Legal considerations on moving from final salary to money purchase

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Abstract This paper considers the legal implications for an employer seeking to switch from its final salary (defined benefit) occupational pension scheme into a money purchase (defined contribution) arrangement. The problem areas follow chronologically, starting with consideration of pension promises in the employees' contracts of employment and supporting pension scheme documentation. On the basis that a change can be made, the paper examines whether the money purchase arrangement should take the form of a new section grafted onto the existing final salary scheme or a new arrangement. The merits of choosing another occupational scheme or individual pension products — group personal pensions or stakeholder — are assessed. The paper closes with two case studies highlighting two different solutions to the problem. (This paper was presented at the IIR Limited Conference 'Successfully adapting to Pension Industry Change' on 10th July, 2002).

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Introduction

This paper will examine the legal aspects facing an employer with a final salary (defined benefit) occupational pension scheme who wants to switch to a money purchase (defined contribution) pension arrangement for the future. It will review four key areas where legal issues arise before considering two case studies as follows:

- contract of employment issues
- adding a new money purchase section onto a final salary scheme

- choosing a stakeholder, group personal pension or occupational DC scheme
- winding up the final salary scheme or continuing it as a closed fund
- case studies.

Contract of employment issues

A bit of history

The trend for employers to move from final salary schemes to money purchase really started in the late 1980s. A number of City institutions, particularly

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banks and investment managers, decided that they did not like the long-term risk to the employer of mature final salary schemes. Some final salary schemes were actually converted into money purchase schemes, which rarely happens now. (This explains why a number of these larger money purchase schemes still have 'surplus pools' which are not normally a feature of a new 'classic' money purchase scheme). Other employers set up new occupational money purchase schemes. They forced/'encouraged' staff to transfer out of the final salary scheme by offering very favourable transfer terms, giving each member an appropriate share of surplus.

Staff were given no choices about these transfers to money purchase schemes. If there were any complaints, the generous terms of the transfer usually resolved the issue. It was the same politically incorrect era where consolidating scheme mergers were engineered regardless of the wishes of unions or scheme members. If there were any complaints, members would be threatened with no future pension provision at all. The utilisation of surplus to upgrade benefits on mergers and make generous final salary to money purchase transfers undoubtedly helped to mask the underlying legal problems.

In the current very different pensions climate of deficits rather than surpluses, it is undoubtedly the case that many members of final salary schemes are now being offered vastly inferior money purchase alternative pension arrangements for the future.

Contractual rights to terminate

Even in the 1980s, lawyers were asked the question whether an employer could just wind up an occupational pension scheme without making

alternative arrangements for employees. The legal advice now remains the same — subject to any new legal precedents arising from threatened employee action about closure of final salary schemes. The case of each employer will depend on its own circumstances and, in particular, the wording of the employees' service contracts or terms of employment. The wording of the pension scheme itself and the explanatory Members' Booklet will also be relevant.

Many service contracts provide that while an employee is in company service, he will be eligible to join its pension scheme. Basic information about the scheme is usually given to employees in the form of an explanatory Members' Booklet. Most Booklets say in the small print that the company reserves the right to amend or discontinue the pension scheme at any time, usually after giving notice. The 1966 case of *Bull v. Pitney-Bowes Ltd. & Others*¹ indicates that an employee must accept membership of the scheme as it stands if he joins (including the employer's power to terminate). If the employer gives the appropriate notice to terminate, the employee will be unable to complain even if he loses the benefit of future company contributions or receives future benefits of lower value and of a different type with more investor risk.

Remedies

If the employee's service contract does contain a more specific pensions promise, or perhaps the Booklet does not refer to the right to terminate, there could be some legal problems and employers should always take specialist pensions and employment advice in this sensitive area.

It would be open to an employee to argue that as a result of the scheme termination, he had been constructively dismissed and resign. He could then bring a claim for wrongful dismissal (a breach of contract claim brought before the County Court or High Court) and/or unfair dismissal (a statutory claim brought before an Employment Tribunal).

