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By email: defined.benefit@dwp.gsi.gov.uk

14 May 2017

Dear Sirs,

Re: Security and Sustainability in Defined Benefit Pension Schemes – BVCA response to the Green Paper

1. We are writing on behalf of the British Private Equity and Venture Capital Association ("BVCA"), which is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of over 600 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers and investors. Further information on our members' investments and contribution to the UK economy is set out in Appendix 1.

2. We welcome the opportunity to comment on the questions posed in Defined Benefit Pension Schemes Green Paper.

The private equity model

3. Understanding the key features of the private equity model is relevant in understanding the BVCA's response below. Private equity and venture capital firms are long-term investors, typically investing in unquoted companies ("portfolio companies") for around three to seven years. Firms will often sell their stake in a company by listing on the public markets or selling to a strategic buyer. We have included a diagram in Appendix 2.

4. There are three key stages of the private equity and venture capital investment cycle:

    a. **Fundraising**, during which managers raise capital from investors. These investors are typically institutional or professional investors such as pension funds and insurance companies.
    b. **Investment**, during which managers source deals and put capital to work by investing in companies that are typically unquoted and SMEs, investing alongside management and founders and supporting these companies through their development and growth.
    c. **Exit**, selling or realising investments and providing returns for investors.

5. Barriers that make any of these stages more difficult or costly therefore impede the ability of

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our members to invest in UK companies and provide returns to their investors, including UK DB Schemes, in an efficient manner.

6. Our members have demonstrated their consistent ability to outperform other asset classes. On a since-inception basis, UK funds returned 13.8% (net of fees) in 2015, and the 10-year IRR generated 13.2% (net of fees), nearly double that of pension fund assets and the FTSE All-Share Index.

Private equity and pensions

7. The focus of our members' interest in defined benefit pension schemes ("DB Schemes") is two-fold: private equity and venture capital funds invest in businesses that have defined benefit pension scheme liabilities; they also receive investment from defined benefit pension funds.

8. Although we do not collect data on DB Schemes for all BVCA member firm investments, data is collected annually as part of the EY report on the performance of portfolio companies in respect of the largest private equity-backed portfolio companies in the UK (see appendix 1). Of the 129 portfolio companies for which data has been collected historically, 40 companies had an existing defined benefit scheme when bought by their private equity owners. In addition, we regularly receive feedback from our members and the professional advisory community on the impact of DB Schemes in private equity and venture capital transactions. These data points give us a broad insight into both:

   - the challenges that some of our members face when considering investments in companies with DB Schemes, particularly where those schemes are in deficit; and

   - the benefits that private equity ownership can bring to strengthening and improving performance in portfolio companies and, in turn, to the support offered to certain DB Schemes.

9. Investors in private equity and venture capital funds are typically institutional investors. This includes DB Schemes. However, our members frequently comment on the difficulty of attracting institutional investment into UK and European venture capital funds, particularly when compared to the US. Pension funds were responsible for 16% of funds raised by BVCA members in 2015 but the proportion from UK pension funds was only 6%. In previous years, this proportion was even lower as the table below shows.

BVCA data on fundraising in the UK - by investor type

	2013		2014		2015	
	£m	**%**	**£m**	**%**	**£m**	**%**
- UK	137	1%	305	3%	687	6%
- Other EEA countries	332	3%	673	6%	372	3%
- US	1,635	15%	1,372	13%	489	4%
- Rest of the world	839	7%	327	3%	360	3%
Pension funds total	**2,943**	**26%**	**2,677**	**25%**	**1,909**	**16%**
Total from all investors	**11,211**	**100%**	**10,822**	**100%**	**11,912**	**100%**

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Responses to Green Paper questions

10. We have responded only to those questions on which our members have a view or contribution to make.

1. b) Should we consider shorter valuation cycles for high risk schemes, and longer cycles for those that present a lower risk?

11. No, we think separate regimes for high risk schemes and low risk schemes would be inappropriate. Increasing the frequency of valuations for high risk schemes is likely only to increase the burdens on their sponsors and undermine their ability to focus on the sponsor's business. Separate regimes would require clear delineation between high risk and low risk, which may be artificial or impractical.

3. Is there any evidence to support the view that current investment choices may be sub-optimal? If yes, what are the main driver of these behaviours and how could they be changed?

