EXPLANATORY MEMORANDUM TO

THE OCCUPATIONAL PENSION SCHEMES (EMPLOYER DEBT AND MISCELLANEOUS AMENDMENTS) REGULATIONS (NORTHERN IRELAND) 2012

S.R. 2012 No. 1

1. Introduction

1.1 This Explanatory Memorandum has been prepared by the Department for Social Development to accompany the Statutory Rule (details above) which is laid before the Northern Ireland Assembly.

1.2 The Statutory Rule is made under Articles 75(5) and (10), 75A(1) to (4) and (5)(a), 122(3) and 166(1) to (3) of the Pensions (Northern Ireland) Order 1995 and Articles 2(5)(a), 64(2)(a), 110(5), 211, 280(1)(b) and (2)(b) and 287(3) of the Pensions (Northern Ireland) Order 2005 and is subject to the negative resolution procedure.

2. Purpose

2.1 These Regulations amend the Occupational Pension Schemes (Employer Debt) Regulations (Northern Ireland) 2005 to set out additional procedures to avoid a debt triggering where an employer no longer employs any active member of a defined benefit occupational pension scheme, but without any detriment to members or the ongoing funding of the scheme. They also increase the flexibility of employers to deal with employer debt whilst maintaining member protection, make a number of minor amendments to clarify the legislation and make consequential amendments to other sets of Regulations as a result of the introduction of the flexible apportionment arrangement.

3. Background

3.1 Where an employer's relationship with their defined benefit occupational pension scheme ends, existing legislation sets out requirements for the employer debt. This is the amount the employer must pay into the scheme in order to relinquish responsibility for the scheme. The amount of debt is based on the employer's share of any shortfall between the assets of the pension scheme, and the benefits owed to the scheme's members.

3.2 Once an employer debt triggers, there are a number of existing mechanisms in legislation relating to payment of the debt. These Regulations introduce additional flexibility for employers, whilst maintaining adequate protection for pension scheme members.

3.3 The Regulations amend existing legislation relating to the payment of a debt where an employer ceases to permanently or temporarily employ any active member of the scheme. For example, they –

- introduce additional flexibility to the existing ways in which employers exiting a multi-employer scheme can reduce the amount of debt they are required to pay (broadly, another employer becomes responsible for the departing employer's debt);

- extend the "period of grace" (where an employer loses the last active member of the pension scheme and employs another active member) from the current 12 month limit up to 36 months. They also extend the time that employers have to write to trustees to seek permission to use the period of grace from 1 to 2 months.

4. Consultation

4.1 There is no requirement to consult on these Regulations as they make in relation to Northern Ireland only provision corresponding to provision contained in regulations made by the Secretary of State for Work and Pensions in relation to Great Britain.

5. Equality Impact

5.1 In accordance with its duty under section 75 of the Northern Ireland Act 1998, the Department has conducted a screening exercise on the legislative proposals for these Regulations. As the amendments are largely technical in nature, the proposals would have little implication for any of the section 75 categories. In light of this, the Department has concluded that the proposals would not have significant implications for equality of opportunity and considers that an Equality Impact Assessment is not necessary.

6. Regulatory Impact

6.1 The impact on business, charities or voluntary bodies is beneficial. Businesses will be able to undertake corporate restructurings without triggering an employer debt. A copy of the Regulatory Impact Assessment is attached as an annex to this Explanatory Memorandum.

7. Financial Implications

7.1 None for the Department.

8. Section 24 of the Northern Ireland Act 1998

8.1 The Department has considered section 24 of the Northern Ireland Act 1998 and is satisfied that these Regulations –

(a) are not incompatible with any of the Convention rights,

(b) are not incompatible with Community law,

(c) do not discriminate against a person or class of person on the ground of religious belief or political opinion, and

(d) do not modify an enactment in breach of section 7 of the Northern Ireland Act 1998.

9. EU Implications

9.1 Not applicable.

10. Parity or Replicatory Measure

10.1 The corresponding Great Britain Regulations are the Occupational Pension Schemes (Employer Debt and Miscellaneous Amendments) Regulations 2011 (S.I. 2011/2973) which come into force on 27th January 2012. Parity of timing and substance is an integral part of the maintenance of single systems of social security, child support and pensions provided for in section 87 of the Northern Ireland Act 1998.

Annex

REGULATORY IMPACT ASSESSMENT

The costs and savings outlined in this Regulatory Impact Assessment are calculated on a United Kingdom-wide basis.

