Some Common Approaches to Pension Plan Deficits

1. Introduction

Occupational pension plan deficits are becoming headline news. Deficits have been caused principally by poor investment performance, low interest rates and increased member longevity. The existence of a deficit has caused concern to all parties involved in a pension plan. Various strategies have been developed to alleviate or deal with a pension deficit. This newsletter briefly considers some of the common approaches.

2. What is a deficit?

A pension deficit (rather like a surplus) has no specific definition. It is a meaningless phrase unless expressed by reference to some measurable solvency standard. There is a fundamental difference between:

- an accounting deficit;
- a statutory deficit;
- an ongoing deficit;
- a winding-up deficit.

Accounting deficits

Financial Reporting Standard 17 (FRS 17) has caused concern for many employers.

Broadly, FRS 17 requires a market-based approach to valuing pension liabilities and assets. In particular, liabilities are discounted by reference to corporate bond yields. Any pension deficit must be shown on the balance sheet. International Accounting Standard 19 (which is to be adopted from 1 January 2005 for EU based and listed companies) also follows FRS 17 in its market-based approach.

The principal worry is the effect a disclosed accounting deficit may have on an employer’s credit rating. This may, as a consequence, inhibit an employer’s ability to raise capital. In extreme cases, the possibility of making dividend payments may be affected if a deficit reduces distributable reserves. An accounting deficit does not, however, necessarily have a negative cash flow consequence.

Statutory deficits

Exempt approved defined benefit occupational pension schemes are currently subject to the Minimum Funding Requirement (MFR) of the Pensions Act 1995. The MFR requires schemes to:

- obtain regular (and sometimes emergency) valuations to assess a scheme’s funding position on a government prescribed basis;
- determine the appropriate funding level;
- revise the contribution schedule from time to time; and
- deal with serious deficits.

An MFR deficit must normally be rectified by the end of the period covered by the schedule. This is usually five years. Where a serious deficit (less than 90% funded) exists, action must be taken within three years.

Ongoing deficits

Many schemes contain an employer contribution rule that requires schemes to be funded at a higher level than MFR. This often produces a higher deficit than an MFR valuation. What is critical is the assumptions used to determine the funding position. How these are set depends on each scheme’s own rules. Likewise, how any disclosed deficit is dealt with will be determined in accordance with the scheme’s contribution rule. The trustees and employer’s
respective bargaining positions are dictated, to a large extent, by an interpretation of the balance of power in the employer contribution rule. The balance of power in other rules (e.g. the winding-up rule) may also be relevant.

An employer may, depending on the terms of its scheme, often need to take little or no action beyond funding for MFR. Conversely, an employer may be required to make significant cash injections.

The Government has announced proposals in the Pensions Bill to replace MFR with a statutory funding objective. This will result in a shift in the balance of power between trustees and employers. The statutory funding objective will require all aspects of funding (including how to deal with any deficit) to be agreed between trustees and employers. Any disputes will be referred to the proposed new regulator.

Winding-up deficits

Section 75 Pensions Act 1995 imposes a statutory underfunding debt on all employers when a scheme winds up in deficit. Historically, where a solvent employer’s scheme wound up in deficit benefits of pensioners needed to be bought out in full with insurance contracts. Benefits of other members, however, only had to be met on an MFR basis. This basis is less than the cost of buying out those members’ benefits with insurance contracts. This has meant many non-pensioner members receiving only a fraction of their pension.

As a result, the Government issued new regulations which apply retrospectively to any scheme that winds up after 11 June 2003. This legislation requires a solvent employer to ensure that a scheme has sufficient assets to secure members’ liabilities on a full buy-out basis. As many schemes are significantly underfunded on a buy-out basis, this may mean employers are required to pay large cash contributions to the scheme.

A small number of schemes may also contain an employer contribution rule that in any event currently requires employers to fund the scheme on the expensive buy-out basis on winding-up.

3. Common ways of dealing with a deficit

There are many different ways of dealing with a deficit. What is important is that each pension scheme is different and the following list is not exhaustive. Common ways of dealing with deficits are:

- increase the employer contribution rate either on an instalment or lump sum basis;
- introduce or increase member contributions;
- change future service accrual;
- change/modify early retirement terms;
- change investment strategy;
- cap pensionable remuneration;
- reduce transfer values;
- wind-up the pension scheme.

