NAPF
Securing the future of pensions

NAPF Response to the DWP's Informal Consultation on the Section 75 (Employer Debt) Regulations as they Relate to Corporate Restructuring

Executive Summary

- The current operation of the section 75 employer debt provisions causes significant and costly problems for companies offering a defined benefit pension and that are seeking to undertake corporate restructuring. These problems include:
    - Prevention of corporate restructuring necessary to ensure the effective operation of private companies;
    - Pension scheme members of companies acquired by larger companies missing out on the opportunity of being placed in larger, more secure and better governed pension schemes;
    - Very substantial administrative costs, including the costs of legal and actuarial advice, due to the triggering of the employer debt provisions in the case of internal and external restructuring.

- We believe that the use of a lower definition of debt (option 3) would be the best way of reducing the problems associated with section 75 in this area, closely followed by the proposals for the automatic apportionment of debt (option 1).

- The adoption of a de-minimis deficit below which a debt is not triggered (option 2) would also be helpful in a limited number of circumstances. All respondents to our member consultation felt that "doing nothing" (option 4) would not be an acceptable decision.

- In the view of the NAPF, the appropriate level of debt to be used under option 3 is the statutory funding objective (SFO). The SFO level of funding aims to ensure that the assets available are sufficient to meet the liabilities of the scheme. In light of this, scheme members would be as well protected after the restructuring as before it. Indeed, in many cases, they may be better off, as the exiting employer would have to ensure that the scheme is fully funded on the SFO basis and that it is not subject to a recovery plan.

- The use of apportionment as a default should also prove a useful means of dealing with the problems with section 75. However, the benefit of default apportionment is unlikely to be achieved unless the new apportionment rules are as simple as possible and the DWP or TPR provides guidance for trustees on how they should be applied.

- If option 2 (de-minimis) is adopted), we suggest that the de-minimis level should be set at somewhere between 3-5% of pension liabilities – using this figure should help reduce costs for all minor changes without placing at risk the funding level of the receiving scheme.

- We are concerned, however, that the changes are to be introduced only for multi-employer schemes for associated employers. We believe that any new rules should also apply to multi-employer schemes for non-associated employers. Adopting different rules for non-associated schemes would lead to regulatory arbitrage and harmful unintended consequences.
- We believe our proposals would not only encourage on-going defined benefit pension provision (especially, if combined with other necessary reforms) but would also achieve the right level of member protection. The UK funding rules are based on the premise that schemes funded to the level of the SFO have sufficient assets to meet all their liabilities. Therefore, in cases such as corporate restructuring, where a new scheme sponsor takes on the commitment to meet the SFO, there seems to be no need to apply a higher funding standard. Moreover, if there are any concerns that members will not be protected as much after the corporate restructuring as before it, we believe that the TPR's new powers introduced in the Pensions Act 2008 should provide adequate means to prevent any detriment to member security.

1. Introduction

1. The National Association of Pension Funds (NAPF) welcomes the opportunity to respond to the DWP's informal discussion paper on the operation of section 75 of the Pensions Act 1995 and how it could be reformed to reduce interference with legitimate corporate restructuring.

2. The NAPF is the leading voice of workplace pensions in the UK. We speak for 1,200 pension schemes with some 15 million members and assets of around £800 billion. NAPF members also include over 400 businesses providing essential services to the pensions sector.

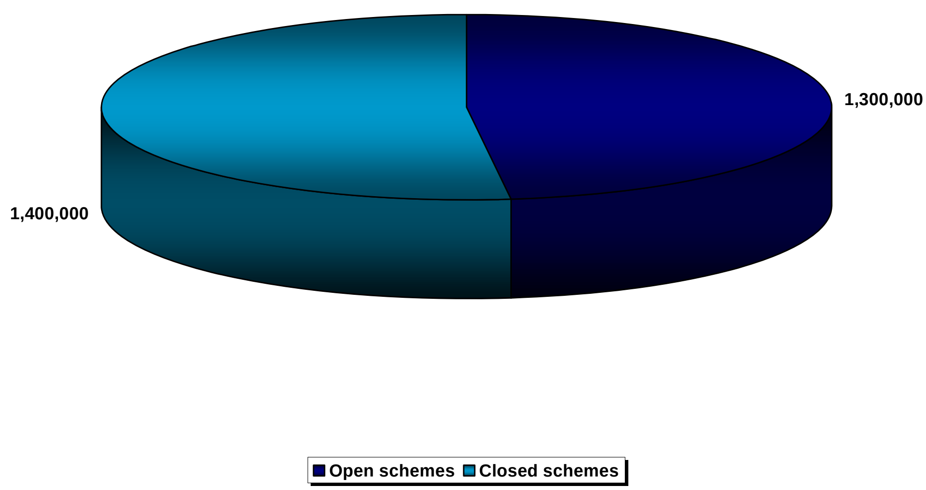
3. Our response sets out why it is important for section 75 to be reformed, the NAPF's preferences for change, and our responses to the specific questions raised in the discussion paper. The annex provides a number of cases studies on recent problems experienced by NAPF member schemes with the regulations.