BACKGROUND

Employer debt

Defined benefit pension schemes provide pension benefits based on the individual member's salary, often his or her final salary, and the individual's length of service. The role of the employer in a defined benefit pension scheme is very important. The employer is the scheme's "sponsor" and if the funds in the scheme are insufficient to pay benefits, it is the employer's responsibility to make good the shortfall.

Where an employer's relationship with their under-funded pension scheme is ended, legislation sets out requirements for the "**employer debt**", which is the amount the employer must pay into the scheme in order to relinquish responsibility for the scheme. This is also called an "**Article 75 debt**"[1]. For a variety of reasons, it may no longer be appropriate for an employer to be the sponsor of a particular pension scheme. During a company restructure, when one company merges with or takes over another, an 'exiting employer' may sever its relationship with its pension scheme, and so trigger an employer debt.

The policy intention behind the employer debt legislation is to provide protection for pension scheme members after the departure of the sponsoring employer. The basis of the protection is that the scheme should be funded to the "full buy-out" level with sufficient monies to fully cover the cost of securing the members' benefits with a regulated insurance company. For larger schemes, employer debts as calculated on a "full buy-out" basis can amount to hundreds of millions of pounds.

The main reasons for the triggering of an employer debt are the insolvency of a participating employer, the winding up of the pension scheme or the occurrence of an "employment-cessation event". An **employment-cessation event** occurs when an employer no longer employs any members of the pension scheme, whilst other employers still employ active members. In these circumstances, the employer's relationship with the scheme is treated as ending, hence the requirement for the payment of the employer debt.

1 *See* Article 75 of the Pensions (Northern Ireland) Order 1995 and the Occupational Pension Schemes (Employer Debt) Regulations (Northern Ireland) 2005 S.R. 2005 No. 168.

Most commentators agree that an employer debt should be paid on an insolvency or winding up. But there has been a long running debate about the appropriateness of an employer debt triggering on the occurrence of an employment-cessation event. An employment-cessation event can occur in a variety of circumstances, for example where an employer's last active member[2] retires or leaves service. However a major cause of concern is where an employment-cessation event occurs as a result of a corporate restructuring. In such circumstances a requirement to pay an employer debt could lead to cash-flow problems for employers and the need to use the capital markets or borrow from banks for additional funds.

The starting point for the policy is that where an employer debt is triggered, the amount of the debt should be paid as a lump sum into the pension scheme. However, it is accepted that it may not always be feasible or necessary for the employer to fund the entire lump sum up front, and there are several easements[3] already in existing legislation which permit the payment of the debt to be deferred or the amount paid up to be safely reduced. One of these existing measures allows for the employer debt to be transferred or apportioned to another employer remaining in the scheme. (Option 2 below builds on this existing measure.)

The above paragraphs cover the situation where an employer experiences an employment-cessation event and has no intention of employing a member of the pension scheme in the future. However an employment-cessation event can occur where an employer **temporarily** ceases to employ an active member of the scheme. This issue has been raised by some faith groups who face difficulties when, for example, a minister may leave a church, but may not be replaced for a number of years. This currently triggers an employer debt if the replacement minister is not appointed within the existing 12 month "period of grace" provision. The **period of grace** is a provision whereby a debt does not trigger if an employer tells the trustees they intend to employ an active member of the scheme within 12 months of losing their last active member (and they do in fact re-employ an active member within that time). Faith groups that could be affected have called for a relaxation of the employer debt rules in this regard.

Rationale for intervention

There are a number of existing mechanisms in the Regulations for deferring the payment of an employer debt. But representations have been made from employers' representative bodies that they would like some extra flexibility. Any changes would not significantly increase the number of instances where the employer debt was deferred, but they would give employers and pension schemes another option, which may be more useful in particular cases, for example in dealing with a corporate restructuring.

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2 An active member is one who is employed by the scheme's sponsor and is making contributions into the pension scheme and accruing benefits within it.

3 Existing provisions for reducing the size of the employer debt paid up front include withdrawal arrangements and scheme apportionment arrangements.

For cases where an employer ceases to employ an active member on a temporary basis, the proposal is to extend the time period of the current 12 month "period of grace" provision up to a maximum of 36 months, but this would be at the discretion of the trustees. This would allow employers more time to replace their outgoing employees before triggering a debt. The intended effects are to relax the rules so that all employers (including faith groups) have more time to replace their outgoing employees. For example, in the case of faith groups, asset sales (for example of a church) would not be required in order to pay an employer debt where the intention is to replace the employee within the period of grace.

