



Defined benefit schemes - a new world for trustees and employers

Only time will reveal the full impact of the new pensions regulatory environment that began coming into force from 6 April this year. It is clear, however, that for most employers and trustees whose schemes have a defined benefit element, the world is rapidly becoming a different place. In this HR ISSUES, we aim to highlight some key issues, including important new obligations and responsibilities such employers and trustees have, and will have, as well as the new Pensions Regulator's thinking on how trustees should behave.

Background

To put these duties and responsibilities in context, the Pensions Regulator now has much greater powers than its predecessor, Opra, to intervene in the running of pension schemes. The aim is to try and avert problems, protect member benefits and reduce the risk of defined benefit schemes falling into the Pension Protection Fund. To be able to do this effectively, the Regulator needs to be kept informed of developments that could affect the security of benefits. In addition, the Regulator expects trustees to act robustly in their funding negotiations with the employer and keep a close watch on any financial or other transactions involving the employer that could affect the position of the pension scheme as unsecured creditor.

All this must be seen in the light of other legislation that is also intended to prevent employers walking away from their schemes. In particular, the 'employer debt' basis has been strengthened considerably over recent years and a debt is now based on the full buy-out cost of benefits in almost all circumstances. The only exception at the time of writing is when a solvent employer leaves a multi-employer scheme, when the debt is the relevant share of any Minimum Funding Requirement (MFR) deficiency in the scheme. However, it is intended that this too will change (probably during the summer). Legislation is still being drafted. We expect the default position to be that the debt will be on a buy-out basis, but with the possibility of the trustees being able to accept a lower immediate payment, provided sufficient guarantees are available from the remaining employers.

Duty to keep the Regulator informed

Trustees, employers and others involved with pension schemes now have a duty to whistle-blow if they become aware that there has been a significant breach of law in relation to the running of the scheme. In addition, much fuller annual reporting of basic scheme information will be required of trustees. Details are still awaited. These requirements apply in respect of all schemes but there are additional responsibilities that apply when an occupational pension scheme contains an element of defined benefits.

The scheme funding provisions (that will begin to replace the MFR from September 2005) will require trustees to inform the Regulator when a scheme is underfunded; there has been a failure to reach any required agreement with the employer on any aspect of the funding process; or the employer has failed to pay contributions.

Finally, trustees and employers involved with a defined benefit scheme now have separate duties to automatically notify the Regulator when certain specified events, that could impact on the security of scheme benefits, occur in relation to the scheme or the employer respectively.

What can the Regulator do?

The intervention powers at the disposal of the Regulator extend beyond the ability, for instance, to intervene in the running of schemes, or to freeze or adjust benefits. In certain circumstances, where the Regulator feels the security of benefits may have been or is prejudiced, it will have powers to impose:

- contribution notices, where there has been an action taken (or failure to act) which was intended to avoid pension liabilities. Contribution notices may be against an individual or a company if they



are party to the act (and are either the employer, or connected or associated with the employer); and

- financial support directions, when the employer linked to the scheme is a service company or deemed to be insufficiently resourced. Directions would normally only be issued to an individual if they are the employer.

The legislative provisions to impose contribution notices are now in force but financial support directions are not yet available – the Department for Work and Pensions having said that they are working through the complexities involved!

Obligation on trustees and employers to report ‘notifiable events’

Trustees and employers involved with a defined benefit scheme now have separate duties to automatically notify the Regulator when certain specified events occur, in relation to the scheme or the employer respectively, that could impact on the security of scheme benefits. In the table below, box A provides the current list of potentially notifiable events and identifies circumstances in which they need to be reported. It is likely that the list will be extended. If a notification has to be made, it must be in writing, wherever possible using the standard form on the Regulator’s website. Notification must be given as soon as possible, which the relevant Code of Practice implies means virtually immediately. It should be noted that some of the ‘events’ are the taking of decisions. **Both trustees and employer need to ensure that all individuals who may be involved with such events are alert to these new obligations to report.** Failure to report could potentially result in a civil penalty of up to £5,000 for an individual and £50,000 for a company.

