

**Employer debt – (Section 75 of the  
Pensions Act 1995):  
a response by the National  
Association of Pension Funds**

**August 2011**



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## Executive Summary

The NAPF welcomes the proposed Flexible Apportionment Arrangement, which appears simpler and more practicable than the General Easement introduced last year.

The new proposal will have a wider 'reach' than the General Easement, applying not only to corporate restructurings but also to non-associated multi-employer schemes.

### **NAPF Recommendations**

- Although the NAPF welcomes the emphasis on placing trustees firmly in charge of approving Flexible Apportionment Arrangements, DWP should recognise that trustees will face a significant challenge in operating the proposed funding test. They will need good guidance to help them through the process.
- DWP should recognise that, in practice, the Flexible Apportionment Arrangement is unlikely to remove completely the need to calculate the Section 75 debt. Trustees of schemes with non-associated employers will still want to have a reasonably accurate idea of its size, and they are likely to ask the scheme actuary at least to calculate it on a notional basis.
- We welcome the extension to 36 months of the maximum 'period of grace' before a debt is triggered. The DWP should go ahead with this.
- We welcome the extension of the notice period (for the employer to notify the trustees that the employer intends to use the period of grace provision) from one month to two, but six months would be more likely to deliver the extra flexibility that the Government wants.
- The DWP's impact assessment should be amended to reflect (i) the fact that the major benefit will stem from greater operating efficiency and (ii) a potential 'rush' of restructuring in the first two or three years as employers take advantage of the new arrangement.

This response also includes a case study supplied by an NAPF member which illustrates how the Flexible Apportionment Arrangement could work in practice.

## **1. About the NAPF**

1. The National Association of Pension Funds is the UK's leading voice for workplace pensions. Our members operate 1,200 pension schemes. They provide retirement income for nearly 15 million people and have almost £800 billion of assets under management. Our membership also includes over 400 providers of essential advice and services to the pensions sector. This includes accounting firms, solicitors, fund managers, consultants and actuaries.
2. Our members include many of the country's leading multi-employer schemes, some of which count hundreds of companies among their sponsoring employers. These include sectionalised and last-man-standing multi-employer schemes.

## **2. The NAPF's approach to Section 75 reform**

3. The NAPF has taken a close interest in Section 75 reform. We agree that, at present, these rules can impede perfectly legitimate corporate restructuring exercises that would benefit scheme members by leaving their employer in a stronger position for the future. We want to see Section 75 facilitating responsible business activity while also ensuring that members' pensions are properly protected.
4. We share the Government's view that the General Easement introduced by the previous administration in April 2010 was not an effective reform. We commented at the time that it was too complex to be of practical use, so we welcome the Government's decision to examine this issue again.
5. Although the present consultation invites views on the specific proposal for a Flexible Apportionment Arrangement, there is a wider issue about whether Section 75 is really an effective way of protecting scheme members. As it currently stands, Section 75 is triggered when the last active member leaves the scheme. Yet in practice, there is little difference between the covenant provided by an employer when it has one active member in the scheme and the covenant provided by same employer with no active members in the scheme. In fact, a strong employer might still be well placed to continue supporting the scheme long after its last active member has left.

6. The real risk for members would arise if the employer were to walk away from supporting the scheme, and this could happen regardless of the number of active members. So there is a question about whether Section 75 actually focuses on the circumstances that are most likely to generate risk for members.

### 3. Answers to consultation questions

**Q.1 We welcome your views on the Flexible Apportionment Arrangement.**

- A. The NAPF welcomes the proposed Flexible Apportionment Arrangement, which appears significantly simpler and more practicable than the current arrangements. The FAA does not involve the time limits which restrict the usefulness of the current General Easement.

Not having to calculate the Section 75 debt in every case where an employer ceases to participate is a step forward, although we see this is as good progress rather than as a 'landmark' proposal.

