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BRIEFING

Dealing with pension scheme deficits

Employment, pensions and benefits: briefing 96

Executive summary

This briefing looks at the implications of deficits in pension funds as disclosed in accounts and actuarial valuations. Various methods for dealing with such deficits are discussed together with statutory requirements.

Pension scheme deficits have become headline news and are causing concern amongst trustees, pension scheme members and company management alike.

This briefing looks at the nature of pension fund deficits and actions that may be taken to deal with the issue.

Actuarial valuations and accounting figures

A distinction can be drawn between a deficit arising from an actuarial valuation and one arising under accounting standards.

Actuarial valuations

Current position

The Pensions Act 1995 (the Pensions Act) and the Occupational Pension Schemes (Minimum Funding Requirement and Actuarial Valuations) Regulations 1996 (the MFR Regulations) require that, in relation to most final salary schemes, trustees:

- obtain regular valuations to determine the appropriate contribution rate and funding level; and
- put in place and revise from time to time a schedule of contributions to be paid to the scheme.

Owing to the variation in the assumptions which an actuary can use in preparing a valuation, the results can vary significantly.

Deficits arising in this situation have an impact on the employer's requirement to fund the scheme. Employers providing the balance of cost in a final salary scheme, for example, may be required to increase contributions to fund the deficit. Some of this cost may be passed on to members by requiring increased contributions (but see below).

Where a deficit is revealed on the minimum funding requirement (MFR) basis, the deficit must normally be rectified by the end of the period covered by the schedule of contributions (normally five years). Failure to make good the deficit results in a debt arising on the employer which must be notified to the Occupational Pensions Regulatory Authority.

Future position

The Actuarial Profession has published an exposure draft (EXD51) proposing amendments to its guidance note dealing with actuarial reports (GN 9). EXD51 will introduce a new requirement for explicit disclosure of a pension scheme's solvency position. Actuaries will have to disclose in a report to the trustees whether the assets of the scheme would be sufficient to meet the cost of buying out the liabilities with an insurance company if the scheme were discontinued on the valuation date. If the assets would not be sufficient, the actuary must state what percentage of the members' pensions would be covered, differentiating the position for pensioners and current members.

At present, the financial solvency of the pension scheme does not have to be disclosed to members. However, the government proposed in its White Paper[1] that trustees

[1] *Simplicity, security and choice: Working and saving for retirement – Action on occupational pensions*, 11 June 2003.

should be required to send information to scheme members each year containing key information about the funding position of their scheme. Where deficits are disclosed, this may evoke concern from scheme members.

The White Paper also proposed that the MFR should be replaced by a scheme-specific funding requirement. Further details are awaited.

Accounting issues

Accounting standard FRS 17 requires that a market-based approach be taken to disclosure of pension fund assets and liabilities in company accounts. At present, adoption of this standard is optional, though where it is not adopted transitional arrangements apply which require FRS 17 figures to be provided in a note to the accounts. The full requirements of the standard will apply to accounting periods beginning on or after 1 January 2005.

The market-based approach is similar to that used in international accounting standard IAS 19, which is required to be adopted from 1 January 2005 for the consolidated accounts of most companies based and listed in EU member states. Concern has arisen over the effect of pension scheme deficits on a company's credit rating, which in turn affects the ability of the company to raise capital.

A further consequence of a pension scheme deficit is that it reduces distributable reserves and hence potentially the ability to make a distribution to shareholders.

Methods of dealing with pension scheme deficits

Increasing employer contributions

Where a deficit is revealed in a scheme where the employer is required to pay the balance of the cost of the scheme, the employer may need to make additional contributions.

As noted above, the Pensions Act imposes on the trustees the duty to put in place a schedule of contributions designed to meet the MFR; however, there is a duty to consult with the employer over the level of contributions required. If agreement cannot be reached, the trustees can decide unilaterally. Note that this provision overrides any contrary provision in the scheme's trust deed.

Subject to the trustees' powers, the employer may decide to fund the deficit by a one-off payment. Alternatively, some employers are negotiating with trustees to give security in exchange for lower contributions, for example, by creating a reserve secured by a charge on the company's assets.

Increasing or introducing employee contributions

Depending on the terms of the scheme, part of the cost of funding the deficit may be passed on to employees by increasing their contribution rate or making the scheme contributory to members. In such a scenario prior consultation with the employees and trustees is advised and employee consent will generally be needed to deduct higher contributions from their wages (section 13 of the Employment Rights Act 1996). Provisions in the scheme documents and booklets will need to be reviewed, as will employment contracts.

Capping pensionability of remuneration

Increases to pay may be offered on the basis that they are pensionable only up to a certain amount, provided either that this would still fall within the definition of 'pensionable pay' in the trust deed or that that definition could be amended. If, for example, the definition covered basic pay only, then the definition may need to be amended. Trustees must, as usual, consider whether such an amendment would be appropriate.

- If the pay increase on those terms is the subject of a collective agreement, the terms of that collective agreement will normally override the terms of the trust deed and the trustees may make the necessary amendment without impeachment.[2]
- If there is no collective agreement, care must be taken in wording the offer of the pay increase to make it clear that acceptance of the increase is also acceptance of the fact that the increase is not pensionable, ie, that it is not possible to accept one part of the offer without accepting the other.[3]

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[2] *South West Trains v Wightman* [1998] PLR 113.

