



Statutory debt to pension schemes

Consultation on proposed changes

August 2007

The s.75 statutory debt is about to change. Many of the recently proposed amendments are for the good, but a few would make the legislation more difficult to manage. The proposals are out for public consultation until 1 October. The consultation is certain to lead to revisions. We understand the aim is to bring changes into force in December 2007.

If a defined benefit pension scheme winds up when it cannot afford to buy annuities for all its members, the sponsoring employer becomes liable for a statutory debt equal to the shortfall. The same applies on an employer's insolvency. In a multi-employer scheme, it also applies when an employer ceases to participate e.g. on being sold outside the group, or as a result of a restructuring.

The legislation (s.75 Pensions Act 1995) gives members strong protection but can hinder corporate activity.

TODAY

Today an employer can respond to the debt in three ways.

- It can pay the debt. This is the default option.
- In a multi-employer scheme, it can negotiate with the trustees for another participating employer to take on some or all of its liability. This requires a scheme rule that allows reapportionment.
- In a multi-employer scheme, it can make a statutory withdrawal arrangement approved by the Pensions Regulator. This involves the employer paying a smaller debt and a third party underwriting the balance. But the legislation is tightly drafted so this option is often unavailable in practice.

TOMORROW

These are the main proposals for change. Most apply only to multi-employer schemes.

Multi-employer schemes

Paying the debt

Paying the debt remains the default option. Known as the employer's **liability share**, it will be calculated broadly as now; that is, as the proportion of the total deficit (on a buy-out basis) that liabilities attributable to the particular employer bear to total liabilities. Today the regulations do not specify what liabilities are "attributable" to an employer. This is clarified as the liabilities that arose from pensionable service with the employer, including transfers-in during that time.

If a member had more than one employer in the group and there are adequate records, liability is divided accordingly. But if there are no records or if the exercise would be disproportionately costly, the trustees allocate all the liability to the member's last employer where they can identify it. Where they cannot, they do not allocate the liability but treat it as orphan. There is some rough justice in these attributions.

Reapportionment

Reapportioning liability will be regulated; it will no longer be possible to rely on a scheme rule alone to reallocate. The policy is to prevent reallocation being used as a way of abandoning a scheme, but to be flexible to assist restructurings.

The employer has to agree a "scheme apportionment arrangement" with the trustees – who therefore have a veto. What the employer agrees to pay is its **apportionment share**.

The trustees must normally satisfy themselves that the remaining employers will be able and willing to fund the scheme's technical provisions in future, and to make contributions in accordance with the schedule of contributions and any recovery plan. This could be a difficult test to satisfy. If a scheme has not yet had a scheme specific valuation, the trustees need to be satisfied that the likelihood of all members receiving full benefits is not reduced.

Exceptionally, an employer can agree an apportionment share under a "regulated apportionment arrangement". This is possible if it is a real possibility that the employer will become insolvent within a year. The aim is to achieve a better outcome all round than insolvency would produce. The Pensions Regulator and the PPF have to approve the arrangement.

There is no specific limit on the proportion of an employer's liability that can be reapportioned.

Withdrawal arrangement

As today, if the trustees and the Regulator agree, an employer that ceases to participate can arrange to pay part of the debt while another party – a guarantor – accepts liability for the

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balance. The employer's part is normally calculated on the scheme specific basis (or PPF basis if the scheme has not yet had a scheme specific valuation). This is a "withdrawal arrangement" and the amount the employer agrees to is its **withdrawal arrangement share**.

The Regulator can only approve an arrangement if it is satisfied that it is reasonable to do so, particularly in the light of the guarantor's finances and the effect on the likelihood of all members receiving full benefits.

A withdrawal arrangement will no longer need to make it more likely that the debt will be met. Today the effect of this requirement is that if the employer can afford the full debt, a withdrawal arrangement is not possible.

Cessation agreement

A "cessation agreement" is like a withdrawal arrangement except that it does not need the Regulator's approval. What the employer pays (calculated as for a withdrawal arrangement) is the **cessation agreement share**.

Before the trustees can make a cessation agreement with an employer they must be satisfied that the ability and willingness of the remaining employers to fund the scheme are not adversely affected, and that the guarantor has adequate financial resources.

Ceasing to participate

Today it is sometimes unclear when an employer ceases to participate in a scheme for the purpose of the legislation. This will be clarified as the time when it ceases to employ active members. In addition, a debt will crystallise whether or not another employer continues to employ actives. So closing a multi-employer scheme to future accrual for all employers will trigger a debt for all of them, whereas today it would not. This makes one common way of managing the legislation more difficult.

On the other hand, a new grace period adds flexibility (though a strict requirement to give the trustees early notice could reduce its usefulness). An employer that is ceasing to participate will be excused its debt if, within a year, it intends to employ someone who will be an active member. If in the end it does not do so, the debt is taken to have crystallised on the original date. This should help groups with restructurings when workforces are often transferred between employers. On the whole, fewer debts should arise by accident.

Pension Protection Fund

If the trustees compromise a debt owed to the scheme, it is normally ineligible for PPF protection. There has been concern that, for example, reapportioning liability for a debt could fall foul of this rule. This would make trustees very reluctant to agree. The recent L v M case centred on this question. To resolve this problem the PPF entry criteria will change so that none of the

arrangements mentioned above will count as a compromise that would bar a scheme from the PPF.

Single and multi-employer schemes

The trustees take the main responsibility for valuing the assets and liabilities for calculating the debt; today the actuary has the responsibility.

The actuary will be required to estimate the cost of annuities using terms that are consistent with the market and that he considers sufficient to satisfy the scheme liabilities. If he thinks this approach is impractical, he has a free hand to decide on another one. This is an improvement on the current regulations which do not give the actuary any guidance on how to estimate the cost of annuities. Many actuaries have found the current regulations unworkable.

COMMENT

Employers and trustees need to be well aware of the debt legislation and of the constraints it puts on the restructuring of companies and pension schemes.

Most of the proposals are improvements e.g. clarifying what liabilities are "attributable" to an employer, clearing up what it means to cease to participate and allowing a grace period, and making withdrawal arrangements a practical option.

The various "shares" make the proposals look more complicated than they are. Apportionment is too powerful a tool not to be regulated. But the proposed requirements are arguably no more than trustees would look for anyway in discharging their duties.

Cessation agreements are a Regulator-free form of withdrawal arrangement that lets schemes choose whether to go it alone or to look for the added comfort and moral authority of the Regulator. Again, the criteria are a reasonably necessary minimum.

The question over PPF availability after the management of a debt is resolved.

The main difficulty is the debt on closing a multi-employer scheme to accrual (without triggering a winding up). It is hard to see the policy reason for this. It will not be the case in a single employer scheme, and there is no reason for a difference in treatment. Also, the legislation continues to protect members after accrual ends because it bites on the death of the scheme (winding up) and on the death of the employer (insolvency). As long as the employer is not sold outside the group, there appears no need for the legislation to cut in earlier. The consultation process should help clarify the thinking here.

The changes will not have retrospective effect.