illegality. If, for any particular mechanism, this risk could impact on the scheme, we will expect the agreement to include an 'underpin', which would provide an alternative funding structure (for example straightforward cash contributions or another arrangement of equal financial value).

We expect to be informed about these funding mechanisms. They should be explicitly described in the valuation submission to the regulator via **Exchange** (for example in the recovery plan, schedule of contributions, or in the contingent asset section of the summary valuation submission). Where such a mechanism is put in place at a time which is out of sequence with the scheme's valuation cycle, we would expect details of the mechanism to be submitted to the regulator, for example, in the revised recovery plan. In addition, we expect the details of the funding mechanism to be communicated to members in a clear and transparent manner, for example in the summary funding statement.

Trustees should ensure that the assets which support the funding mechanisms are independently valued; further information about this and other risks which trustees will need to consider in relation to contingent asset agreements can be found in our draft guidance on monitoring employer support, on which we have recently consulted: www.thepensionsregulator.gov.uk/docs/employer-support-consultation-document.pdf

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Employer related investments and collective investment schemes (CISs)

On 23 September 2010, an exemption from ERI restrictions, which previously existed for investments made through CISs⁴, was removed (as a result of the 5-year transitional period for investments to comply with the IORP Directive⁵ coming to an end). This means that any investment made in the sponsoring employer or its associates through a CIS is ERI and is, therefore, subject to the relevant restrictions.

We expect breaches of this nature to be rare; such a breach would at least require both the CIS to hold more than 5% of its portfolio in the employer or its associates, and for the pension scheme to have a disproportionate percentage of its fund invested in the particular CIS⁶. However, just as trustees are expected to manage direct investment in the sponsoring employer(s), they will be expected to manage the level of indirect investment through CISs in the sponsoring employer in a reasonable and proportionate way. The regulator recognises that some schemes may not easily be able to ascertain accurately the details and value of the underlying holdings in a CIS, and that these holdings may change frequently.

The regulator expects trustees to have adequate internal controls in place to satisfy themselves that the scheme is being well managed in accordance with the law⁷. The following examples set out some ways in which trustees might try to reduce the risk of breaching the amended ERI restrictions. These examples have been produced for illustrative purposes only. They are not exhaustive, nor do they illustrate circumstances in which the regulator may or may not act. The examples have been simplified and assume that the scheme's only possible investments in the sponsoring employer or its associates are through the CIS, that the CIS could not invest in any associates of the sponsoring employer and does not invest in any employer-related loans⁸. In practice, schemes will need to ensure, as far as possible, that direct and indirect holdings in the sponsoring employer or its associates do not breach the relevant restrictions.

Example 1

Scheme A notes that the CIS cannot invest more than 10% of its assets in shares from any one issuer. Since the CIS must meet this standard, if scheme A restricts its investment in the CIS to 50% of scheme assets, its indirect investment through the CIS in any one company, including the sponsoring employer, will not exceed 5%.

Example 2

After discussion with its CIS provider, scheme B establishes that the CIS it invests in is well diversified and does not invest more than 5% of the CIS's assets in any one firm. So the scheme will not invest more than 5% of its assets in the sponsoring employer, even if all its assets were invested in the CIS.

Example 3

Scheme C agrees that its CIS provider will provide a report of its investment holdings of 5% or more of its assets on a regular basis. If scheme C's sponsoring employer appears as one of these holdings, scheme C can calculate its overall investment in its sponsoring employer and adjust its investment in the CIS accordingly.

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⁴ Collective investment schemes include unit trusts and ICVCs/OEICs.

⁵ Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision.

⁶ Assuming that the scheme holds no other ERI and that the CIS does not hold investments that could be employer related loans (prescribed by regulation 12 of the Occupational Pension Schemes (Investment) Regulations 2005)

⁷ www.thepensionsregulator.gov.uk/codes/code-internal-controls.aspx#s1979

⁸ See footnote 6.

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The regulator's approach to ERI

In considering whether it would be appropriate to use powers in respect of a potential breach of the ERI restrictions, the regulator will take into account the following factors, where relevant:

In respect of funding mechanisms, whether:

- The mechanism provides demonstrably better protection to members' benefits than available alternatives that do not carry risk of ERI breach (for example straightforward contributions from employers);
- The mechanism complements, or is underpinned by, a suitable alternative arrangement which does not carry risk of ERI breach;
- The mechanism replaces, or is in addition to, direct cash payments from employers and does not use existing scheme assets;

And also more generally whether:

- The mechanism reduces risk to the scheme;
- The mechanism reduces the risk of a call on the PPF;
- The trustees are acting prudently and are adhering to appropriate investment principles and obtaining appropriate investment advice;
- The trustees have received appropriate independent advice;
- There are concerns about potential conflicts of interest on the trustee board;
- The ERI breach follows, relates to or facilitates any other breach;
- The ERI breach was the result of a genuine mistake or misunderstanding;
- Where it was unintentional, the breach has since been remedied within a reasonable time frame.

The last 2 points are particularly relevant to breaches in relation to a CIS. This is not an exhaustive list and other matters may also be considered depending on the specific circumstances of the scheme. Each case will be considered on its own facts and merits.

In making a decision whether it is appropriate in any particular case to bring a prosecution against any trustee or manager who agreed to invest in breach of the regulations, the regulator will apply the principles of the Code for Crown Prosecutors⁹ which includes the Public Interest test.

The regulator cannot provide a definitive interpretation of the law and this statement must be read in conjunction with relevant legislation.

⁹ www.cps.gov.uk/publications/code_for_crown_prosecutors/

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Statement from The Pensions Regulator

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