Change in the balance of power for UK pensions

Received: 23rd May, 2005

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Abstract This paper reviews the developing shift in power in the UK between employers and trustees under their defined benefit (DB) pension schemes. In particular, it explores the gradual loss of power of the employer, resulting primarily from recent changes to the 'debt on employer' legislation and the introduction of the Pensions Act 2004. It considers what practical impact these changes are likely to have on corporate activity, what employers might do to adapt to the new 'trustee-friendly' environment and how they might go about retaining some degree of control going forward.

Keywords: *defined benefit (DB) pension schemes; scheme funding; underfunding; pensions regulator; scheme specific funding; anti-avoidance provisions; corporate activity*

It wasn't so long ago ...

that employers called the shots when it came to their pension schemes. Trustees generally kept a relatively low profile. The Maxwell 'scandal' put pensions on a new footing and the resulting Pensions Act 1995 meant that employers and trustees were open to much greater scrutiny than before. Many felt that the Pensions Act 1995 led to overregulation in the pensions arena in the UK ... in retrospect that was just the beginning!

Defined benefit (DB) pension schemes have received a huge amount of publicity in the last few years, primarily with the wide coverage of pensions deficits in the press. There have also

been a few high profile cases concerning pensions in the context of corporate takeovers, that have received large amounts of media attention. In particular, these cases have focused on the powers of the scheme trustees, which much to the surprise of most, the corporate parties involved were unable to ignore.

Last year, the W H Smith takeover bid appeared to fail because the venture capitalist involved was not prepared to meet the pension scheme trustees' demands over funding the scheme deficit. Likewise, the trustees of the M&S pension scheme seemed prepared to use their powers to dissuade a takeover bid by Philip Green. Another recent example is Uniq, where takeover

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talks collapsed earlier this year, at least in part it seems, because of the pension trustees' concerns over making good the scheme deficit. In particular, they were concerned that the bid in question would involve too much debt and they considered this a threat to the scheme.

The authors understand that the common factors in these three cases were the particular trust deeds and rules governing the pension schemes involved. All three contained strong trustee powers to set the employer contribution rate and/or wind up the scheme. This meant that the trustees in question could (and it appears did) effectively block the proposed takeovers by demanding such high funding commitments to the schemes that the deals were no longer commercially viable. Such strong powers are relatively rare in pension schemes, but where trustees do hold these powers, they should not be taken lightly. These cases were probably the first real public displays of trustees acting as key players in their sponsoring employers' corporate affairs.

The 'slippery slope'

The above cases were unusual because of the scheme documentation in question. What was interesting about them was that they were examples of how relatively uncontroversial powers can evolve as the context changes to become highly relevant and material powers in situations that were probably never anticipated or intended by the original settlor.

These isolated examples of loss of employer control have been followed by a much more widespread pattern of a gradual decline in employer power. Most notably, this has appeared with the changes to the 'debt on employer' legislation and with the introduction of the Pensions Act 2004.

Debt on employer legislation

Pensions legislation provides that if a DB scheme is wound up (or a participating employer becomes insolvent), any scheme deficit at the 'applicable time' becomes a debt due from the employer to the pension scheme trustees.¹ Until March 2002, this meant that on a scheme wind-up, employers had to ensure that the scheme was at least fully funded on the minimum funding requirement (MFR) basis.² The benefits which could be met on this basis tended to be significantly less than members' full benefits.

In March 2002 the requirements were raised so that the cost of pension benefits had to be assessed in full on a buy-out basis (ie securing with insurance company).³ This was followed in June 2003 by further draft regulations, which provided that solvent employers voluntarily winding up their pension schemes must meet the full buy-out costs for other members, as well as for pensioners.⁴ This was confirmed in February 2004.⁵ The pressure on employers was increased again in February 2005 when the buy-out basis was extended to insolvent employers with scheme wind-ups commencing on or after 15 February 2005.⁶

The April 2005 Regulations⁷ confirmed the above position but went further still. The current position is as follows: solvent and insolvent employers of single employer schemes going into wind-up will have their pension scheme debts calculated on the full buy-out basis. All employers of multi-employer schemes in wind-up will be subject to the full buy-out debt. Where there is no wind-up, but an employer of a multi-employer scheme is subject to an insolvency event, it will be liable for the full buy-out debt.