To succeed in the wrongful dismissal claim, the ex-employee has to show that the termination was a fundamental breach of his contract going to its root. For unfair dismissal purposes, however, the employer may still successfully defend the case if he has acted reasonably eg by increasing wages instead of paying pension contributions, or by showing that the company is in financial difficulties. The employer would also be expected to have undergone proper consultation in these circumstances with employees and/or their trade union. Alternatively, if withdrawal of the pension scheme is a fundamental breach of the employee's contract, he could possibly elect to stay in his job and be awarded compensation from his employer for breach of contract.

Normal position

While the accrued pension rights of an employee are protected by pensions legislation (eg preservation, Section 67 Pensions Act 1995), there is usually no enforceable promise that his employer's pension scheme will continue in its present form (or at all) in the future.

In many cases, it will be possible for the employer unilaterally to terminate a final salary occupational pension scheme and offer a money purchase alternative, frequently with a lower employer contribution rate. Communications with

the staff will obviously need to be sensitively handled, but the financial reality facing most employers (which can be easily demonstrated by the increase in most MFR Schedules of Contributions at the last triennial actuarial valuation) will provide justification, as may the employer's FRS 17 figures.

Discretionary bonus similarities

The way in which the employment contract refers to an 'invitation' to join an occupational pension scheme subject to its provisions means that final salary pension benefits increasingly operate like an arbitrary discretionary bonus scheme.

The fact that the employer can terminate the final salary pension at any time by giving notice to the employee means that the benefit is not guaranteed to continue for the future. The current under-funding in final salary schemes (with the majority significantly under-funded on a discontinuance basis so that annuities to the full value of pensions cannot be purchased for all members on a winding-up) means that even the value of the accrued final salary pension will fluctuate at any given period of time. A member might retire with a fully funded final salary pension — or he might not but this will not be within his control.

100 per cent MFR cash equivalents will not purchase the promised pension as a deferred annuity. If the scheme funding falls below 100 per cent MFR, the trustees are legally entitled to pay a reduced MFR cash equivalent. The reality therefore is that a final salary pension scheme promise is worth a lot less than most members have thought and is less protected than a money purchase pension.

Grafting a new DC section onto a DB scheme

The reasons behind an employer wishing to establish a new money purchase scheme will normally dictate whether the employer grafts a new money purchase section onto its existing final salary scheme, or sets up a new free-standing money purchase scheme.

Hybrid scheme with DC/DB sections

The main reason for establishing a hybrid scheme with final salary and money purchase sections is where the final salary scheme is in significant surplus and part of that surplus can be used to finance a contribution holiday for the employer both in the existing final salary section and in the new money purchase section. The most recent and detailed legal authority in this area is the case of *Barclays Bank plc v. Holmes & Others*.²

Although unions (and some members) are most unhappy about surplus which has arisen over the historic life of the final salary scheme being taken away from members and used to provide benefits for other employees who have only recently joined the money purchase section, in legal terms this type of arrangement will normally be possible. It will, however, require some careful drafting. In particular, any restrictions on the amendment power of the final salary scheme contained in the historic Trust Deed and Rules should be carefully checked.

New money purchase scheme

If the employer's final salary scheme is in deficit, there seems no point in confusing the administration or the deficit funding programme with the establishment of a new money purchase section. A 'clean break' also makes it easier to offer the money purchase scheme only to new hires.

Stakeholder/GPP or occupational DC scheme?

New DC scheme for larger groups

In the current scenario where employers are looking to set up new money purchase schemes to cut their pension costs, the whole paraphernalia of a final salary scheme with its member-nominated trustees, its audit, actuarial and investment adviser costs is already discredited. Unless there is a workforce of a minimum of 100, consultants would not normally recommend establishing a new occupational money purchase scheme because of the regulatory compliance costs. If an occupational scheme is not viable, the other alternatives are personal pensions, group personal pensions or stakeholder.

GPP or stakeholder?

