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# Recent Changes to U.K. Pensions Legislation

by Paul Geeson

Recent years have seen pensions rise steadily up the political agenda in the United Kingdom. The trend started in the 1990s with the collapse of the Mirror Group Pension Scheme, when it emerged that the late Robert Maxwell had walked off with a substantial proportion of the pension fund. Measures to protect members of occupational pension schemes were introduced in the 1995 Pensions Act which created a new regulator for occupational pension schemes and required all defined benefit schemes to meet the Minimum Funding Requirement (MFR).

Unfortunately, over time, the measures introduced by the 1995 Act proved inadequate to address the problems in defined benefit schemes. The assumptions on which the MFR was based proved increasingly unrealistic, and most schemes are now in deficit on an ongoing basis. (The total deficit in FTSE100 companies on the FRS17 accounting basis has been estimated at £130 billion with the total deficit in all UK schemes likely to be around double that). Opra, the regulatory body introduced by the 1995 Act, turned out to be a toothless box-ticker.

There were also concerns about what happened to members' benefits when a defined benefit scheme went into wind-up: a debt was levied on the employer, but only based on MFR for non-pensioner members, meaning that many members received only a fraction of their benefits when secured by annuity policies. Even worse, in many cases the employer was insolvent and no debt at all could be recovered, leaving many non-pensioner members with practically no benefits once pensioner liabilities had been secured.

The first key step in remedying this situation was that, from June 11, 2003, a solvent employer winding up a pension scheme was required to pay a debt to enable the scheme to buy out all liabilities (pensioner and non-pensioner) in full. The 2004 Pensions Act has then built on this foundation to increase the security of the defined benefit promise to members. Many of the changes in the 2004 Pensions Act also derived from a need to comply with the EU Directive on Occupational Retirement Provision.

## Pensions Act 2004

The three key areas covered by the Act are:

- The introduction of a new Pensions Regulator with much wider powers to intervene in the running of pension schemes.
- A compensation scheme called the Pension Protection Fund (PPF) to provide a certain minimum level of benefits to members of defined benefit schemes, which are under-funded following the insolvency of their sponsoring employer.
- A new Statutory Funding Objective to replace the existing MFR.

## Pensions Regulator

The Pensions Regulator came into being on April 6, 2005, taking on all the existing powers of Opra, but with a much wider set of powers keyed to three main objectives:

- To protect the benefits of members of "work-based" pension schemes (i.e. occupational pension schemes and other pension schemes to which employers contribute).
- To reduce the risk of situations that may result in claims on the PPF.
- To promote good administration of work-based pension schemes.

The Regulator has indicated that it aims to use its powers sparingly. Rather than impose solutions, it wants to bring about a sea change in the way that trustees and employers view their defined benefit pension schemes and to encourage a change in their behavior. In particular, it has indicated that trustees should view a scheme in deficit as a material unsecured creditor of the employer, and should therefore learn from the way that a bank that has issued a large loan to the employer. Trustees should monitor the employer covenant, i.e., the employer's willingness and ability to support the scheme. This new approach can be seen in two areas in particular: clearance and scheme funding.

## Clearance

The Regulator has the power to issue contribution notices to an employer where there is an action (or failure to act) to avoid the debt due to the scheme in the event of it winding up. This could require the employer to pay up to the full value of the debt (based on the cost of securing benefits with annuities) into the pension scheme.

It can also issue *financial support directions* where the sponsoring employer has insufficient resources to meet at least half of the winding up debt and where there is another company in the group that does have the resources or where the sponsoring employer is classed as a 'service company.' The employer must make proposals for other companies in the group to back all or part of the pension liabilities and the Regulator will then approve these proposals. If the employer does not comply, then the Regulator can issue a contribution notice.

These new powers caused considerable alarm when first proposed. While the aim is clearly to avoid the moral hazard of employers trying to 'beat the system' by manipulating corporate structures to avoid becoming liable for the pension scheme debt, many people were concerned that apparently innocent corporate transactions could later fall foul of a contribution notice or financial support direction. In order to allay such fears, the concept of *clearance* was introduced.

The Regulator has the power to issue *clearance statements*. The idea is that those who may be carrying out transactions involving companies with defined benefit schemes can have greater security by obtaining clearance from the Regulator before the transaction takes place. Clearance means that the Regulator agrees that the main aim of the transaction is not to avoid pension liabilities and so the employer should then not be liable to either a contribution notice or financial support direction.

Applying for clearance is optional and the Regulator has issued guidance to indicate the sort of situations where it thinks it may be appropriate to seek clearance. These are when one of the following events occurs, where a scheme is in deficit on a FRS17 or IAS19 basis:

- A change in priority—a change in the security given to creditors, e.g., the granting of a fixed or floating charge.
- A material return of capital—a reduction in the overall assets of the company, which could be used to fund a pension deficit, e.g., dividends, share buy backs, de-mergers.
- A change in control structure—a change in the group structure of an employer, which reduces the overall employer covenant, e.g., change of employer or participating employer.

In addition, the employer must try to obtain trustee agreement to their proposals. The trustees are expected to be able to negotiate with the employer in the same way as any material unsecured creditor and should seek to obtain additional security for the scheme where appropriate.

It has been observed that, while contribution notices and financial support directions are likely to be rare in practice, the Regulator is using the clearance process as a way of drawing trustees' attention to the possible implications of corporate transactions to the scheme and employers' attention to the fact that they cannot ignore the pension scheme deficit when making corporate decisions.