There was one exception to the buy-out obligation, where an employer

withdraws from a scheme and other employers continue to participate but is solvent, it was until 2nd September, 2005 only responsible to make up any MFR shortfall. This position, however, has been amended to bring it in line with all other situations. Unless alternative withdrawal arrangements are approved by the Pensions Regulator, the share of the buy-out debt applicable to the departing employer will become due on cessation of participation.⁸

Effectively, this means that in all but one limited circumstance (which is likely to be removed shortly), employers are now liable for meeting the full buy-out cost of securing benefits. Employers can no longer walk away from their responsibilities by winding up their schemes and fulfilling only part of their pension promises to members. This came as a huge blow to employers with large scheme deficits and has caused many employers to seriously rethink any ideas they may have had to wind up their schemes. The latest change to the multi-employer situation from 2nd September, 2005 will also have a price impact on corporate deals.

The debt on employer legislation has been followed by the Pensions Act 2004 ... arguably more bad news for employers.

Pensions Act 2004

The Pensions Act 2004 will come into force in various stages over the next few years.

It introduced a new regulator, the Pensions Regulator, which opened its doors to business on 6th April, 2005. It is clear that the Regulator will be far more pro-active than its predecessor, adopting a risk-based approach to its function and '... concentrat[ing] its resources on schemes where it identifies

the greatest risk to the security of members' benefits'.⁹ Its stated key objectives are to:

- (a) protect the benefits of pension scheme members;
- (b) reduce the risk of calls on the Pension Protection Fund; and
- (c) promote the good administration of work-based pension schemes.

The Regulator will be expecting employers and trustees to help it to meet its objectives.

The Pensions Protection Fund (PPF) is also up and running. This is essentially a scheme to protect members of private sector DB schemes whose employers become insolvent with insufficient funds in their pension schemes. The PPF will be funded by a levy on all DB schemes, so it is ultimately a cost to employers.

September 2005 sees the introduction of scheme specific funding, a new method of assessing scheme assets and liabilities ('technical provisions'). The new regime will, regardless of what the particular scheme rules provide, see employers having to agree with trustees in setting employer contribution rates. So, whereas before some scheme rules allowed the employer to set its contribution rate, such rules will be overridden by the new law, which will require the employer to get the trustees' agreement to the funding approach. This is an important loss of control when coupled with the legal position on investment decisions, which is firmly in the trustees' hands already.¹⁰

Whilst it is still unclear exactly how the new method will unfold in practice, it seems that the pressure will generally be upwards on contribution rates and downwards on the period of recovery plans for eliminating deficits. The Regulator (who must be informed if the

trustees and employer are unable to reach agreement on the funding basis and who also insists on being notified where a recovery plan becomes necessary) will almost certainly, as its starting position, support trustees in any funding discussions with their employers. After all, it does not distinguish between trustees of underfunded pension schemes and any other material unsecured creditors and it will be expecting trustees to behave consistently with this.¹¹ David Norgrove, chairman of the Regulator has said that:

‘... the defined benefit pension scheme should be given the status that would be accorded to any other material unsecured creditor.’¹²

Regardless of the Regulator’s own interests, trustees will be mindful of their new statutory duty to act ‘prudently’ in choosing actuarial assumptions.¹³ Ultimately, this means that trustees are likely to want to set rates as high as possible to ensure that they comply with their duties. This will be particularly the case where trustees have concerns over the strength of the employer covenant or doubts as to how forthcoming the employer is being in providing the trustees with financial information relating to the business. There is of course a certain paradox in all of this though, which makes trustee decision making difficult. Less strong companies are precisely the ones who need the trustees to be relatively ‘lenient’ in order to keep the business going.

The Act introduces a requirement for trustees to have knowledge and understanding.¹⁴ Whilst this is consistent with trustees’ general trust duties, it is the first time such a requirement has been written into legislation. The Scope Guidance,¹⁵ issued by the Regulator suggests that as far as the requirement for

knowledge regarding funding is concerned, trustees will need sufficient information from employers to enable them to understand:

- (a) the nature of the employer/trustee relationship and the effect of pension liabilities on the sponsoring employer;
- (b) the nature and strength of the employer covenant and its ability and willingness to meet the costs of members’ benefits (and especially an awareness of the employer’s business and its risk exposure); and
- (c) potential risks to the scheme including those arising from the financial instability of the sponsoring employer or corporate restructuring.¹⁶