For reasons of administration, most employers with more than a dozen staff will want to set up a group personal pension (GPP) or stakeholder arrangement so monthly contributions are paid to just one selected provider (rather than to a number of different providers according to member choice). Despite the introduction of stakeholder pensions in April 2001, many independent financial advisers and actuarial consultancies still recommend the establishment of what they call 'stakeholder-friendly' GPPs. The fact that financial advisers receive more commission for setting up a GPP than a stakeholder may explain this otherwise curious advice. The other justifications for using a GPP (ie they offer a better 'with profits' investment facility and a wider range of investment choices) have to be balanced against a charging structure which could exceed the 1 per cent stakeholder maximum charge. An

employer who chooses the GPP route will also need to offer a designated stakeholder to its staff unless:

- the GPP has ‘stakeholder-friendly’ transfer terms; and
- it makes a 3 per cent employer contribution to the GPP, while the current employer contribution to a stakeholder is nil.

Wind up final salary scheme or operate as a closed fund?

Wish to wind up

Most of the employers seeking to close their final salary schemes would like to wind them up immediately in order to remove the financial exposure. Normally, the decision is prompted by receipt of a triennial actuarial valuation showing an MFR deficiency and the need to make an urgent cash injection into the pension scheme to bring the MFR solvency level back to the 90 per cent rate, with the remaining deficiency to be funded over a longer period of time.

Minimum funding requirement (MFR) debts

A typical final salary scheme whose last March 1997 triennial valuation showed an MFR surplus of 125 per cent will have managed to convert that surplus, without any warning, into a 85 per cent MFR deficit at its next March 2001 triennial valuation. The new Schedule of Contributions increasing the employer contribution rate significantly often creates an unacceptable financial burden. If the ongoing deficit funding creates a financial strain, it is even more unacceptable for the whole MFR statutory debt to become payable if the scheme goes into winding-up.

Closed funds

In order to avoid crystallising the whole of the MFR under-funding in one hit (which in many cases could push the employer into insolvency), employers often wish to operate the pension scheme as a closed fund.

Whether this is possible will depend upon the wording of the Trust Deed and Rules of the scheme. Section 38 of the Pensions Act 1995 gives trustees power to run their scheme as a closed fund once winding-up has commenced. Unfortunately, this power has been severely restricted by Regulation 10 of The Occupational Pension Schemes (Winding-Up) Regulations 1996³ so that it only applies if the scheme has gone into winding-up as a result of the liquidation of the principal employer. In many cases, establishment of the money purchase scheme is an attempt by the employer to stave off liquidation so the statutory power will not assist.

Scheme documentation may therefore need to be amended to insert a power to operate as a closed fund. If a power is already there, the employer may find that it is the trustees alone who have the power to decide whether to operate a closed fund instead of progressing the winding-up and, if so, for how long a period. As the effect of triggering a wind-up and then operating the fund as a closed fund allows the MFR Schedule of Contributions to continue (without crystallising the full statutory debt), employers are often unhappy for trustees to have the power at any time to call in the full debt by commencing the winding-up. The relationship between the employer and the trustees and the basis of trust between them will therefore be critical in these cases.

Legal case studies

Post wind-up closed fund

A typical scenario encountered this year by the author's firm was of a charity client with a medium sized final salary scheme. Given the nature of the charity's work, a considerable number of part-timers were employed so pension costs increased considerably when the scheme was forced to admit part-timers to comply with European law. In addition, their MFR surplus at the previous valuation had magically disappeared without any warning from the actuary (for the usual reasons of poor investment performance, demography, the tightening of MFR and the part-timer admissions) to give them an MFR deficit below 90 per cent.

The charity's first reaction was to close the scheme to new members and to provide all new hires with a money purchase alternative with a considerably reduced employer contribution rate. To their shock and surprise, the revised Schedule of Contributions for the final salary scheme from the actuary showed that the contributions as a percentage of payroll for the current members would then increase considerably, so there would be no cost saving. The explanation for this was that the scheme would be ongoing with an increasingly high earning and older workforce and reduced cross-subsidies from early leavers and younger members. The new proposed Schedule of Contributions was unaffordable so it was then decided that the scheme would need to be closed to current active members as well as new joiners and run as a closed fund. Even when this was done, the combined deficit funding and the new employer contribution rate was higher than the previous ongoing employer contribution rate. So the charity was faced with paying a higher pension contribution but

not providing ongoing pensions or life cover for any of its staff!

