ASSOCIATION OF ACA CONSULTING ACTUARIES

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Declan Montgomery
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9th December 2008

Dear Declan

Consultation on Section 75 of the Pensions Act 1995

I am writing on behalf of the Association of Consulting Actuaries in response to the consultation document issued by the Department for Work and Pensions dated November 2008 that is making some limited proposals to ease the employer debt requirements.

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and are subject to the code of professional conduct of the Faculty and the Institute of Actuaries. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of defined benefit pension schemes.

The ACA is effectively the 'trade association' for consulting actuaries, whilst the Faculty and Institute of Actuaries are the professional bodies.

We set out in the body of this letter some general comments. Our responses to your specific questions are set out in the appendix.

The initiative is welcome but more clarity is needed

We welcome any initiative to deliver easements to the complex employer debt regulations – particularly to address legitimate corporate concerns over situations that really ought not to have triggered under the employment-cessation event heading.

We would like to welcome this limited easement. However we have found a number of aspects of the proposals, as expressed in the consultation document, hard to grasp and would have preferred if more work could have been done to clarify your intentions before exposing the document for consultation. Given this we have held back from raising queries on some of the technical wording that has been used.

The intended targets of the easements are not clear

We are not sure to which situations your proposals are intended to apply. You say that they are limited to employers undertaking a *"corporate restructuring"*, but these can take many shapes and forms. We believe that the following situations should benefit from an easement from the section 75 requirements; perhaps via a clear exclusion from the definition of employment-cessation event (see our suggestion one in our answer to question 10):

- simple housekeeping by the corporate group under which the relationship and covenant of the group to the scheme is not altering in reality;
- departures of minor participating companies with negligible, if any, impact on the covenant, where having to comply with an employer debt process is potentially a disproportionately costly nuisance; and
- the departure of the last active member from a subsidiary company, perhaps through being transferred to another participating company, where the subsidiary company continues to participate in the scheme and in so doing continues to 'stand behind the pension promise' that it has made, perhaps via the group, to its current and former employees.

We understand that it is the application of the current regulations to precisely these sorts of events that have led to criticism by employer groups.

Although some may see any changes in this area as a weakening in the protective provisions, we would challenge why, for the situations we have outlined above, such protections were there in the first place. The debate must be seen in this light otherwise there will be no progress. It was therefore disappointing that the consultation paper did not set out a clear policy view as to when it ought to be appropriate for an employer debt to be triggered and when it ought not.

By contrast, changes involving potentially significant movements of value around and perhaps out of the corporate group seem to us to be corporate restructuring exercises to which there should not necessarily be an easement to the current employer debt provisions.

Clarification of the covenant requirement is required

Options 1 – 3 are only to apply to circumstances where *"the employer covenant was strong before the restructuring, and there is no detrimental effect / weakening of that covenant following the restructuring"* (para 1 of the consultation paper)

It is not clear to us how the requirement for a strong covenant is to be given legislative expression. We have some concern that in order to achieve a limited deregulation, more complexity might be added to already far too complex requirements. The requirement for a strong covenant is also unnecessary, in our view and suggests a lack of appreciation of from where the core argument for change is coming. We think that your deregulatory efforts should be focussed on removing from the employer debt legislation events that currently trigger under the April 2008 regime when the covenant is not changing in reality, regardless of the strength of the covenant prior to the trigger.

The second strand – the non detrimental effect / weakening of the covenant following the restructuring – appears to be contained within the covenant conditions under each of Options 1-3. These covenant conditions appear to be as follows:

- Option 1 – the scheme apportionment funding test which requires that after the arrangement takes effect the remaining employers are reasonably likely to be able to fund the scheme and the security of members' rights are not adversely affected.

- Option 2 – this appears to require that the transfer of liabilities in respect of the departing employer to other participating employers is not materially detrimental to the scheme.

- Option 3 – under which the expectation of reaching and/or sustaining the funding target must not be materially changed and the strength of the overall employer covenant must also remain unchanged.

In our response we have assumed that the covenant conditions are for an initial strong covenant followed by the above Option-specific conditions.

The issues that arose following the April 2008 regulations need to be addressed

We note that this informal consultation makes no mention of the many difficulties that the April 2008 amendments to the employer debt regulations have created; not so much in what they set out to achieve, but rather in the manner of their delivery. Amendments are needed to the regulations so that the regime as envisaged by the Department can be made to work.

We welcome your separate proposals, issued on 2nd December, to make corrective amendments to these regulations, but have not analysed them in preparing this response. At this stage we do not know whether we will be able to respond in time for your 18th December deadline.

Our initial thoughts

Please see the appendix for our responses to your specific questions, but in summary we feel that, as currently presented, with its firm linkage to scheme apportionment arrangements, there are difficulties with Option 1; there is some merit to Option 2, but it could be delivered in an alternative manner; we cannot see any merits in Option 3 and Option 4 is not viable as it is not tackling the specific problems that have been reported.

We hope that you find our comments of assistance and in this regard you will see that in our answer to question 10 we have put forward some alternative solutions, either of which could deliver a similar result to a modified version of your Option 1, but without the complexity of a formal scheme apportionment arrangement.