2. Why Section 75 must be reformed

4. Despite the recent trend away from defined benefit pension provision and into defined contribution pensions, Government action to reduce the regulatory burden on defined benefit provision can still make a real difference, not only to stemming the closure of such schemes to new members but - importantly at this time of economic recession – also by forestalling the risk that employers will cease to provide future accruals to existing members of closed schemes.

5. According to the most recent ONS Occupational Pension Schemes Survey, 2.7 million private sector workers are actively accruing rights in a defined benefit scheme. This amounts to 43% of all pension saving in the private sector.

Fig 1. Active members of private sector DB schemes



6. One year ago, the NAPF undertook a survey of its open defined benefit schemes and asked which of the deregulatory measures being considered by the DWP would be most likely to help employers to keep their schemes open to new members. They responded that reform of section 75 would offer the best hope of sustaining defined benefit provision.

Changes to regulations most likely to sustain DB provision – September 2007

Issue / Proposal	Score
Relaxation of s.75 employer debt regulations in cases of legitimate corporate transactions to allow transactions to take place without additional requirements being placed on the pension scheme.	7
Return of surplus to employer with agreement by trustees	6.5
A move to more principles-based legislation, i.e, where the outcome would be prescribed but not the process	6.5
The introduction of a limited statutory override to allow specific changes to be made where the trust deed and rules may prevent introducing future changes as a result of changes to legislation	5.5
For future accruals, removing the requirement to index pensions in payment	5.5
For future accruals, reducing the requirement to revalue deferred pensions from 5% to 2.5%	5.5
Making it possible to increase NPA for past service as well as future service	5
Amending the requirement for all trustees to have full TKU so that the trustee board as a whole have collective TKU	4
New risk-sharing regime where new schemes would be established under rules which allowed changes to past and future accruals at any time	3

7. Further discussion with NAPF members in recent weeks confirms that reform of section 75 is still needed. The section 75 regulations are causing the following problems:

   - Prevention of corporate restructuring necessary to ensure the effective operation of private companies. These problems arise due to employers being faced with a sudden increase in the funding requirement of the scheme from the level of the Statutory Funding Objective to the buyout level – for a typical fully funded scheme this results in a debt being triggered amounting on average to an extra 33% of scheme assets.

   - Pension scheme members of companies acquired by larger companies missing out on the opportunity of being placed in larger, more secure and better governed pension schemes. This occurs where an employer avoids rationalising their smaller pension scheme in to the main group pension scheme in order to avoid the increased costs associated with a debt being triggered.

   - Very substantial administrative costs, including the costs of legal and actuarial advice, due to the triggering of the employer debt provisions in the case of internal and external restructuring – for example, in the case of one large scheme (35,000 members, £3.5 billion assets) a recent external restructuring resulted in costs to the ceasing employer of over £500,000 simply to move 12 employees into the large scheme and, a recent internal reorganisation resulted in £50,000 in actuarial costs alone.

- Specific problems and additional costs for very large schemes which, due to the impossibility of receiving a buyout quote, are forced to obtain additional actuarial advice and legal statements, if a debt is triggered.

8. Further details of the types of problems that arise due to section 75 in the context of corporate restructuring are set out in the annex.

3. NAPF preferences for the reform of section 75

9. The NAPF is committed to encouraging good quality pension provision. On the basis of our research with members, it is clear that the current rules on section 75 actively discourage employers from providing defined benefit pensions. Therefore, in light of these difficulties, the NAPF believes that a series of major reforms are needed:

   - The adoption of a lower definition of debt (option 3) would be the best way of reducing the difficulties caused by section 75, closely followed by the proposals for the automatic / default apportionment of debt (option 1);

   - The introduction of a de-minimis rule (option 2) under which no debt is triggered if the difference between assets and liabilities is only small would also be of assistance in a limited number of circumstances;

   - The option of "doing nothing" (option 4) should not be adopted.