Policy objective

Commentators say that employer debts are often triggered inappropriately, for example when a corporate restructuring is being undertaken and no value leaves the group. The policy objective is to avoid a debt triggering where an employer ceases to **permanently** or **temporarily** employ an active member of the scheme, but without any detriment to members or the ongoing funding of the scheme.

The intended effects are to increase the flexibility of employers to deal with employer debt whilst maintaining member protection.

Description of options considered

Four options have been considered:

Option 1 Group guarantees

Option 2 Apportionment arrangements (preferred option)

Option 3 Extended period of grace (preferred option)

Option 4 No change

Discussions on the options have taken place with selected United Kingdom–wide stakeholders (for example the Pensions Regulator, the Pension Protection Fund, CBI, EEF, TUC and faith groups) have taken place in Great Britain. An informal consultation with a wider range of stakeholders was held between December 2010 and January 2011, to seek their views on options. In addition, in the same period, the views of a small group of industry practitioners were sought about various technical aspects of the Regulations. The Department for Work and Pensions also conducted a formal consultation on the equivalent draft Great Britain Regulations and on the Great Britain Impact Assessment between June and August 2011. The consultation on draft Regulations was on the preferred options 2 and 3. There were nearly 50 responses to the consultation. The results of the consultation as they relate to the Impact Assessment are considered below.

Policy Option 1: Group Guarantee Proposal

The purpose of the group guarantee option would be to allow companies within a group to restructure without triggering an employer debt.

The measure on group guarantees would be:

- available to group employers participating in a multi-employer pension scheme, and
- used with respect to employment-cessation events arising from a group or corporate restructuring.

Where guarantee arrangements had been entered into, an employer debt would not be triggered on the occurrence of an employment-cessation event where this arose as part of a corporate restructuring.

In the arrangements there would be two main safeguards for members:-

- **the funding test** contained in regulation 2(4A)(a) of the Employer Debt Regulations[4] would need to be met. The test requires the trustees to be reasonably satisfied that the remaining employers in the scheme would be reasonably likely to be able to fund the scheme and that it would have sufficient and appropriate assets to cover its liabilities on a technical provisions basis[5];
- **resources** - the trustees would need to be satisfied that at the date of the guarantee agreement, the guarantor(s) had sufficient financial resources to be able to pay the amount entered on the guarantee at that point in time.

Costs and benefits of the Group Guarantee Proposal

It has been difficult to quantify the costs and benefits of the options in this Regulatory Impact Assessment because government does not require employers to report the triggering of employer debts and how they are dealt with, nor any intentions about corporate restructuring. Doing so would impose an unnecessary burden on sponsoring employers for no reason. The Pensions Regulator has confirmed it does not possess data on the number of instances where employers participating in multi-employer schemes trigger an employer debt through their actions. There is no requirement on scheme sponsors to report the triggering of employer debts to the Regulator.

A best attempt to quantify costs and benefits has been made. In doing so, reliance has been made on informal discussions with industry figures with experience in this

4 The Occupational Pension Schemes (Employer Debt) Regulations (Northern Ireland) 2005 S.R. 2005 No. 168.

5 These are an estimate, made on actuarial principles, of the assets needed at any particular time to make provision for benefits already considered accrued under the scheme – in other words, what is required for the scheme to meet the statutory funding objective at a given date.

area to generate assumptions about take-up of the options and how employer debts are currently dealt with.

However in the formal consultation conducted between June and August 2011, the Department for Work and Pensions did endeavour to obtain more detailed information from respondents. As well as seeking views on the draft Impact Assessment itself, the consultation document also asked three questions to elicit respondents' views on: (i) the estimates used in the Impact Assessment; (ii) whether respondents had any additional data; and (iii) respondents' views on the methodology used in the Impact Assessment.

On questions (i) and (ii), the general consensus was that the estimates in the Impact Assessment might be too conservative – respondents considered that more employers would make use of the options than the estimates suggested, and the savings would therefore be higher. No substantive evidence of this was provided by respondents. On question (iii) respondents considered it was a reasonable methodology for an Impact Assessment. But respondents noted that in individual transactions the extent of savings could be affected by the nature of the multi-employer group and whether, for example, international taxation and accounting requirements were brought into play by the restructuring.

In the light of the fact that no substantive new evidence was provided in the consultation, government decided to make no changes to the cautious original assumptions and estimates. Similarly no changes have been made to the methodology. However the opportunity has been taken to update some of the figures used in the estimates. In particular, the figures have been updated to take account of firstly, the latest scheme funding position and secondly, the latest spread of AA yields over gilts. The assumptions and estimates used in the Impact Assessment are described in the following paragraphs.