12. There are a variety of factors that limit investment by UK DB Schemes in private equity and venture capital. These include both legal requirements to limit investment in assets not traded on regulated markets and guidance on scheme funding. Expectations of prompt responses to funding volatility reduces the ability of DB Schemes (and their sponsors) to take a long term view and drives them into asset strategies that match gilts (or other measures used to value pension liabilities) and away from less correlated investments, such as private equity funds.

3. b) Do members need to understand the investment decisions that are being made?

13. No, it is for the trustees to manage the investments and in a DB Scheme members' benefits are not closely correlated to investment performance. The statutory funding statement should give the members sufficient information to understand the security of their benefits. A requirement to explain investment decisions to members could undermine sound investment decisions by encouraging trustees to focus on ease of explanation rather than more relevant considerations.

3. c) Would it be appropriate for the Regulator to take a lead in influencing or determining an acceptable overall level of risk for a scheme in a more open and transparent way?

14. Openness and transparency in regulation is always important. However, the decision on investments is a fiduciary power vested in the trustee subject to consultation with the sponsor and it would be inappropriate for the Regulator to do more than offer guidance. If powers were transferred to the Regulator, this could cause further "herding" and create further risk concentration issues.

3. d) Would asset pooling or scheme consolidation help schemes to access better investment opportunities?

15. Yes. A minimum amount of investment is required to enter a private equity or venture capital fund. As DB Schemes are also restricted in the allocation they can make to investments not traded on regulated markets and illiquid investments, smaller DB Schemes are restricted in making investments to private equity and venture capital funds.

3. e) Is regulation (including liability measurement requirements) incentivising overly risk-averse behaviours/decisions that result in sub-optimal investment strategies? If yes, which regulations and how do they impact on these decisions?

16. We noted above that a low proportion of investment into private equity and venture capital funds is made by UK pension funds. This is despite material assets being held by UK DB Schemes. Given the above average returns made by our members (as also noted in paragraph 6) and the contribution made to the UK economy and jobs by private equity and venture capital, we would suggest this is sub-optimal.

17. We understand that this may be caused by trustees being encouraged to minimise funding volatility for a variety of reasons including: accounting rules which require DB Scheme deficits to be reflected on the sponsor's balance sheet, expectations derived from Regulator guidance (rather than specific regulations) that sponsors cure deficits promptly when they arise and that DB Schemes with weaker sponsors prioritise risk avoidance. Pressures to avoid or minimise or react to deficits force prevent DB Schemes taking a long-term view and providing a counter-cyclical force in the economy.

18. Requirements in the Occupational Pension Schemes (Investment) Regulations 2005 (derived from the EU Pensions Directive), particularly the requirement to limit investment in assets not traded on regulated markets, may also have an impact on allocations on private equity.

4. Is there a case for making special arrangements for schemes and sponsors in certain circumstances such as a different regime for employers who can afford to pay more, and/or new or enhanced flexibilities for stressed sponsors and schemes?

19. No, we think different regimes for employers who can afford to pay more would be inappropriate. It risks penalising success and creating perverse incentives and diverting resources that could be invested in the sponsors' business or returned to investors (that may include other DB Schemes).

20. Defining the boundaries for "stressed" schemes is likely to be impractical and may create new moral hazards.

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4. d) Are there any circumstances where stressed employers should be able to separate from their schemes without having to demonstrate that they are likely to become insolvent in the near future?

21. Yes. If it is clear to the trustees, on reasonable assumptions, that the sponsor cannot fund the DB Scheme's deficit in the long term so as to pay benefits as they fall due and the sponsor agrees, it should be possible to agree terms for such separation with the Pension Protection Fund and the Regulator even if there is no near term expectation of insolvency.

4. e) How would it be possible to avoid the moral hazard of employers manipulating such a system in order to offload their DB liabilities?

22. The same safeguards as are used for "regulated apportionment arrangements" currently could be used. As without an imminent insolvency event, there would be less time pressure, a better assessment of the facts could be made. Independent advice to the trustees would be required and could be required to be shared, with supporting evidence, with the Pension Protection Fund and the Regulator as part of any application.

4. f) Are there any circumstances where employers should be able to renegotiate DB pensions and reduce accrued benefits?

23. Yes, provided:

- they would have been able to do so under the terms of the DB Scheme prior to s.67, Pensions Act 1995;
- benefits are not reduced below PPF compensation;
- the trustees agree and are independently advised and satisfied that the sponsor cannot fund the DB Scheme's deficit in the long term so as to pay benefits as they fall due.