Yours sincerely

David Everett

David Everett
Deputy Chairman, Pension Schemes Committee

Appendix

This Appendix follows the structure for comments set out in the consultation document.

Option One

1) We would welcome 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.

It seems to us that a formal scheme apportionment arrangement is cumbersome and unnecessary if the intention is that it should be available in the situations that we think should benefit from the limited easement to the employer debt provisions.

Since April 2008 a scheme apportionment arrangement involves the scheme actuary working with the trustees to determine and certify the scheme-wide buyout debt, an assessment of the liability share of the departing employer and the drawing up of a legal document to incorporate within the scheme rules the precise nature of the arrangement including what the departing employer is to pay. This all seems unnecessary if the policy intention is that the departing employer should pay nothing. Any apportionment to others in the agreement would either be purely notional or would introduce complexity on any further section 75 debt trigger – such as the scheme commencing winding up.

Furthermore, the current regulations are not clear in a number of respects as to how these arrangements operate. For example, it is not clear what must be apportioned to one or more of the remaining employers – a fixed sum or responsibility to meet the liabilities of the former employees of the departed employer. The interaction of the funding test with the Regulator's clearance guidance is also not clear (see our answer to Question 5 below).

We also have concerns over the ambition to make the "funding test" objective. It seems that any test that involves covenant issues has to be subjective. Option 1 as presented also has the potential to put trustees into an invidious position – they are being invited to carry out a subjective test, the passing of which then limits their section 75 powers. However, with appropriate guidance, this may not be a major obstacle.

As currently presented, we feel that with its firm linkage to scheme apportionment arrangements, there are difficulties with Option 1. However, you will see that in our answer to question 10 we have put forward some alternative solutions, either of which could deliver a similar result to a modified version of your Option 1, but without the complexity of a formal scheme apportionment arrangement.

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 other group companies).

We would have hoped that the scheme apportionment funding test would be a sufficient protection especially as there is an initial condition of the covenant being strong before the corporate restructuring.

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.

We do not understand the relevance of the purchase of a company from outside the existing group. This is surely not an employment-cessation event in relation to the purchaser's scheme?

As indicated above, we do not think that Option 1 in its present form is suitable for the situations where we believe there should be an easement to the employer debt regulations. We comment on the suitability of Options 2 and 3 for particular situations in our answers that follow.

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.

This seems to be a question on all of Options 1-3. Our answer applies whether the question is asked in the context of any of the Options.

Clearly, any restructuring that involved only non-participating employers would not generate an employment-cessation event so does not have to be considered any further. If the restructuring involved both participating and non-participating employers, there would need to be some care in the construction of the covenant aspects of the tests in each of Options 1-3. This would be to ensure that any value which is made more remote from the scheme, through being placed with non-participating employers, is properly assessed. It appears to us that the covenant tests that are being proposed for each Option achieve this. Given this we have no particular concerns with an easement to the employer debt provisions extending to reconstructions that involve non-participating employers.

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?

We have some difficulties in responding to what appears to be a question asking how trustees can go about their duties under the April 2008 regulations. We believe that this is an area where guidance from the Pensions Regulator would be helpful and we raised this with them in June. We feel in particular that the interactions of the second strand of the funding test (applicable only to scheme apportionment arrangements) with the Regulator's clearance guidance needs some clarification.

The clearance guidance says that a scheme apportionment arrangement is a Type A event, unless there is "no net reduction of employer covenant" (or the debt payable is increased, or is approximated on a 'best estimate' basis). If it is a Type A event the parties "should consider and agree the most appropriate mitigation". Trustees may want to know whether they can assume that the funding test is met if the Regulator has given clearance, or if the trustees have concluded that there is no net reduction of employer covenant.

It could be argued that it would be inappropriate for the Regulator to grant clearance if it thought that the apportionment did not pass the funding test. Alternatively, it could be argued that clearance statements have nothing to say about whether there has been compliance with the employer debt legislation. We therefore feel that it is important for the Regulator to clarify what inferences in relation to the funding test may or may not be drawn from the clearance guidance.

We have focussed 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 funding test including the test of covenant may be unaffected by 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 it would rank with shareholders not unsecured creditors).

We do not see why you should be limiting consideration to those corporate restructurings that "streamline or are otherwise beneficial to the overall solvency of the company". Some of the situations we have outlined that should benefit from an easement in the current legislation do not necessarily fall under these headings.

Whilst we agree that the funding test within a scheme apportionment arrangement would not pick up pre-existing weaknesses in the covenant towards the scheme (caused for example by the trading business and assets being held in subsidiaries that are remote to the scheme), your initial condition of a strong covenant presumably would. Given this we do not share your concerns.

Option Two

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.

We have difficulties in understanding precisely what is being proposed. The expression "outstanding debt" is not clear, but if we can proceed on the basis of it being the liability share following an employment-cessation event, then we would have some sympathy with the trustees not being able to pursue liability shares that are below a certain percentage of scheme-wide liabilities (although it might be better to express this as a certain percentage of the scheme-wide buyout deficit). However, we would see this Option as being more appropriate in situations where some, albeit minor, value is leaving the business – for example the sale of a small subsidiary to an unrelated employer. It is not obvious why in this situation there should be an initial condition of the covenant being strong.