Responsibility for trustee reporting falls on each individual trustee, although they are likely to report as a body. If any party becomes aware of a failure to report an event (whether that failure is by the trustees or the employer), then they should report the failure under the new whistleblowing requirements.

Obtaining advance clearance of an event

In an attempt to mitigate the uncertainty that the potential imposition of a contribution notice or financial support direction could have on corporate transactions, parties considering transactions or restructuring involving companies with pension schemes (that include defined benefits) are now able to apply to the Regulator for an advance clearance statement. This will provide assurance

that a particular transaction or restructuring will not result in an unplanned pension liability.

Comprehensive guidance on clearance statements can be found, together with a standard application form, on the Regulator’s website. Box B gives a brief summary of the process, but we would stress that the full guidance runs to 40 pages and goes into much greater detail, not only on clearance but also in relation to the wider issues of the anti-avoidance legislation. As such it is essential reading for trustees and employers with defined benefit schemes, even if they do not think they need to use the provisions yet.

Clearance is not about whether a transaction is possible but whether the Regulator might feel that the pension scheme’s position would be unreasonably weakened as a result. It is clear that the expectation is that parties applying for clearance will have discussed the transaction with the trustees. Only experience will show when the Regulator feels they have to intervene, but we suspect that their ideal would be for them to be presented with a negotiated arrangement involving the trustees, giving the scheme appropriate protection. Box C lists some ways to improve scheme security, as suggested by the Regulator.

The Regulator’s expectation of trustees

An important issue covered in the guidance on clearance is the Regulator’s outline of how it believes trustees should behave. Although within the clearance guidance, it is indicative of how the Regulator expects trustees to act generally. Some key points are listed in Box D. From these, it is clear that far more is expected than simply sticking to the letter of the law. For a scheme in deficit, the trustees should behave like any other (often major) creditor of the company and take their cue from the banks. In most cases, this will require a fundamental change of mindset for trustees – and indeed employers – and has far-reaching implications, not least in the area of conflict of interest for trustees, who are usually also senior management of the employer. Getting to grips with the implications of this new mindset should be high on the list of priorities for trustees, irrespective of the fact that the new ‘trustee knowledge and understanding’ provisions of the Pensions Act 2004 do not come into force until April 2006.

We will be following up on some of these issues in later editions of HR ISSUES but will, of course, be discussing them in greater depth individually with our clients.

A. Notifiable events

Scheme events notifiable by trustees	When notifiable	Employer events notifiable by employer
<p>A decision by the trustees to grant benefits, or a right to benefits, on more favourable terms than those provided for by the scheme rules, without either seeking advice from the Scheme Actuary or securing additional funding where such funding was advised by the Actuary.</p>	<p>Always notifiable.</p>	<p>Any decision by the employer 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.</p> <p>A decision by the employer to cease business in the United Kingdom.</p> <p>Where applicable, receipt by the employer of advice that it is trading wrongfully, or circumstances being reached in which a director or former director of the company knows that there is no reasonable prospect that the company will avoid going into insolvent liquidation.</p> <p>The conviction of an individual, in any jurisdiction, for an offence involving dishonesty, that was committed while the individual was a director or partner of the employer.</p>
<p>Two or more changes within the previous 12 months in either the Scheme Actuary or the Scheme Auditor.</p> <p>A decision by the trustees of a scheme to make a transfer payment to, or accept a transfer payment from, another scheme, the value of which is more than £1,500,000 or 5% of the scheme assets, if less.</p> <p>A decision by the trustees to grant benefits, or a right to benefits, to a member the cost of which is more than £1,500,000 or 5% of the scheme assets, if less.</p>	<p>Notifiable if either:</p> <ol style="list-style-type: none"> 1. scheme in deficit on the relevant basis (<i>see below</i>) at last valuation or 2. trustees had to report an employer's failure to make contributions within last 12 months. 	<p>Two or more changes within the previous 12 months in the chief executive or any other director or partner responsible in whole or part for the financial affairs of the employer.</p> <p>Where the employer is a company, a decision by a controlling company to relinquish control of the employer company.</p> <p>Any breach by the employer of a covenant in an agreement between the employer and a bank or other institution providing banking services, other than where the bank or other institution agrees with the employer not to enforce the covenant.</p>
<p>Any decision by the trustees to take action which will, or is intended to, result in any debt which is, or may become, due to the scheme not being paid in full.</p>	<p>Notifiable if either 1 or 2 above apply or:</p> <ol style="list-style-type: none"> 3. debt is 0.5% or more of scheme assets on the relevant basis (<i>see below</i>). 	
	<p>Notifiable if either 1 or 2 above apply or:</p> <ol style="list-style-type: none"> 4. change in credit rating has not been provided by recognised agency or is a change from investment to sub-investment grade. 	<p>Any change in the employer's credit rating, or the employer ceasing to have a credit rating.</p>