4. k) Should Government consider allowing or requiring longer, deferred or back loaded recovery plans? If so in what circumstances?

24. We understand that there are currently no restrictions in legislation on longer, deferred or back loaded recovery plans, although trustees are encouraged to avoid these under Regulator guidance.

25. These should be used in appropriate circumstances, namely where the trustees consider that such recovery plans will adequately ensure that they will be able to pay benefits as they fall due and that there is a good reason for them not to seek to make good the deficit within a shorter time-scale: this may include accommodating cash flow and investment cycles of the sponsor. The availability of contingent assets may be a factor in trustee

considerations. New regulation is not required but Regulator guidance and the Code of Practice could be revised.

5. Do members need further protection, and should this be delivered by a stronger and more proactive Regulator, and/or trustees with enhanced powers?

26. There have already been significant statutory improvements to DB member rights and to trustee powers (particularly in relation to investment and funding). Further enhancement could discourage investment in sponsors of DB Schemes, undermining their ability to fund their DB Schemes. The cost of funding DB Schemes has been very materially affected by low interest rates and this has already had an impact on UK business. It may also cause intergenerational unfairness and damage to the UK economy if it results in reduced investment in sponsor businesses and diverts resources into gilt purchases. It may impact the competitiveness of UK business and the attractiveness of the UK market.

5. a) Would greater clarity over the requirements of scheme funding be helpful to members and to sponsors?

27. We think the regime is well understood.

5. b) Is it possible to design a system of compulsory proactive clearance by the Regulator of certain corporate transaction, without significant detriment to legitimate business activity?

28. We believe that a functioning voluntary clearance process for corporate transactions, even where no material detriment is identified by the parties, would be the most appropriate and practical system for the future.

29. In particular, we believe that consideration should be given to introducing defined powers to the Regulator to bless an agreed approach to address a defined benefit scheme deficit by private equity or venture capital investors who look to invest in more challenged companies with significant defined benefit schemes in deficits. We have seen a number of possible transactions where private equity investors have considered acquiring this type of company and have presented a clear and coherent strategy to buy out the defined benefit scheme over time. However, in these cases, the private equity investor has been unable to obtain sufficient comfort that, even should that plan be adhered to, the investor would not be subject to subsequent Regulatory action in respect of the execution of that Plan. The particular concern is exposure under the moral hazard provisions of the investors in the private equity or venture capital funds, piercing the corporate veil.

30. We believe that there may be advantages to encouraging the private equity and venture capital community, which may be the source of material funding to companies with defined benefit schemes in deficit, to engage, at the appropriate time with the Regulator to agree a

particular course of action against which the threat of subsequent Regulatory intervention and exposure of the funds would be removed.

31. While we believe that a voluntary process is the most appropriate approach for the future, we could support a compulsory clearance process which:

    a. is focussed on material schemes in deficit (and not on every defined benefit scheme – a compulsory clearance process covering every defined pension scheme would create a material burden on the Regulator and negatively impact corporate transactions involving companies with defined benefit schemes);

    b. has very clear defined parameters, a clear and efficient process and appropriate time frames for responses and clearance.

32. Great care would need to be taken to ensure that a compulsory system would not fetter or cause delays to legitimate business activity, including M&A.

5. c) Should the Regulator be able to impose punitive fines for corporate transactions that are detrimental to schemes?

33. No. As above, this may discourage investment in sponsors of DB schemes and impact the broader competiveness of UK business and attractiveness of the UK market.

34. The current moral hazard provisions already provide a material deterrent to unscrupulous activity or other normal and balanced investment and financing activity which could, in many cases inadvertently, be to the detriment of defined benefit pension schemes. Private equity and venture capital investors already spend a great deal of time focussing on the law relating to defined benefit pension schemes in the context of transactions, particularly given that these powers create potential exposure and potential liability to the investors in private equity funds. We have seen many transactions which could have enhanced the underlying financial position of the scheme employers and, as a result, the defined benefit scheme itself, falter based on concern over exposure to the private equity/venture capital funds. Adding a punitive fine system on top of the existing system will create increasing concern and is highly likely to reduce investment in companies with defined benefit pension schemes, which we believe would not be in the best interest of those companies or the relevant pension schemes.

5. e) Should the Regulator have new information gathering powers?