## Scheme funding

The new Statutory Funding Objective (SFO) will be phased in over the next three years. Schemes will be required to have sufficient and appropriate assets to meet their liabilities; however, whereas the MFR was a set basis that applied to all schemes, it will now be up to the trustees to decide how this applies to their scheme. In so doing, trustees

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will need to take actuarial advice and, in most cases, obtain the employer's agreement to their decisions on scheme funding. For many schemes, this represents a shift in the balance of power towards the trustees, with the trustees setting the funding agenda rather than the employer. The actuarial role has in turn shifted from recommending a contribution rate to providing appropriate advice to the trustees to enable them to make a decision. For many trustees, it means that they will need a much better understanding of the basic principles of scheme funding than is currently the case.

Once again, the Regulator has issued guidance (at present in draft) to attempt to influence behavior, indicating its views on what it sees as appropriate funding targets and deficit recovery periods. While these are not legal requirements, the expectation is that many schemes and employers will attempt to follow them in order to avoid possible regulatory intervention. The Regulator indicates that it may intervene where schemes have a funding target below 70 percent to 80 percent of the cost of securing annuities (which is roughly equivalent for typical schemes to full funding on FRS17) or where the deficit recovery period is more than 10 years. However, it has also confirmed that it will take the affordability of contributions into account, and will not necessarily intervene where trustees have a longer recovery period or weaker funding target where they can demonstrate that they have taken appropriate advice about what the employer can afford.

## Pension Protection Fund

The clearance and scheme funding measures described above are aimed at ensuring that defined benefit schemes will be better and more securely funded in the future. The Pension Protection Fund (PPF) is primarily there for those schemes for which these measures are too late. The PPF opened for business on April 6, 2005 and, by December 2005, there were 29 schemes in the assessment period. Once schemes have successfully completed the assessment period, the assets of the scheme will be transferred to the PPF, which will then take over the responsibility for paying out compensation to affected members. The compensation is set at providing 100 percent of pensions for members over normal pension age, with 90 percent of pensions subject to a cap for those under normal pension age.

PPF compensation will be funded partly by the assets received from schemes transferred into it and partly by a levy on all defined benefit schemes potentially eligible for the PPF. This levy aims to raise £575m across the United Kingdom in the 2006/7 year, and consists of a scheme-based and a risk-based element. The former is based on the value of the scheme's liabilities on a prescribed basis and the latter on the level of underfunding in the scheme and the probability of insolvency of the sponsoring employer. For many schemes where there is serious underfunding or where the employer insolvency risk is high, the risk-based element will be a very significant amount that could in itself add to the scheme deficit or to the increased likelihood of insolvency if the employer meets the cost of the levy. The PPF has reduced the impact by announcing that the risk-based element will not exceed 0.5 percent of the scheme's liabilities.

The government has stated that it does not intend to act as guarantor for the PPF, despite calls from many organizations for it to do so. This means that it is unclear what would happen should the fund become technically insolvent as has the Pension Benefit Guaranty Corporation the United States. There is, however, scope for the PPF benefits to be reduced and also for the PPF to borrow money on a short-term basis.

Compensation will not be retrospective. This has resulted in the Financial Assistance

Scheme (FAS) to provide some assistance (considerably less than that from the PPF) to members of underfunded schemes which commenced wind up between Jan. 1, 1997 and April 5, 2005 and so are not eligible for compensation from the PPF. So far the scope of the FAS is extremely limited, with payments only being promised to members within three years of retirement as of May 2004.

## Tax Simplification

Alongside these major reforms to defined benefit occupational pension schemes, the United Kingdom is also about to see sweeping changes to the taxation regime applying to all non-state pension schemes, which are due to come into force on April 6, 2006 (known as A-Day). The intention is to simplify the existing complex arrangements for taxation of pension schemes and introduce one unified set of tax rules for all pension schemes. The basic outlines of the new regime are simpler and should provide greater scope for most individuals to contribute more to their pension schemes in a more flexible manner; however, there are many complications in areas of detail, and further changes continue to be announced even though A-Day is now very close.

After A-Day, there will be a single lifetime allowance of tax-privileged savings at retirement (set at a capital value of £1.5m per annum at A-Day and increasing annually thereafter). Funds in excess of the lifetime allowance are subject to a recovery charge of 25 percent in addition to income tax at 40 percent. For defined benefit schemes, the capital value will be calculated by multiplying the annual pension by a factor of 20, irrespective of the member's sex or age. Individuals who already have benefits in excess of this value at A-Day will be able to apply for transitional protection. There will also be a restriction on the amount of additional tax-privileged savings that can be made in any year (set at £215,000 initially). For the vast majority of people in the United Kingdom, these allowances will leave individuals free to pay as much as they can afford into their pension schemes.

## The Pensions Commission

While the Pensions Act attempts to address some of the legacy problems of defined benefit pension scheme provision and the new tax regime hopes to provide simpler and more flexible opportunities for members to save for retirement, there remain deep problems within the U.K. pensions system as a whole. A government-sponsored pensions commission has just produced its recommendations for reform. The key proposals are an increase in state provision partly paid for by a rise in state pension age and a low-cost savings scheme into which employees will be automatically enrolled. The government is expected to indicate in spring 2006 which of these proposals they plan to adopt. Whatever the government says, it looks likely that the pace of change to the U.K. pensions scheme is not set to slow down just yet. □

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