The charity is philanthropic and has an excellent relationship with its workforce. It consulted with staff in considerable detail and openly explained the financial circumstances of the charity and the reasons for the dramatic escalation in pension costs. The possibility of asking members to increase their own contributions was considered but had to be rejected. This was because the scheme was underfunded on an MFR basis. Since the charity might find itself in funding difficulties in future years, if the MFR deficit was not made good at the time the scheme went into wind-up, the increased contributions of the active members would in fact be used to provide annuities for the pensioner members under the Pensions Act 1995 discontinuance priorities. On this basis, the charity did not feel that it could ask the members to increase their own contributions.

The employer and the trustees worked closely together and had very open discussions. It was eventually decided to wind up the scheme but on the understanding that the trustees would continue to operate it as a closed fund for the foreseeable future. This would enable the charity to continue to make good the deficit over a number of years. The plan would be for the winding-up to be progressed when 100 per cent MFR had been reached and there was no statutory debt on the employer.

Active members of the final salary scheme and new joiners were offered membership of a 'stakeholder-friendly' GPP with a 3 per cent employer contribution and a separate life cover arrangement. Despite the employer contribution at 3 per cent being considerably lower than the former employer contribution of 12 per cent (and vastly inferior to the actual cost of

providing the benefits had the scheme remained ongoing), the charity was still left with a larger pensions bill than before. The deficit funding for the final salary scheme plus the cost of the new GPP and life cover produced a larger pensions bill for the charity than it had faced in 2001.

Pre-wind-up closed fund

Another client with more serious MFR underfunding which had already continued for a number of years faced a more difficult dialogue between the trustees and the company. There was little trust between the two groups and the financial future of the company was less certain.

The company, given its difficult relationship with the trustees, was most unhappy for the scheme to wind up and for the trustees alone to be able to postpone crystallisation of the MFR statutory debt at will. Given the large debt, the directors felt that the obligation to keep the trustees closely informed as to the business of the employer was an unacceptable burden on their management style. It was therefore suggested that the Rules of the scheme should be amended to allow the scheme to operate as a closed fund but without triggering a winding-up of the scheme. This would then enable the employer to pay the deficit funding over a number of years. This plan, however, required an amendment to the Trust Deed and Rules and therefore the trustees had to agree to the change.

The trustees were advised that they would be giving up their power to call in the statutory debt which would otherwise have been available on a winding-up of the scheme. Their consent was eventually given, but only after detailed negotiations in which they took a charge over the company's property as

extra security for the underfunding and as protection against the 'priority drift' of members who would otherwise not have reached normal retirement date.

An interesting feature of this documentation exercise was the need to make a Rule amendment so as to terminate the accrual of future service benefits of active members. In pensions terms, the only way in which the members could terminate pensionable service was:

- on their voluntarily opting-out of the scheme (which they did not wish to do)
- on their leaving pensionable service (which was not proposed), or
- on the winding-up of the scheme (which the company did not want to do to avoid triggering the MFR statutory debt).

A Rule amendment was therefore essential to break the pensionable service accrual cycle.

Even when employers only close their final salary schemes to new members, this is frequently done by the employer simply offering new hires membership of a GPP or stakeholder instead of the final salary scheme. In legal terms, it is very important for an amendment to be made to the Trust Deed and Rules of the final salary scheme to change the eligibility rule. This avoids the possibility of members arguing that they should have been entitled to join the more favourable final salary scheme instead of the money purchase arrangement.

Conclusion

Closing down a final salary scheme and moving to a money purchase arrangement is not a simple or straightforward process legally. It also may not reduce either long-term or

short-term pension costs as significantly as employers may hope. Deficit funding for the closed or wound-up final salary scheme remains payable on top of the cost of the new money purchase arrangement.

References

- 1 *Bull v. Pitney-Bowes Ltd. & Others* [1966] 3 AER 384.
- 2 *Barclays Bank plc v. Holmes & Others* (HC)[2000]PLR 339.
- 3 Regulation 10 of The Occupational Pension Schemes (Winding-Up) Regulations 1996 (SI 1996/3126).