

corporate briefing



Section 75 debt – draft amending regulations look to reduce the barrier to corporate activity

Summary

Draft amendments to the Section 75 debt regulations will bring about welcome changes, although they do not go as far as some would wish.

The proposals raise issues around Section 75 debt on scheme closure and potentially scheme mergers.

The appendix to this briefing looks at options to help manage debts arising before the amending regulations come into force.

Background

Currently, Section 75 debts, triggered when a participating employer ceases to have any employees in a multi-employer pension scheme, can be a barrier to many employers carrying out their business – hindering or even preventing corporate activity.

On 7 August 2007, the Department of Work and Pensions (DWP) issued draft amendments to the regulations with the stated aims of providing more flexibility for employers (particularly in the area of corporate restructuring) and making the regulations easier to operate.

The consultation runs until 1 October 2007 and the aim appears to be for the new regulations to come into force in December 2007. The changes will not be retrospective and therefore will only apply to debts that crystallise after the amending regulations come into force.

In this briefing, we explore how the proposed changes would impact multi-employer schemes. We also include an appendix looking at the options currently available to employers to manage debts arising under the current regulations.

The current position and the need for change

By default, the Section 75 debt in a multi-employer scheme is the departing employer's share of the overall buyout shortfall.

There are fairly limited methods that allow employers and trustees to reduce the debt below this amount:

- **Withdrawal arrangements** – a departing employer pays a lower debt and a guarantee is provided for the balance. This requires Pensions Regulator agreement.
- **Offsetting contributions** – the debt is paid and then offset against future contributions.
- **Apportionment** – a lower debt figure is agreed by the trustees and employer.

In practice, these have proved problematic: a withdrawal arrangement requires the Regulator to be satisfied that the debt is 'more likely to be met' as a result of the arrangement being entered into – this can be an onerous test; offsetting contributions can require a significant cash outlay; and apportionment needs to be specifically provided for in the scheme's rules which requires the agreement of the trustees. These methods are discussed in more detail in the appendix, as they remain relevant for debts that crystallise before the amending regulations come into force.

In addition, there are difficulties in calculating the debt as lack of data makes it difficult to identify all liabilities relating to an employer and, particularly for larger schemes, the 'buyout cost' can often not be determined in practice.



The proposed amendments

The draft regulations propose a number of changes to the way Section 75 debts are calculated. In particular, they propose four possible methods for determining the debt:

- **Liability share** – the debt (as at present) is proportionate to the liabilities in respect of service with that employer.
- **Scheme apportionment arrangement** – the trustees and employer agree to apportion the overall scheme deficit in a different way, typically allocating a lower amount to the departing employer than the default. In this case, the trustees must be satisfied that the remaining employers will be able and willing to meet the cost of the liabilities.
- **Cessation agreement** – the trustees, employer and a guarantor agree that a lower debt payment (the minimum amount being based on the scheme specific funding objective rather than a buyout cost) will be made with the guarantor assuming contingent liability for the balance. Because of the existence of the guarantor, the criteria for trustee agreement are intended to be less prescriptive than for a scheme apportionment arrangement.
- **Withdrawal arrangement** – (as at present) the Regulator approves an arrangement between the trustees, employer and a guarantor to make a lower debt payment. However, the test that the Regulator needs to apply has been made easier.

Table 1 compares these methods. In addition, a 'regulated apportionment agreement' has been introduced for limited cases where an insolvency event leading to possible entry to the Pensions Protection Fund (PPF) is expected within the next 12 months.

There are a number of other changes included in the consultation document, at least one of which could have a significant adverse impact on pension change:

- A debt would be triggered if all employers cease to employ active members at the same time, for example, if a multi-employer scheme closes to future accrual – this could cause significant issues for those companies who are considering such an option.
- Employers who have ceased to have active members but expect to employ one or more in the near future will have a possible 12-month 'grace' period before a debt is triggered.
- Where a member has been employed by more than one employer but the scheme's records do not enable a division of liabilities between those employers, the Section 75 debt would be calculated on the basis that all liabilities attributable to a member should be attributable to his last employer.
- The debt calculations may be based on updated asset and liability figures from accounts and an actuarial valuation that are up to 12 months old.
- A new provision whereby, if a market buyout cost is not available, the actuary can instead estimate the cost in an 'appropriate' manner.