You are also proposing that the transfer of liabilities must not be materially detrimental to the scheme with the new liability. We assume that you are referring to an internal reattribution of the liability. The concern is surely whether the remaining employers who are implicitly picking up the responsibility for the orphaned members will be good for the money? Presumably trustees are to be the arbiters of this which then gives rise to the invidious position issue that we have outlined in Option 1.

There is some merit to Option 2, but it could be delivered in an alternative manner to that which you propose. We expand upon this in our answer to Question 10.

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

We have great difficulties in understanding paragraphs 26 and 27. They seem to be talking about the solvency position of schemes rather than the outstanding debt and as such seem to be in conflict with the concept that you are promoting. A de-minimis of 30% would offer no protection whatsoever.

We feel that the threshold needs to be set at no more than 5% of the scheme-wide buyout deficit.

Option Three

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.

We cannot see any merits in this proposal in relation to those situations for which we believe there should be an easement of the current employer debt legislation, especially as your starting point is that the employer covenant is strong before the corporate restructuring and there is no detrimental effect / weakening of that covenant following the restructuring. Why should, in this situation, the trustees be able to accelerate the scheme's funding?

We do not see any pressing need to introduce this facility in other situations. In any event, the same result can be achieved voluntarily through a scheme apportionment arrangement under the April 2008 regulations.

It is not clear under this option who determines that there is no material change in the expectation of reaching and / or sustaining the funding target and that the strength of the overall employer covenant remains unchanged. If it is the trustees then the invidious position issue as expressed in our answer to Question 1 could arise.

Option Four

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.

"Do nothing" as expressed in the consultation paper is not viable since the specific problems reported by companies that have caused you to embark on this project remain. It is also not appropriate to wait for the April 2008 regulations to bed down when they have significant flaws in their execution and a number of practitioners have in any case asked that the Lewin and Sweeney proposal be taken on board as part of the April 2008 regulations.

Other options

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 no detrimental effect on the scheme following the reconstruction might be addressed.

We have two suggestions.

<u>Suggestion One</u>

Our first is that you modify the definition of employment-cessation event so as to remove from it certain excluded events, which you then go on to define.

The ideal is for you to fully define these situations in law, but we think that it is likely that there will need to be guidance from the Pensions Regulator (which could be directed towards employers and their advisers, rather than trustees) as to how these excluded events should be interpreted. It may be necessary for this guidance to be in the form of a Code of Practice so that there is a clearer path to action being taken by the Pensions Regulator should the trustees object to the employer interpreting away what ought (in the trustees' view) to be an employment-cessation event. Alternatively, an extension to the Clearance guidance might suffice.

As an alternative to relying on employer interpretation, a trustee safeguard, along the lines that you have suggested in your consultation paper, could be used. In other words, to the extent that the legislation leaves scope for judgment, the trustees would have to reach a view as to whether there had been an employment-cessation event. As above, for this to work, there would need to be appropriate guidance from the Pensions Regulator.

We suggest that either approach is preferable to making employment-cessation events always a matter of fact which would then beg, in some situations, unnecessary section 75 debt compliance actions.

We suggest that the excluded events should be those we have mentioned in the main body of our response – ie:

- simple housekeeping by the corporate group under which the relationship and covenant of the group to the scheme is not altering in reality;
- departures of minor participating companies with negligible, if any, impact on the covenant, where having to comply with an employer debt process is potentially an administratively costly nuisance; and
- the departure of the last active member from a subsidiary company, perhaps through being transferred to another participating company, where the subsidiary company continues to participate in the scheme and in so doing continues to 'stand behind the pension promise' that it has made, perhaps via the group, to its current and former employees.

<u>Suggestion Two</u>

Our second suggestion is that you make no change to the current legislation in respect of this initiative, but instead commission the Pensions Regulator to provide guidance so that trustees can feel comfortable in not pursuing the liability share when the current law allows them so to do. We are aware of situations where the debt is triggered under the current legislation, but following advice on the unchanged nature of employer support to the scheme, the trustees are minded not to pursue it.

We were under the impression that the Pensions Regulator was going to provide some guidance on the April 2008 regime. Certainly, guidance is outstanding on the practicalities of the April 2008 regulations – eg interpretation of the funding test, explanation of the operation of regulated apportionment arrangements, approved withdrawal arrangements and the notification requirements under scheme apportionment arrangements.

From a deregulatory point of view there may be some merit in this approach, if having examined the way in which you would have to give legislative expression to your proposals, it would be more straightforward to seek to engender altered trustee behaviour through appropriate trustee guidance on section 75 debt apportionment.

The problem is that the April 2008 regulations have not limited trustees' bargaining power – if anything they have increased the situations in which employment-cessation events occur and have given the trustees more options with which to tackle the employer. Unless trustees are guided otherwise they may be fearful of not pursuing the liability share.

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.

We do not have any suggestions to make.