10. In the view of the NAPF, the appropriate level of debt to be used under option 3 is the statutory funding objective (SFO). The SFO level of funding aims to ensure that the assets available are sufficient to meet the liabilities of the scheme. In light of this, scheme members would be as well protected after the restructuring as before it. Indeed, in many cases, they may be better off, as the exiting scheme would have to ensure that the scheme is fully funded on the SFO basis and that it is not subject to a recovery plan.

11. The use of apportionment as a default should also prove a useful means of dealing with the problems with section 75. However, the benefit of default apportionment is unlikely to be achieved unless the new apportionment rules are as simple as possible and the DWP or TPR provides guidance for trustees on how they should be applied.

12. If option 2 (de-minimis) is adopted), we suggest that the de-minimis level should be set at somewhere between 3-5% of pension liabilities – using this figure should help reduce costs for all minor changes without placing at risk the funding level of the receiving scheme.

13. We believe our proposals would not only encourage on-going defined benefit pension provision (especially, if combined with other necessary reforms) but would also achieve the right level of member protection. The UK funding rules are based on the premise that schemes funded to the level of the SFO have sufficient assets to meet all their liabilities. Therefore, in cases such as corporate restructuring, where a new scheme sponsor takes on the commitment to meet the SFO, there seems to be no need to apply a higher funding standard. Moreover, if there are any concerns that members will not be protected as much after the corporate restructuring as before it, we believe that the TPR's new powers introduced in the Pensions Act 2008 should provide adequate means to prevent any detriment to member security.

14. Finally, we are concerned however, that the changes would only be introduced for multi-employer schemes for associated employers. Instead, we believe that any new rules should also apply to multi-employer schemes for non-associated employers.

4. Responses to the Specific Questions Set Down in the Discussion Paper

Question 1. We would welcome your views as to whether consideration should be given to allowing scheme apportionment as the default option. In this way, while any employer debt is automatically apportioned to the stronger employer(s), they also accept responsibility for all future liabilities due to such apportioned debt?

NAPF response: Yes, we would support the use of scheme apportionment as a default option.

Question 2. If you believe consideration should be given to allowing scheme apportionment as the default option, we would welcome views on the final point in paragraph 22 (i.e. where a smaller company is acquired by a larger company, but the smaller company's section 75 debt is apportioned among all or some of the group companies).

NAPF response: We believe such an apportionment would be reasonable provided all the new scheme sponsors formally accept their legal obligations to the scheme.

Question 3. We would welcome suggestions for the specific nature of company reorganisations which would most benefit from this proposal (and other proposals in our paper), including whether the purchase of a company from outside the already existing group should be considered under such proposals.

NAPF response: In principle, we support the use of default apportionment for all corporate restructuring, unless specific and tangible risks to the security of member benefits are manifest. However, we suggest that the DWP undertake further analysis of the pros and cons of this approach before making its final proposals.

Question 4. We would welcome views as to whether the proposals should apply to where the restructuring is only in relation to associated participating employers, and not other employers who are associated in the group but who are not participating in the scheme.

NAPF response: We believe the proposals should apply as widely as possible. To use different rules for multi-employer schemes with associated employers compared to those for unassociated employers would add cost and complexity, and may result in regulatory arbitrage or may have negative unintended consequences.

Question 5. We would also welcome views on how trustees would, in practice, establish if the funding test would be met – particularly if debts are to be apportioned amongst several participating employers i.e. what would be looked at before and after, and how would this be done? Also, what if the parent company is a mere holding company?

NAPF response: We believe that trustees should focus their attention on ensuring that the new employers are committed to providing formal sponsorship of the scheme and that the covenant is the same, or no worse, after the operation as it was before it.

We have focused on company reorganisations in the understanding that these streamline or are otherwise beneficial to the overall solvency of the company. We are concerned however, that while the restructuring of a company's subsidiaries, if the business and assets are in those subsidiaries, then the parent company and the scheme will always be structurally subordinated to other creditors (i.e. the scheme could receive very little on the insolvency of the group because id would rank with shareholders not unsecured creditors).

Question 6. We would welcome views as to whether consideration should be given to allowing a de-minimis level, below which an employer debt is not triggered.