One of the positive features of the new proposal is that it will have a wider 'reach' than the General Easement introduced last year. The General Easement required the employers involved to be part of a corporate group, so it was only of use for restructurings. The new proposal makes no such requirement, so it will also be of use in the case of non-associated multi-employer schemes, although these schemes will incur some costs (see answer 3 below).

NAPF members point out that the practical use of the new FAA will be most useful in cases where a number of participating employers merge, involving the absorption of the leaving institutions into a newly formed entity. The FAA could also be used when an institution changes its legal status – for example, where a registered charity changes its legal structure or association to a limited company.

Annex A sets out a 'real life' case study, supplied by an NAPF member, which shows how the new Flexible Apportionment Arrangement could work in practice. As the case study shows, the new FAA should both (a) ease legitimate restructuring and (b) continue to protect members' benefits.

**Q.2 Do the proposals include sufficient protection for members?**

Yes – the proposals do provide sufficient protection, due to the central role of the trustees. We discuss their role in more detail in the answer to question 3 below.

**Q.3 Are the proposals easier for people to use than the restructuring easements?**

A. Yes they are. The NAPF expects they will be more widely used as a result.

Clearly the proposal places a major responsibility on trustees, as no FAA will be able to go ahead without their approval. Although this is a welcome and important safeguard (the trustees are, after all, best placed to judge the strength of the employer covenant), the DWP should recognise that this will present a significant challenge for trustees, and it will be important that they have good guidance to help them through the process. The NAPF would be willing to work with the DWP and other stakeholders to produce a NAPF *Made Simple Guide* to Section 75.

Although removing the obligation to calculate a Section 75 debt is a step forwards, trustees of *non-associated employers* will still need a reasonably accurate idea of the size of the debt if they are to consider using the Flexible Apportionment Arrangement. It is likely that these trustees would want their scheme actuary at least to calculate a notional Section 75 debt. The institution receiving the debt would also want an accurate determination of its scale. This work would require an actuarial calculation, with associated fees. This significant cost would minimise the advantage of an FAA as compared with a scheme apportionment arrangement.

The NAPF urges DWP to consider whether there is scope for simplifying this task of calculating a notional debt.

The situation will be different for trustees of schemes with *associated employers*. In these cases, the debt would remain within the same group, albeit apportioned from one employer to another, so determining its scale is likely to be much less of an issue for the trustees.

Care will be needed over the way in which the legal expectations on trustees will be worded. For example, if trustees are required to be 100 per cent certain that the apportionment will not have any adverse effect on scheme funding, then some perfectly sensible apportionments might not go ahead. At present the funding test

regulations require trustees to be *reasonably* certain that the funding test is met and that there will be no adverse impact on the scheme, and this seems appropriate.<sup>1</sup>

**Q4. We would welcome your views on the proposal to extend the period of grace to up to 36 months.**

- A. We welcome the extension of the period of grace beyond 12 months to a maximum of 36 months, subject to the discretion of the trustees. Whereas the FAA will help in cases where an employer *permanently* ceases to employ an active member of the team, the extended period of grace will help where an employer *temporarily* ceases to employ an active member of the scheme.

The requirement for trustee discretion is crucial, as we anticipate that it will only be appropriate to offer a notice period of more than 12 months in a limited number of cases.

**Q.5 We would welcome your views on the proposal to extend the period within which employers must write to trustees to two months.**

- A. We welcome the extension of the notice period, but two months would be insufficient to deliver the extra flexibility that the Government wants.

The NAPF suggests that a six-month notice period would better reflect the practical challenges involved in operating large multi-employer schemes, particularly those with non-associated employers.

A typical case in point is supplied by one of the NAPF's members, a scheme with over 300 non-associated employers, although only around 100 are still contributing to the scheme. In many cases, contributions from one corporate group cover a number of different participating employers, so there is a challenge in co-ordinating individual payroll deductions for each participating employer, such that contributions are remitted to the scheme in one payment within the statutory due date.

