Clearing pension deficits is in the hands of the trustees

The Pensions Act 2004 has taken the power to decide pension scheme contributions away from employers and put it in the hands of the trustees. It is a move that, it is hoped, will accelerate and better regulate the funding of deficits. Aaron Punwani and Lucy Hughes explain

The Pensions Act 2004 replaces the current Minimum Funding Requirement (MFR) with new 'scheme funding' requirements.

The new regime represents a dramatic shift in the balance of power in determining pension scheme funding. Given the current environment of large deficits, this could revolutionise pension scheme funding, with trustees requiring significant increases in contributions. The act introduces two key elements:

- Technical provisions – an estimate of the assets needed to make provision for the benefits when they fall due.
- A recovery plan – setting out the planned manner and timeframe in which the deficit is to be eliminated.

That sounds straightforward enough but how should technical provisions be calculated and what is an acceptable recovery plan?

To address these questions, a package consisting of draft regulations and a draft code of practice and guidance from the Pensions Regulator was released in March 2005. Consultation on these documents ended last month. Final versions are planned to be issued in the autumn to apply to actuarial valuations from September 23 2005.

The code and guidance total almost 80 pages. Although the new legislation was originally billed as offering simplicity and flexibility, these objectives appear to have been abandoned and the emphasis is now firmly on improving the security of members' benefits. The outcome is a significant loss of control for companies in managing their pension liabilities.

In the past, many pension scheme rules effectively gave the employer a unilateral right to set the level of contributions to the scheme. In future, trustees will be responsible for determining the technical provisions and devising the recovery plan, although they should attempt to agree these with the employer. This is a fundamental shift in the balance of power.

Trustees are required to determine technical provisions prudently but we have no guidance yet on the meaning of 'prudent'. If the chosen assumptions give a 75 per cent chance of a successful outcome, is that prudent? Would a member be content with a one-in-four chance that there are insufficient funds to meet his benefits? This debate will run and run.

Removing the deficit

Trustees are encouraged to aim for any deficit to be removed as soon as practicable, recognising that this depends on the ability of the employer to pay.

In setting technical provisions, the draft code requires trustees to take into account the financial standing of the employer and its prospects, and to take specialist financial accountancy advice where necessary. This reflects guidance from the regulator that indicates a pension liability should be considered in a similar way to any other material creditor of the company.

As an extension of this, trustees will take a greater interest in corporate activity and may seek to renegotiate the funding terms if they feel their position has been adversely affected. Examples are mergers and acquisitions, payment of special dividends, share buybacks and business refinancing.

Indeed, the draft code encourages trustees to commission out-of-cycle actuarial valuations where circumstances have changed and they consider it to be in the interests of scheme members to do so.

Further pressure to accelerate pension scheme funding, and loss of control over the pace of funding, could be the last straw for those companies who still offer defined benefit pension schemes. This is evidenced by the recent Association of Consulting Actuaries' survey, which found that 68 per cent of defined benefit schemes are closed to new entrants and 10 per cent closed to new accrual of benefits.

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However, there is now no escape from the benefit promises already built up. Previously, employers could voluntarily wind-up their pension schemes but, since June 2003, this triggers a large employer liability – equal to the amount required to secure all the benefits by purchasing insurance policies.

Where the trustees and employer cannot agree on an acceptable funding plan, the regulator will be able to intervene. Its powers include setting the contributions, stopping or changing the future accrual of benefits and even winding up the scheme.

Answering to the regulator

For companies that are deemed 'insufficiently resourced', the regulator can issue financial support directions to make other associated companies liable for the pension scheme deficit. And where the regulator decides that a company or individual has acted so as to avoid a liability to the scheme, a contribution notice can be issued, requiring that company or individual to make an immediate contribution to the scheme.

A key reason for these powers is that the Government has established a Pension Protection Fund (PPF) to protect a significant proportion of members' benefits in the event of employer insolvency and it wishes to prevent calls on the PPF arising from 'moral hazard'.

Recognising that the possibility of a financial support direction or contribution notice can make it difficult for companies to carry out normal transactions, the regulator has established a clearance procedure to give the company certainty that a contribution notice or financial support direction will not be issued against the parties to the transaction. The regulator will need to be satisfied with the circumstances of the transaction.

The regulator expects companies to have obtained the view of the trustees before applying for clearance, so companies will need to involve trustees in corporate transactions at an early stage. In many cases, we feel that trustees are likely to push for the company to pay a lump-sum contribution to the scheme in return for cooperation with the clearance application.

A clear outcome of all this is that it creates greater scope for conflicts of interest between the trustees and the employer. Indeed, the draft code states: "Trustees should act independently and robustly when negotiating with the employer."

Individuals who are both trustees and company directors can find themselves in a difficult position. Situations can arise where it becomes appropriate for such individuals not to participate as trustees in discussions on particular issues, or even to resign as trustees.

All in all, the main thrust of the new requirements is that trustees of pension schemes in deficit should ask for a high degree of funding as quickly as possible, recognising that asking for too much may be detrimental to the employer and may jeopardise their prospects of obtaining further funding in future.

Companies will have to treat the trustees as a creditor with the ability to exert significant leverage over the company, with a potentially detrimental impact on other creditors and shareholders. Keep a close watch over the next year or two on the level of contributions to pension schemes, the impact on dividend payouts to shareholders and the actions of the Pensions Regulator, with its far-reaching powers.

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