Employers are being asked to share sensitive information with their scheme trustees, fully aware that this information will go to the Regulator if the trustees have any concerns over the employer covenant (consistent with the trustees’ new duties) and which the trustees will be using in any event alongside their new powers to agree the employer contribution rate with the employer. The issue of sharing sensitive information with trustees is perhaps aggravated by the fact that employers will, from April 2006, no longer be able to choose the members of their trustee boards. All schemes will have to have at least one-third of trustees member-nominated.¹⁷ This means that employers will potentially have to divulge highly confidential information to staff who may not hold executive positions within the business. This is likely to cause employers concern. The plan is for member representation to move to 50 per cent in 2008/9, although this is now being consulted on.

The Regulator will rely on employers and trustees to give it early warnings of potential future calls on the PPF, so that

it has the opportunity to seek to avoid any scheme falling into the PPF's remit. From an employer's perspective, this looks a bit like a duty to 'turn itself in' to the Regulator:

- (a) Trustees will be required to submit an annual return to the Regulator. This will operate as a traffic light system with the aim of giving the Regulator early warning of 'risky' schemes.
- (b) Employers will be under a duty to notify the Regulator of certain 'employer-related events' which have a potential impact on employer solvency and the strength of the employer covenant.¹⁸ For example, they may have to notify the Regulator of any decision to take action which will, or is intended to, result in a debt which is or may become due to the scheme not being paid in full; of any breach of its banking covenants; and of any change in its credit rating or ceasing to have such a rating. Trustees will be responsible for notifying the Regulator of certain 'scheme-related events'.
- (c) Employers, trustees, professional advisers and others involved in the administration of pension schemes will be required to report breaches of the law to the Regulator where a person has reasonable cause to believe that there has been a breach of law and believes the breach is likely to be of material significance to the Regulator.¹⁹ There is a traffic light system. Red breach situations are always of material significance to the Regulator and should be reported. They include employer-related investment breaches, particularly making illegal loans (because the effect is to weaken security for members' benefits) and failure by the trustees or employer to

inform the Regulator when a notifiable event occurs.

- (d) Employers will be expected to use the 'clearance procedure' under the new anti-avoidance provisions where it is proposing certain corporate activities (see below for more detail). It acts to bring potentially detrimental events to the pension scheme to the attention of the Regulator.

What do these changes mean for corporate activity generally?

A separate feature of the 2004 Act (and possibly the most radical) is the anti-avoidance provisions, which have been designed to ensure that employers do not avoid their pension liabilities or fail to support them in a meaningful way. The provisions could potentially result in companies having to put in place support for another group company's pension obligations (financial support directions) or having to make payments to a pension scheme if the Regulator considers that the company's act or failure to act was motivated by a desire to reduce or avoid pensions liabilities (contribution notices).

Certain corporate activity will potentially have to be cleared in advance to ensure that the Regulator will not issue a contribution/financial support direction as a result of the behaviour. All corporate activity will be assessed by reference to three categories. Category A will be for events in relation to which the Regulator expects clearance to be seriously considered. They are events that are financially detrimental to the ability of the scheme to meet its liabilities. In particular, they encompass events which:

- (a) result in a change in the priority of the pension liability when compared with the position of other creditors

- (eg granting a fixed or floating charge, entering into new covenants, leveraged finance transactions);
- (b) involve a capital reduction (eg dividends, dividend strips, share buy-backs, distributions *in specie* and demergers); and
- (c) involve a change or partial change in the group structure (eg a change of sponsoring employer or a change in control of the group).²⁰

The key point, from the examples above, is that apparently normal corporate activities will need to be considered for clearance.

Contribution notices can be served on companies throughout a group and even on directors of the sponsoring employer, effectively piercing the corporate veil which has existed in UK legislation for over a century. Arguably, this puts pension scheme creditors in a stronger position than other unsecured creditors who do not have such powers. Some employers have questioned the Regulator's abilities to affect corporate activity in this way.²¹

Despite the Regulator's assertion that the anti-avoidance provisions will not hinder genuine corporate activity, it is clear that pensions has moved right up the corporate agenda. If the activity in question could affect the position of the scheme trustees as a creditor of the employer in respect of any scheme deficit (usually viewed on an accounting FRS17 basis), it will be expected to participate in discussions with the scheme trustees and to notify the matter to the Regulator in order to consider clearance. Even if it is not an appropriate case for clearance, employers will have to go through the same steps to arrive at that conclusion. Many corporate and trustee bodies initially adopted a cautious position on clearance, simply because of the very significant impact that falling

foul of the legislation is likely to have on them. More recently, after seeing evidence of the Pensions Regulator's proactive stance, some companies are risking not asking for clearance.