[3] *Trustees of the NUS Officials and Employees Superannuation Fund v Pensions Ombudsman* [2002] PLR 93. For further information on non-pensionable pay increases, see our briefing no. 78: *Pensionable and non-pensionable remuneration* (September 2002).

Reduction of transfer values

Regulations[4] have now come into force which permit trustees to reduce cash equivalent transfer values payable from the scheme in circumstances where the pension fund is in deficit as determined by the actuary in accordance with actuarial guidance note GN 11. The actuarial guidance requires the actuary to advise the trustees where the immediate payment of a full cash equivalent would reduce the security for the benefits of other members. The regulations set out certain restrictions on the level of reductions that can be applied, ie, that the reduction should not be greater than the level of underfunding and that the transfer value must cover preferential liabilities.

Review of investment policy

In accordance with their powers under the scheme documents, trustees may consider the effect that changing the investment policy might have on the deficit. Consideration may be given to the impact of the volatility of the investments on accounting figures. However, in implementing any changes, trustees will need to act in the best interests of the members.

Sections 35 and 36 of the Pensions Act require trustees to put in place and revise from time to time a statement of investment principles and consult with relevant persons on those principles. Investments made should then accord with these principles. If trustees are considering changing the investment policy they will need to consult with investment advisers and the scheme's sponsoring employer and modify their statement of investment principles as appropriate, having regard to the requirements of the Pensions Act.

Winding-up

A drastic measure taken by some smaller schemes in the light of deficits and increased burden of operating final salary schemes has been to wind up the scheme. Nevertheless, *Imperial Group Pension Trust v Imperial Tobacco* [1991] 2 All ER 597, which established the good faith principle, indicates that an employer must be able to justify scheme termination.

The Pensions Act 1995 imposes a statutory debt on employers when a scheme winds up. Until recently, where a final salary scheme was in deficit on winding-up and the employer was solvent, benefits of pensioners were required to be bought out in full and the deficit in respect of other members had to be met on the MFR basis. However, as this basis is less than the full cost of buying out the benefits with insurance annuities, members may receive only a percentage of their benefits under the scheme – that is, unless the employer decides to fund a full buy-out of the benefits.

On 11 June 2003, however, the government's draft Winding up and Deficiency on Winding up (Amendment) Regulations 2003 were issued. If enacted, these will require the calculation of the debt for an employer not in liquidation to be based on benefits under the scheme being secured on a full buy-out basis. Employers winding up a scheme may therefore need to make a substantial additional contribution to enable them to wind up the scheme and discharge their liabilities. Although the implementation of these regulations has been delayed, the government has stated that they will apply retrospectively from 11 June 2003.

In its June White Paper, the government proposed that a Pensions Protection Fund should be set up from 2005 to protect employees against loss of pension rights by virtue of schemes being wound up where the employer is insolvent.

There are concerns about how the fund will operate in practice and the level of security which the fund will offer. The fund is intended to be modelled on the Pension Benefit Guaranty Corporation (PBGC) in the US and be financed by a levy on pension schemes – a flat-rate levy for all schemes and a top-up levy for underfunded schemes (to deter schemes from deliberately underfunding). The White Paper suggested that the scheme will guarantee 100 per cent of pensions in payment and 90 per cent of liabilities for those still working, with salaries capped on a final salary of between £40,000 and £60,000. The government's stated intention is that the fund should start in 2005.

[4] The Occupational Pension Schemes (Transfer Values and Miscellaneous Amendments) Regulations 2003/1727; in force 4 August 2003.

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Changing the nature of the scheme for future members/service

Numerous employers have decided to close their final salary scheme to new entrants and offer a money purchase arrangement to new employees. Others have closed the final salary scheme for future accrual for existing members, offering instead, both for existing members and new entrants, a money purchase scheme or a less generous final salary scheme.

If the package is less generous for new joiners than for existing members, this could lead to a possible claim for discrimination – for example on the grounds of age (age discrimination regulations are to be in force by December 2006).

Where the benefit type is to be changed for existing as well as future members, the effect on accrued entitlements needs to be considered. Section 67 of the Pensions Act prohibits amendments which would or might affect any accrued entitlement of any member of the scheme; therefore, a guarantee will need to be provided that benefits accrued in relation to past service will not be reduced. Actuarial advice needs to be sought. In addition, there are employment law issues: the terms of the employment contract need to be considered and requirements of employee consent and consultation considered.

Conclusion

From the employer's perspective, pension fund deficits through disclosures in the accounts and funding obligations impact on the profitability of the business. This has caused companies to consider the nature of the pension plans they offer. From a trustee's perspective deficits impact upon their duties and require positive action to be taken to remedy the situation. Trustees need to find a balance between increasing liabilities on the employer and protecting the interests of pension scheme members, who are increasingly concerned that they may lose out.

Typical methods for dealing with deficits are increasing levels of contributions and restructuring the level of benefits offered under the scheme. In taking this approach possible member and union action must be considered. Alteration of the investment policy and the impact on transfer values may also need to be considered. Winding up the scheme is generally seen as a last resort and increasingly less viable given the future legislative requirement that benefits be fully bought out.

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