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<sup>1</sup> Occupational Pension Schemes (Employer Debt and Miscellaneous Amendments) Regulations 2008, 4.4A.a



The same scheme highlights further administrative challenges that can arise – for example in situations where:

- the employer operates out of more than one location;
- the employer is located overseas;
- members are working in remote locations for long periods and changes may not always be promptly notified to the scheme; and
- the employer is remitting contributions to a number of pension schemes of which the multi-employer scheme is just one (and where the majority of employees may belong to the employer's own in-house pension scheme).

In a scheme with some or all of these characteristics it is possible that an institution might unintentionally experience a cessation event, thereby triggering a section 75 debt, and the trustees might not be notified of this (or become aware of it) until more than two months later. This is why the NAPF feels that a six-month notice period would do more to deliver the extra flexibility that the Government is looking to provide.

**Q.6 We would welcome your views on the Government's estimates.**

- A. The NAPF suspects that the DWP's estimate – that 2 per cent of schemes might make use of the FAA – should be higher.

The NAPF expects that there could be an initial 'rush' as large employers with one or two small subsidiaries take the opportunity provided by the FAA to carry out restructures that had hitherto appeared unattractive due to the fact that Section 75 debts would have been triggered.

We would suggest, therefore, that DWP's impact assessment should record a higher 'benefit' figure – at least in the first two or three years of the reform.

**Q.7 We would welcome any additional data that you could supply to improve the robustness of the Government's estimates.**

- Q.8 Previous employer debt Impact Assessments have estimated the benefits of the policy as being the foregone interest payments on funds borrowed to meet the inappropriately-triggered debt. However, there is a benefit to the debt being paid off at the point it is crystallised, because liabilities no longer increase over time (as discounting unwinds). This needs to be netted off against the benefits of the**

**foregone interest payments. Does this represent a reasonable methodology for estimating the benefits of the policy?**

- A. This analysis misses the point: the main benefit of the policy is that it will facilitate greater operating efficiency as employers no longer need to take steps to maintain small subsidiary companies with just one or two employees in order to avoid triggering a Section 75 debt.

We would also caution against assuming that, under the current rules, employers borrow to meet the Section 75 debts payments. Some large companies will simply pay these sums out of cashflow.

## **4. Conclusion**

As indicated throughout this response, NAPF welcomes the proposals and remains committed to working with DWP to ensure their successful implementation.

Please do not hesitate to contact the NAPF for any further information.

## Annex A: Case study

This anonymised case study sets out details of an NAPF member pension scheme and shows how it could make use of the new Flexible Apportionment Arrangement.

A UK contracted-out defined benefits scheme has several participating employers. All the employers are Companies within a UK Corporate structure that is itself part of a global corporate structure. Employer A and Employer B are two of the participating employers.

Employer A took over another business as part of a global acquisition. The scheme has a small number of active members who transferred employment to Employer A after A took over their former employer, Employer F. There are a far bigger number of deferred members who had been employed by Employer F and whose liability bulk transferred to the scheme at the time of the acquisition.

For reasons of operating and financial efficiency, it is being considered that Employer B, which is relatively large, might take over the employment of the employees of Employer A. Fewer than 30 of them are active members of the scheme, but the deferred member liability is significant.

The scheme is about 100% funded on an ongoing basis, and the Corporate Covenant is strong.

There is a strong desire to avoid a Section 75 debt if Employer A ceases to employ any members and, therefore, undergoes an employment-cessation event. All the participating employers and the Trustees would be content to find a straightforward way to apportion all the liabilities in respect of the actives and deferreds associated with Employer A to the bigger Employer B.

By allowing Employer B to step into the shoes of Employer A, the proposed Flexible Apportionment Arrangement would facilitate a corporate restructure going ahead to achieve aims of simple business efficiency, and it would be easy to demonstrate to the Trustees that it would not jeopardise the security of members' benefits.