Employers are also likely to notice pensions causing (bigger) price reductions on transactions. This will be as a result of the changes to the 'debt on employer' legislation we discussed above and the change to scheme funding; and a general wariness of the anti-avoidance provisions and a mindfulness that contribution notices and financial support directions can be very wide-ranging in their application. There will almost certainly be a greater due diligence exercise on a target's group companies as a result of contribution notices and financial support directions. The position will be flagged to interested parties by the changes to the accounting regime under FRS17/IAS19 for pensions, which means that pension scheme underfunding will appear on companies' balance sheets alongside all other debts. Of course, the size of pension deficits can sometimes significantly outweigh the assets of the associated employer. There is no easy way of hiding such a position any more.

The Regulator's view is that corporate activity will not be hindered due to the recent changes in pensions law. Certain corporate activity can continue much as before, provided pensions are considered and dealt with at an early stage, which of course means satisfying the trustees (and the Regulator) that there is no added risk to the scheme. But pensions will feature much more heavily on the due diligence agenda for corporate deals involving DB schemes and sellers are likely to notice a knock-on effect on pricing where purchasers identify any pensions risk at all. Where targets have large scheme deficits, there may be problems with pricing adjustments — scheme deficits can be bigger than the

assets/turnover of the target itself. Deficits are a very real risk for purchasers, especially given the changes in the debt on employers' legislation and scheme funding regime. There is of course only so far price reduction can go before a deal is no longer viable for one of the parties involved.

Is it really a 'lost cause' for employers?

It is clear that employers will have to give more thought to pensions when conducting their corporate activities. The authors' overall view, however, is that this does not have to mean the end of deals involving DB schemes.

More generally, employers need to be getting on the front foot with their trustees (and the Pensions Regulator) and working in partnership with them going forward. This will facilitate the ability of companies to continue with their corporate activities and also reduce the impact of the 2004 Act changes on employers. Many of the new requirements under the 2004 Act are primarily relevant where a scheme is underfunded, the trustees have concerns over the employers' ability (and desire) to fund any deficit, and where there is a poor standard of scheme governance. These are issues within the employer's control to some extent and they can do a lot to help themselves in this regard. Indeed, company board directors should be managing the risk in their pension schemes much more proactively, simply for good corporate governance and for their shareholders.

Employers will be faced with competing demands from their shareholders, pension scheme trustees and other creditors. For example, shareholders will be pressing for maximised returns, while the trustees will be pushing for security of members' benefits. This might

appear as a conflict on the face of it, but the two are not mutually exclusive. In any event, ultimately, it is not in shareholders' interests to avoid company liabilities. This is all about addressing the same circumstances as before in a different light, with the trustees featuring much more highly on the agenda.

Employers should help themselves to retain some degree of control over their pension schemes. By understanding their trustees' new obligations and adapting to the new environment they can engage constructively with trustees. Ultimately, employers need to be viewing trustees in the same way as all other unsecured creditors of the business. By being pro-active, employers can suggest options best suited to their business and work on getting trustees comfortable with the pension scheme. So what do the authors have in mind?

In the context of corporate activity employers should be talking to the scheme trustees at an early stage so that there are no surprises when the trustees seek to consider their position as unsecured creditors just at the time the company wants to complete a strategic transaction. Employers should be considering funding schemes to a higher level going forward, but even where there are large scheme deficits at the point of a sale, employers can take the lead in offering 'approved financial support arrangements', as an alternative or in addition to, meeting the debt, for endorsement by the trustees and Regulator.

On an ongoing basis, employers should take the initiative and present a detailed business case to the trustees supporting its proposals for funding. Trustees will be expected to 'test' the employer, so employers can help themselves by providing well thought out and robust financial plans. Many of the 2004 Act requirements are only relevant to schemes

the Regulator regards as 'high-risk'. For example, the clearance provisions are only relevant for schemes with a deficit; the 'risk-based' part of the PPF levy will be lower for schemes that are well funded or with a strong employer covenant; reporting breaches of the law is only applicable where the standard of scheme governance is low; and notifiable events, where an external employer event is likely to have a negative impact on the scheme. So there are encouragements for employers to gradually improve their scheme funding.