4. Employer contribution increases

This is the simplest (but not necessarily the cheapest) way of dealing with a deficit. Depending on the exact terms of the underlying scheme, it may be possible to fund the deficit by a one-off lump sum payment. Equally, some employers have negotiated lower contributions in return for granting some form of security over the employer’s assets.

5. Increased member contributions

The terms of a scheme would usually allow an amendment to be made to introduce or increase member contributions. This usually (but not always) requires trustee consent. Generally, employee consent would be required either as a matter of contract law or because the employer will need authority to deduct higher (or new) contributions from wages. Prior consultation with the employees is often advisable.

6. Change future service accrual

Three principal options are:

- close scheme to new entrants leaving existing members unaffected;
- close scheme to new and existing members and introduce a money purchase section for future service;
- close scheme to new entrants and change the future service benefits of existing members.
If the new arrangement is less generous, any potential sex (and, from 2006, age) discrimination should be considered. If the change is to apply to existing members, the following will need to be considered:

- any requirement for consent;
- any requirement for consultation;
- the actuarial effect;
- whether the change is prohibited by any statutory or scheme specific restriction on the amendment power.

7. Modify early retirement terms

Pension scheme rules will generally allow a member to retire early after age 50. Early retirement pensions can be costly as they are paid earlier and for a longer period. It may be possible to reduce costs by changing the practice on early retirement. Any change usually raises legal issues. Different legal considerations apply if the early retirement pension is subject to trustee or employer consent.

If trustees’ consent is required, they may be able to withhold consent where they believe it would be fair to other members. This might be the case if the trustees were concerned about the employer’s funding covenant or the scheme’s funding position.

If the early retirement pension is subject to employer consent, there is generally more flexibility. The employer must, however, exercise the power in good faith. Moreover, custom and practice may mean that members have a legal right to retire early. An assessment of each member’s legitimate expectation is also often advised.

Finally, the early retirement reduction factors could be reviewed to try to make them cost neutral. This would usually require a scheme amendment and confirmation from the scheme actuary that the member’s accrued rights were not being adversely affected.

8. Change to investment strategy

Consideration can be given to the effect that altering a scheme’s investment policy would have on any deficit. Equally, the accounting impact of a volatile investment strategy should be considered. Trustees will need to consider their fiduciary duties in effecting any change. In addition, the scheme’s employers will need to be consulted and expert investment advice obtained and considered. Finally, any change will need to be reflected in a modified statement of investment principles.

9. Cap pensionable remuneration

The pension consequences of annual pay negotiations can be considered. It might be possible to make a pay increase offer subject to the employee agreeing that some or all of the increase is not pensionable. The definition of pensionable pay in the scheme documents would need to be considered. Case law also indicates that care needs to be exercised in any increased pay offer wording to ensure that the employee has in fact agreed that the pay rise is not pensionable. If pay is subject to a collective agreement, other considerations may also apply.

10. Reduction in transfer values

New regulations allow transfer values to be reduced where the scheme has a deficit. The deficit must have been determined by the scheme actuary acting in accordance with the relevant actuarial guidance notes. This requires the actuary to inform the trustees where a full cash equivalent payment would reduce the security of benefits payable to other beneficiaries. The reduction cannot, however, be greater than the level of underfunding. In addition, the residual transfer value must, as a minimum, cover certain preferential liabilities.

11. Winding-up

As a last resort, some employers have taken steps to wind-up their pension schemes. Employment contracts and other associated literature would need to be checked to see whether consent was required. Sometimes, this option also requires consent of the trustees. Generally, case law requires the employer to be able to justify the winding-up.

On winding-up, the scheme employers will be responsible for their share of the statutory debt under Section 75 Pensions Act 1995 (see 2 above). This may (even more so following the new winding-up deficit regime) require large lump sum payments.
Further Information

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If you require advice on this issue or other issues in relation to pensions matters, please contact:

John Papadakis, Partner
+44 (0)20 7039 5272
jjpapadakis@jonesday.com

Martin Scott, Partner
+44 (0)20 7039 5270
mscott@jonesday.com