NAPF response: Yes, we support the use of a de-minimis level.

Question 7. We would also welcome views as to what level the de-minimis threshold could be set at.

NAPF response: We believe that de-minimis level of between 3-5% would be appropriate. However, we believe that this option will only be of substantive assistance if options 1 (default apportionment) and 3 (lower definition of debt) are also adopted.

Question 8. We would welcome views on whether consideration should be given to lowering the current employer debt level to either the scheme funding level or the level of the PPF protected rights.

NAPF response: We believe that the employer debt level should be lowered to the level of the statutory funding objective. We believe that this is the most appropriate figure for schemes where there is an on-going commitment from the employer / sponsor to fund the scheme.

Question 9. We would welcome views on whether the do nothing option is the most appropriate option, given that the current ED regulations have had little time to bed in.

NAPF response: We feel strongly that "do nothing" would not be an appropriate option. The current regime is discouraging employer commitment to defined benefit pensions and adding considerably to the costs of their administration. It is also disrupting legitimate corporate activity.

Question 10. We would welcome any suggestions for other ways in which concerns about not triggering a debt for those employers participating in associated DB multi-employer schemes who are undertaking a corporate restructuring, where there is not detrimental effect on the scheme following the reconstruction might be addressed.

NAPF response: We do not have any additional proposals at present.

Question 11. In addition we would also welcome suggestions for alternative data sources from which we may derive more robust estimates for quantifying the impacts of proposals.

NAPF response: The NAPF would be pleased to assist the DWP in identifying data from NAPF member schemes on quantifying the impacts of their proposals.

5. Conclusion

We welcome the Government's intention of reforming section 75. While we appreciate, and endorse the principle that any changes should not undermine member security, we also firmly believe that section 75 must be reformed if the UK is to maintain and sustain defined benefit pension provision in the private sector.

16 December 2008

For queries, please contact Nigel Peaple, NAPF (nigel.peaple@napf.co.uk)

Annex

Case studies - current problems caused by section 75 in relation to corporate restructuring

Issue 1: Prevention of corporate restructuring necessary to ensure the effective operation of private companies.

A Medium-Sized Multi-Employer Scheme

We currently have a situation with one of our multi-employer schemes where the company simply wants to merge two subsidiary companies that are both participating employers in the scheme. The intention is to TUPE across the employees of the one company to the other. The rationale is essentially to simplify the group structure, reduce the number of legal entities, merge payrolls, achieve operational efficiencies, etc. This however would trigger a section 75 debt which, if it had to be paid, would probably halt the project.

Large Corporate in the Manufacturing Sector

In our experience the current section 75 debt provision presents a significant barrier to legitimate corporate activity. We have experienced section 75 debt issues when attempting to sell a subsidiary company, or our holding in a joint venture company, and also when "divisionalising" an existing subsidiary i.e. when transferring share ownership of a subsidiary to the parent. The buyout costs are volatile and are often disproportionate to the commercial value of the businesses concerned.

An example:

- Business valued at £20m
- Current section 75 debt is estimated at between £20m and £40m
- The equivalent debt twelve months ago (when the sale/purchase was under consideration) was zero.

Large Pension Scheme

I was involved on behalf of trustees when the sponsoring employer took over all the contracts of employment from other companies within the group to streamline HR issues. The sponsor did not appreciate until after the event that it had triggered a section 75 debt amongst all the other participating employers. There was no change in the overall covenant of the group, but we had to go through approved withdrawal arrangements. Some of the companies were sufficiently well funded that approved withdrawal arrangements were not available and they had to pay their share of the debt. The cost in terms of legal fees was significant. The rationalization process would not have gone ahead if the pension implications of the move had been understood in advance.

Issue 2: Pension scheme members of companies acquired by larger companies missing out on the opportunity of being placed in larger, more secure and better governed pension schemes.

A Large Pension Scheme in the Retail Sector

We presently only allow a very limited number of employers to participate in the scheme. We would like to allow others but don't specifically to avoid the risk of a debt being triggered at some point in the future, e.g. if we restructure or sell this company. The current easements in the section 75 Regulations all depend upon the actions of the Trustees at the point the debt is triggered which means we cannot plan now for an unknown decision in the future, e.g. we are unable to rely upon them agreeing to an apportionment for example. The prospect of having to actually pay a debt into the scheme whilst it remains an ongoing entity is clearly something we wish to avoid.