35. No. The Regulator already has wide-reaching information gathering powers. which should be utilised.

BVCA

5. f) Should civil penalties be available for non-compliance?

36. This would be more appropriate than the use of criminal sanctions for non-compliance with information requests.

5. g) Should levy-payers be asked to fund additional resources for the Regulator?

37. No. As above, this may discourage investment in sponsors of DB schemes and impact the broader competitiveness of UK business and attractiveness of the UK market.

5. h) Should trustees be given extra powers such as powers to demand timely information from sponsors, to strengthen their position?

38. No. Trustees can ask for information as a condition of their agreement on a range of matters and this is often provided subject to confidentiality restrictions. However, the rights of sponsors and other stakeholders to withhold confidential information should be respected to avoid damaging the competitiveness and attractiveness of UK business and sound corporate governance (which includes internal circulation and protection of confidential information). Protecting confidentiality is often critical and proper in commercial negotiations.

5. i) Should trustees be consulted when the employer plans to pay dividend if the scheme is underfunded – and if so, at what level of funding?

39. No. This could harm the attractiveness of the UK market and of sponsors of UK DB Schemes in particular. It would also drive DB Schemes (and their sponsors) to be overly risk-averse in relation to DB Scheme investment and funding, further encouraging allocations to gilts and other "liability matching" rather than long-term, return-seeking, deficit-curing investment.

40. It may be appropriate in stressed schemes but can, in such cases, be agreed between the trustees and sponsor as part of routine funding negotiations.

6. Should Government act to encourage, incentivise, or in some circumstances mandate the consolidation of smaller schemes into vehicles with greater scale and better governance in order to reduce the risk to members in future from the running down of closed, especially smaller, DB schemes?

41. We would welcome such consolidation as likely to result in greater allocation of assets held in UK DB Schemes to private equity and venture capital and more efficiency in the provision of benefits.

42. We would be very keen to discuss the contents of this letter further with you and please contact Gurpreet Manku (gmanku@bvca.co.uk) at the BVCA to arrange a meeting.

Yours faithfully,

Amy Mahon
Chair, BVCA Legal & Accounting Committee

Appendix 1

BVCA members' investment and contribution to the UK economy

- Our members have invested over £27 billion in nearly 3,900 UK-based companies over the last five years.
- Private equity and venture capital funds managed in the UK currently back around 2,980 companies, employing over 900,000 people on a full-time equivalent basis ("FTEs") across the world. Of these, around 385,000 FTEs are employed in the UK.
- In 2015, 34 companies experiencing trading difficulties were rescued by BVCA member firms, helping safeguard around 16,500 jobs.
- In 2015, around 965 companies, employing around 290,000 FTEs, were invested in by private equity funds managed in the UK.
- Of these, around 795 were in the UK, employing around 110,000 FTEs. (2014: 728, 2013: 710).
- 63% of investments were in small companies, with around a further 21% being medium-sized companies.
- We do not have details on pension schemes for all BVCA member firm investments but these are collated for the largest UK assets as shown below.

EY report on the performance of portfolio companies

This report (www.bvca.co.uk/Research/BVCA-Research-Reports) provides comprehensive and detailed information on the effect of private equity ownership on many measures of performance.

- The data is collected for companies subject to the Walker Guidelines on disclosure and transparency. They cover the largest PE-backed companies in the UK.
- The report provides details on changes to pensions schemes under PE ownership and information on defined benefit pension schemes' liabilities and assets over time.
- Portfolio companies have much higher levels of financial leverage than public companies, 6.5x net debt to EBITDA versus 2.4x, respectively.
- The total equity return on 64 portfolio companies that were exited by PE investors in the period 2005-15 was well in excess of the comparable public company benchmark, by a factor of 4.3. This significant outperformance is explained in equal measure by PE's strategic and operational improvement, and the net benefit of additional financial leverage.
- Organic employment growth at the portfolio companies has been faster in the last two years, averaging c.3% per annum, consistent with economy-wide benchmarks.
- Investment at the portfolio companies has grown by 1.6% to 7.6% per annum across a number of measures.
- Annual growth in labour productivity in the portfolio companies at between 2.0% and 2.4% is on a par with public company and economy-wide benchmarks.
- The portfolio companies have grown reported revenue at 5.8% per annum and profit at 4.6% per annum; organic revenue and profit growth are both 3.6% per annum.