Note: For the purpose of establishing whether an event is notifiable, the relevant basis is that prescribed for risk-based PPF levy valuations. If such a valuation has not yet been undertaken, the basis is the MFR. This differs from the criterion for establishing whether it is appropriate to seek clearance.



B. Clearance statement procedures

key issues

- Clearance applications are optional.
- Objectives of the procedure are:
 - the continuation of appropriate deal activity involving employers with defined benefit schemes
 - the protection of jobs, particularly where clearance is needed to prevent employer becoming insolvent.
- It is expected that clearance will only be sought in relation to 'specified events' – a 'specified event' is an event (affecting an entity) which is financially detrimental to the ability of a defined benefit scheme to meet its pension liabilities.
- For an event to be regarded as measurably detrimental, the first requirement is that the scheme must be in deficit – normally assessed on the FRS17 basis or its successor, IAS19. However, there are circumstances where other, stronger measures of deficit would apply.
- Events affecting a company can be classified into three distinct categories:

Type A events are transactions or restructuring that directly affect the position of the pension scheme as a creditor and for which it may be appropriate to seek clearance. Examples given include:

- granting of a fixed or floating charge which affects more than 25% of the assets of the employer or group

- a return of capital (including dividends, share buy-backs and distributions in specie) which over a year is 'large or unusual' or leaves the employer with negative distributable reserves
- a change in the control group structure of the employer.

Some of these events will be 'notifiable events'. For others, irrespective of whether clearance is sought, the Regulator would generally like to be informed about such events if the scheme is in deficit.

Type B events that do not affect the position of the pension scheme as a creditor. Clearance is not necessary for these events.

Type C events that might affect the pension creditor. All events which point towards a deterioration in the employer's covenant and which may be outside the control of the employer. Clearance is not available for these events if they do not also fall within Type A.

- Any party who believes they may need to make an application for clearance should comply with the Regulator's published guidance and involve the Regulator as early as possible in the process, to ensure the Regulator is able to consider the request within appropriate timescales.
- Any application for clearance should be accompanied by full and accurate disclosure.

Useful web addresses

The Pensions Regulator's home page:

<http://www.thepensionsregulator.gov.uk/>

Guidance on clearance:

<http://www.thepensionsregulator.gov.uk/pdf/clearanceGuidance.pdf>

Clearance application form:

<http://www.thepensionsregulator.gov.uk/pdf/clearanceApplicationForm.pdf>

Notifiable events code of practice:

<http://www.thepensionsregulator.gov.uk/pdf/codeNotifiableLaid.pdf>

Notifiable events directions (i.e. the exemptions)

<http://www.thepensionsregulator.gov.uk/pdf/Directions.pdf>

Notifiable events reporting form:

<http://www.thepensionsregulator.gov.uk/pdf/reportFormNotifiableEvents.pdf>



C. The Regulator's suggestion of ways in which the pension scheme security may be improved

suggestions

- **A new contribution schedule** could be drawn up, with higher contributions and a shorter period to make up the deficit.
- **Additional cash or other assets** could be requested to make up a shortfall in scheme funding or in return for supporting an event taking place.
- **Insurance of contributions** could be requested where there is doubt over the employer's ability to make contributions. This could cover, for example, the next three to five years' contributions.
- **Escrow accounts / deposit up front** may be appropriate and are used, for example, to cover interest costs on bond offerings over a number of years, or a number of months' rent of a new tenant to the landlord.
- **An improvement in priority** can be achieved by granting a fixed or floating charge to the pension creditor. For example, an event which trustees may be asked to consider could be the purchase of a company with a pension deficit by a private equity fund. These transactions will often be leveraged, with the bank providing debt to buy the company secured on the assets of the company. In these circumstances, a charge which ranks alongside, or in priority to, the bank should be considered, along with associated covenants and reporting obligations.
- **Information** is something which a bank may require as part of an arrangement agreed with a company and should be requested in addition to one of the items discussed above. Information can take the form of:
 - monitoring information, including monthly management accounts, key performance data and access to selected executives; and
 - covenants with which the company is required to comply as a condition of an agreed compromise. Covenants may, for example, help to ensure that the company has enough cash flow to meet future contribution levels, and that it does not dispose of key assets.
 - advance notice of any **Type A** events (*see Box B*).
- **Negative pledges** could be used to restrict the activities of the company which may be seen to prejudice the pension creditor. A negative pledge is a promise that something will not be done, for example any **Type A** event.

The Pensions Act 2004

scheme funding

The seminars are free of charge and will run for approximately 90 minutes each on the following days:

Newmarket	Monday, 23 May 2005	9.30am registration, 10.00am start
London	Tuesday, 24 May 2005	8.30am registration, 9.00am start
Manchester	Thursday, 26 May 2005	9.30am registration, 10.00am start

We will be holding seminars on scheme funding which will be of interest to employers and trustees alike. We will cover:

- details of the legislation
- the actuarial valuation process
- what help the trustees may need
- the role of the employer
- what does it all mean in practice?

Attendees at this seminar will be accredited for 1.5 hours formal development for the Pension Management Institute's CPD scheme.

If you would like to attend, please contact **Julie Green** ASAP on tel: **020 7163 6040** or email: green.ja@mellon.com.



D. The Regulator's view on how trustees should act

key points

- The scheme trustees have the prime responsibility for safeguarding members' interests.
- The pension scheme, if in deficit, is an (often material) unsecured creditor of the employer and, although not identical to a large unsecured bank loan, it does have many similarities in the form of:
 - its size relative to other unsecured creditors;
 - its importance – particularly in cases where there is a large number of active members; and
 - its ability to exert leverage over the company, particularly because of trustees' ability to whistleblow to the Regulator, with the Regulator's powers to issue contribution notices or financial support directions.
- The trustees should therefore learn from the way a bank with a large unsecured loan would look to negotiate with a company. They need to understand the sponsoring employer's financial position and the strength of its commitment to the funding of the scheme. They should monitor corporate activity and seek the employer's agreement to be given information at an early stage, subject to the usual restrictions such as those on handling price-sensitive information.
- Any concerns should be raised with the sponsoring employer and, where appropriate, other companies in the group.
- Trustees can also contact the Regulator who will be able to help and advise them.
- Trustees must understand that information they receive in their position as trustees is confidential. This is particularly important when it comes to sensitive information – involving either scheme members or the employer.
- One way of ensuring that all parties understand the importance of confidentiality is to enter into a confidentiality agreement. This should ideally be done every time a new trustee joins the board, rather than waiting until there is an important issue which the employer is reluctant to discuss because of confidentiality issues.
- Many trustee boards have members who may have a conflict of interest – for example, trustees who are directors of the employer or union representatives. Trustees must remember that, at all times, they must act in the interests of scheme members and other beneficiaries, not just the active members.
- Trustees and employers should plan in advance their approach for when a conflict of interest arises. They may, for example, set triggers which would result in an independent trustee being appointed.
- The regulator expects a trustee who could be involved in both sides of the negotiation on a potential **Type A** event (*see Box B*) (for example, a finance director or chief executive) to ensure that the trustees have the appropriate information on a timely basis; to draw his fellow trustees' attention to the potential conflict; to absent himself from trustee meetings when the issue is discussed; and to play no part in decision-making.
- Trustees may need to commission an investigating accountant or insolvency specialist with industry knowledge to assess the financial circumstances of the employer or group of companies before negotiating, particularly if the conflicted trustee is the trustee board's main source of financial knowledge.

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Telephone 020 7163 6000
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