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Table 1 | A comparison of the different debt sharing methods

	Liability share (default)	Scheme apportionment arrangement	Cessation agreement	Withdrawal arrangement
Basis for calculating immediate debt	Buyout	Trustees and employer agreement	Scheme specific funding objective	Scheme specific funding objective or lower (with Regulator agreement)
Guarantor required?	No	No	Yes	Yes
Trustee agreement required?	No	Yes – must be satisfied that the remaining employers are able and willing to meet the cost of the liabilities	Yes – ability and willingness to fund the scheme not adversely affected by the agreement and the guarantor has adequate financial resources to cover remainder of buyout debt	Yes
Regulator approval required?	No	No	No	Yes – with a simpler test for approval than at present
Restrictions on timing of agreement	N/a	Before or after withdrawal	Before or after withdrawal	Before or after withdrawal

Commentary

The suggested amendments do not go as far as many employers would like – Section 75 debts could still be triggered by corporate actions that do not adversely affect the employer covenant (for example, group reorganisations and small sales/acquisitions).

There are some further concerns – most notably that a debt will be triggered if all employers in a multi-employer scheme cease to employ any active members, for example, as a result of a decision to cease future accrual of benefits. Any scheme mergers would also require careful consideration in the light of the new regulations.

However, there are a number of changes that are very welcome. As long as the pension scheme is not jeopardised, the draft regulations introduce new ways for companies and trustees to negotiate corporate transactions and remove some of the barriers to corporate activity.

Appendix

Interim methods for reducing Section 75 debts

The proposed amendments are not expected to come into force for some months and will then only apply to debts that crystallise after they are in force. These amendments are, therefore, of little help for companies currently going through transactions or restructuring. Using short case studies, we look at some of the methods that employers and trustees have been using thus far to reduce or remove Section 75 as a barrier to corporate activity.

Withdrawal arrangements

Until the new regulations come into force, under a withdrawal arrangement the payment required is calculated on the minimum funding requirement (MFR) basis. The remainder of the debt is guaranteed, for example, by another employer within the group.

Withdrawal arrangement – a case study

Company A was looking to sell a subsidiary, Company B, for £2 million. The Section 75 debt associated with the subsidiary was £10 million (although there was no MFR deficit). Company B could not pay this debt and as such the sale could not proceed without a withdrawal arrangement.

Companies A and B entered into a withdrawal arrangement with the pension scheme trustees which meant there was no immediate debt payment. Company A became a guarantor of the debt and the sale took place. In addition, Company A agreed to meet Company B's share of the scheme's accounting deficit (£3 million) over 4 years.

Offsetting contributions

This approach involves paying the Section 75 debt in full but reducing future company contributions by the payment made. There is no reduction in the immediate cash requirement, however, no additional cash is ultimately paid.

This approach works particularly well where a group is being restructured (or the selling company agrees to pay the Section 75 debt) as the companies that agree to take on responsibility for paying the debt can benefit from the reduction in the future contributions.

Offsetting contributions – a case study

Company C had a deficit of £45 million disclosed at its first scheme specific funding valuation. It agreed to meet this deficit by cash payments of £6 million over 9 years. Following the valuation, a subsidiary was sold triggering a Section 75 debt of £50 million.

As part of the sale, Company C agreed to pay the Section 75 debt on behalf of the exiting employer and agreed with the trustees that this would be considered an advance payment of the total deficit contributions which would cease immediately.

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Apportionment

The default position under the current legislation is that the Section 75 debt is equal to the exiting employer's share of the scheme's buyout deficit allocated in proportion to the employer's buyout liabilities. However, legislation currently allows the rules of a scheme to specify how any debt is apportioned. Using this approach, the Section 75 debt payable by the departing employer can be reduced to effectively zero.

Very broadly an amendment is made to the scheme rules before a transaction takes place, which allows the trustees to consent to apportion a nominal debt to the exiting employer and allocate the remaining liabilities of that employer to another group company. It is usual to seek Regulator clearance to each apportionment.

Apportionment – a case study

Company D agreed with the trustees to amend the scheme rules, giving the trustees discretion in advance of the cessation event to reduce the debt on any exiting employer to £1. The remaining liabilities in relation to that employer would be allocated to another participating company. The trustees will consider each case on its merits and clearance will be sought on a case by case basis.

Please note this briefing is for general information only and legal advice should be taken when considering these options. Making a wrong decision could result in a Contribution Notice from the Regulator or the pension scheme no longer being eligible for the PPF.

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Managing pensions risk

Thursday 27 September 2007 at 4.30pm

For the next in our series of seminars, Watson Wyatt's Corporate Consulting Group will explore how scheme sponsors can holistically manage their pension risks. More information on this event, including a booking form, is available at www.watsonwyatt.com/europe/CorporateConsulting/ManagingPensionsRisk/default.asp

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