This has the consequence of us continuing to run several small schemes in parallel with our main pension scheme. Each of these:

- incurs its own set of administration and management charges (substantially higher than if they could participate in our main scheme);
- takes up time for that company's management team who don't have the same level of expertise as the management of the main scheme;
- doesn't benefit from the investment management expertise (and cost efficiencies) of our larger scheme;
- creates discrepancies in our benefit offerings across the business;
- prevents the small scheme benefiting directly from the covenant of the stronger group parent.

Issue 3: Very substantial administrative costs, including the costs of legal and actuarial advice, due to the triggering of the employer debt provisions in the case of internal and external restructuring.

A Large Company Pension Fund

On internal restructures - e.g. mergers of subsidiary companies often with small numbers of employees involved. Actuarial costs of doing the section 75 can be of order of £50k; trustee meeting to consider the advice (even if a sub committee authorised to undertake is still a time resource). The cost to the ceasing employer of £560k in respect of 12 employees moving from one participating subsidiary (which ceased to exist) to a larger participating subsidiaries in a around £3.8 billion fund with a strong Principle employer covenant where employer contributions were continuing and a deficit repair programme in place.

A Sectionalised Scheme with Multi-Employer and Single Employer Sections

We have had re-organisations that have been mainly within the group and all with no adverse impact on member pension benefit security. However we have needed to spend significant time on reviewing with legal advice the section 75 issues and where these exist take steps to ensure that the liability did not crystallise. The time and advisor cost would be well over ten thousand pounds.

Multi-Employer Scheme (Non-Associated)

As multi-employer scheme for mainly not-for-profit organisations, the problems of section 75 in the context of a commercial transaction are not really applicable. However, we have many small employers that do operate on a commercial basis, some of which trigger the section 75 debt when having insufficient funds to meet their liabilities. Employer debt brings huge administrative problems, with extensive work needed to communicate the issues to the leaving employer, to establish what assets remain, to consider applications for withdrawal arrangements etc., not to mention that the rules have changed significantly in the last 12 months.

Small Scheme

The owner of our company is a private investment company, similar to a private equity firm. The business is made up of different elements and there are circumstances where they might wish to sell off parts of the business. Under the previous section 75 regulations we were able to put in place an apportionment rule which allowed the 'orphan' liabilities from historical elements of the company which no longer exist, to be allocated to the principal employer, which would avoid triggering the debt on the employer, if one of the remaining participating employers ceased to participate or ceased to have any employees, to the same extent as would be the case if the whole of the liabilities were apportioned between the remaining companies. This is no longer possible.

Large Corporate Pensions

The trustees have needed to undertake section 75 exit debt calculations for five different companies who have ceased to participate in the principal company's scheme. The companies ceasing to participate have been small in relation to the overall fund, and would have certainly fallen within a de-minimis level of 3%. The costs incurred have been actuarial costs, most of which have been incurred due to difficulties in assessing the actual full buy-out costs. As the section 75 regulations are not clear in relation to how the buyout costs should be valued where the scheme is too large to obtain an accurate buyout indication it has been necessary for the actuary to provide a qualified section 75 certificate. This has added to the discussion time and costs of assessing the debts. The actuarial costs have however been covered by the amount of debts received from the employers.

Multi-Employer Scheme (Non-Associated SMEs)

We have 600 participating employers, many of whom are very small businesses with as few as 1 contributing member. There is so much movement in this industry (businesses being bought and sold, businesses closing for various reasons etc) that we technically have cessation events every single month. Equally we recruit new employers every month and while overall numbers have declined, we are working to increase rather than decrease levels of participation.

Our Scheme records are based on the individual members rather than on their employers. We operate in an industry in which there is significant mobility of labour and members could accrue service with as many as 10 employers during their careers. For this reason we have no means of calculating what an employer's debt liability might be at the time of the cessation event. The task of changing our records so that individual employers could be identified and have their share of any liability calculated would be significant.

On the advice of TPR, our trustee agreed to implement an apportionment rule under which any debt of exiting employers would be apportioned among all remaining employers for £1. The rule has a second section which permits a greater amount to be applied by the Trustee but the intention was only to use this in extreme circumstances. NB. This scheme is fully funded on the Statutory Funding level basis and so had no problems before section 75 was revised in 2005 to apply a buyout, rather than an MFR, level of debt.