Employers should be considering a variety of 'tools' in working towards a 'better' scheme, perhaps not just focusing on immediate cash contributions. The kinds of arrangements the authors expect to see more of, and which the Regulator is likely to encourage trustees to consider are:

- letters of credit;
- escrow accounts;
- fixed/floating charges;
- borrowing to pay off the deficit;
- credit default swaps;
- parent company guarantees;
- shares in income stream, sale proceeds, future profits, dividends;
- buying insurance for trustees against insolvency of the company;
- equity stake in employer;
- employer covenants and negative pledges;
- generally, obtaining a far greater amount of information from the sponsor.²²

It may be that some of these arrangements are a better commercial solution to the employer than cash injections into the scheme. Having said that, the paradox does not go away. For example, it is more difficult for a struggling company to get lines of credit. The employer should think about the

overall picture when considering these options. So would it be more cost effective for the employer to put one or more of the above solutions in place if regulations allow that, to reduce the cost of an inflated PPF levy, as a result of the Regulator's concerns for the scheme?

As it was in the beginning ...?

Well maybe not, but employers can still do a lot to help themselves in reducing any negative impact of the new provisions. Life is certainly more difficult, but by facing the reality and being open and business-like with trustees, employers can find solutions. However, the ball is in the employer's court and it is up to them how they approach things going forward.

References

- 1 Section 75, Pensions Act 1995.
- 2 Occupational Pension Schemes (Deficiency on Winding Up etc) Regulations 1996 (SI 1996/3128).
- 3 Occupational Pension Schemes (Minimum Funding Requirement and Miscellaneous Amendments) Regulations 2002 (SI 2002/380).
- 4 Occupational Pension Schemes (Winding Up and Deficiency on Winding Up etc) (Amendment) Regulations 2003, Draft Regulations.
- 5 Occupational Pension Schemes (Winding Up and Deficiency on Winding Up etc) (Amendment) Regulations 2004 (SI 2004/403).
- 6 Occupational Pension Schemes (Winding-Up, Deficiency on Winding Up and Transfer Values) (Amendment) Regulations (SI 2005/72).
- 7 Occupational Pension Schemes (Employer Debt) Regulations 2005 (SI 2005/678).
- 8 The Occupational Pension Schemes (Employer Debt etc) (Amendment) Regulations 2005 (SI 2005/2224).
- 9 Paragraph 3, Clearance Statements: Guidance from the Pensions Regulator, April 2005.
- 10 Sections 34–36, Pensions Act 1995 which require trustees to consult with employers only on investment decisions.
- 11 Paragraph 3, Clearance Statements: Guidance from the Pensions Regulator, April 2005.
- 12 www.thepensionsregulator.gov.uk/mediaCentre/pressReleases/pn05-14.aspx.
- 13 The requirement for 'prudence' was introduced with the EU Directive on Institutions for Occupational Retirement Provisions 2003 (2003/41/EC) and will be implemented in the UK in September 2005 (see

- paragraphs 33–42 of the consultation document, Code of Practice — Funding Defined Benefits, March 2005).
- 14 Sections 247–249, Pensions Act 2004.
- 15 Trustee knowledge and understanding, Scope Guidance — Defined benefit schemes with associated defined contribution arrangements.
- 16 Unit 4, Trustee knowledge and understanding, Scope Guidance—Defined benefit schemes with associated defined contribution arrangements.
- 17 Sections 241–243, Pensions Act 2004.
- 18 Section 69, Pensions Act 2004.
- 19 Section 70, Pensions Act 2004.
- 20 See Guidance from the Pensions Regulator on Clearance Statements, April 2005.
- 21 For example, Martin Broughton, Chairman of British Airways, was recently reported to have questioned the Regulator's rights to interfere in corporate activity generally saying, '... Can you tell me what authority [the Regulator] has? This sounds to me like a personal view but I don't think he has the power to do this ...' *The Independent* (Online Edition) 14 May 2005 — Article by M Harrison, Business Editor.
- 22 See Guidance from the Pensions Regulator on Clearance Statements, April 2005.