Defined benefit scheme sponsors are not required to do anything unless they wish to make use of the easements introduced by these Regulations. If they choose to do so, they would inevitably incur some one-off administrative, legal and actuarial costs. These costs would vary considerably from scheme to scheme, but are estimated to fall in the range of £40,000 - 60,000. Actually paying an employer debt already involves a similar level of costs. So there are no *additional* costs of using this proposal. Furthermore, these costs would be small in relation to the estimated benefits to the employer of not having to pay an employer debt. In addition the costs would only be incurred if the employer felt it was in its commercial interests to do so ie if the expected benefits of taking up the option were greater than the costs of advice.

There may also be some costs in terms of impacts on members' benefits. The option would mean that instead of paying an employer debt to the pension scheme immediately, there would be an agreement that, if appropriate, it would be paid at some time in the future (under the terms of the guarantee). If at that future time, the guarantee could not be paid in full, it is possible there could be an effect on scheme funding and on members' pension benefits. However, given the very small number of employers to which this option could apply (see below), and the fact that guarantees could last for many years, it is not possible to estimate how many guarantors might fail to meet their obligations in the future, but reassurance would be provided by the trustees being able to end the guarantee arrangements where a material adverse change had occurred to a guarantor.

A shortfall in funding could also mean that an eligible scheme had to be admitted to the Pension Protection Fund (PPF). The PPF is funded by means of a levy on pension schemes, so potentially there could be another cost in terms of an increase in the levy requirement. But, just as it is not possible to estimate the number of guarantors who might fail to meet their obligations in the future, so it is not possible to estimate the number of schemes that might ultimately be admitted to the PPF for that reason.

The benefit of the group guarantee proposal is that unnecessary employer debts will no longer trigger, allowing corporate restructuring to be managed more effectively. No debt will be payable as a lump sum, and, there will be a wider benefit to employers who will find it easier to restructure their business.

However information from the pensions industry is that whenever an employer debt currently triggers, employers and pension schemes do in practice make use of the existing mechanisms in order to defer payment. The number of "new cases" using this option is therefore likely to be at the margins. In this context, "new cases" is taken to mean cases where the employer debt would otherwise be paid. Nonetheless, the benefits from this option would still be significant for the individual employers who use it

The flowchart below and the following paragraphs describe the assumptions and calculation of the estimated benefits.

Flowchart showing calculations of estimated benefits for group guarantees

1,975 Multi-Employer Schemes (MES), average of 5.5 employers per scheme, so 1,975*5.5= 10,862.5 employers in MES

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Employer Debt (ED) for 10,862.5 employers = £490bn

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Average per-employer ED = £490bn/10,862.5 = £45.1m

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1% of employers take-up = 1%*10,862.5 = 108.625 employers taking up

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Of these 108.625 employers, only 75% are eligible due to the restriction allowing only those with wholly-owned status to benefit. Because we do not know which schemes are wholly owned, we reduce the total ED by this amount, rather than the number of schemes: = 0.75*108.625*£45.1m = £3.7bn

↓

Average of 5.5 employers in a MES, and only one restructure per ME group. Again, because we do not know precisely which employer in the group would restructure, we multiply the total ED by (1/5.5). So total accidentally triggered ED would be £3.7bn*(1/5.5) = £668m

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The estimated benefits are the foregone real interest payments on this £668m of ED that would be accidentally triggered in the absence of this option, net of the increase in liabilities that arises from the debt no longer being paid off in full. These are £92.2m in present value terms over 10 years

The estimates of benefits are based on the following assumptions. There are 1,975 associated multi-employer schemes, with an average of 5.5 employers per multi-employer scheme[6], so 10,862.5 employers.

Information on assets and estimated liabilities (on a full buy-out basis) of these employers' pension schemes have been taken from a dataset provided by the Pensions Regulator at the end of February 2009. These scheme funding estimates have been updated to end July 2011 using information from the PPF 7800 Index[7], a monthly index showing the aggregate values of assets and liabilities of private sector defined benefit schemes covered by the PPF. The aggregate employer debt across the schemes estimated to be eligible to take advantage of the easement is currently estimated to be around £490 billion. This represents the excess of full buy-out liabilities over scheme assets. The per-employer amount of Employer Debt is simply £490bn/10,863 = £45.1 million.

6Source: The Pensions Regulator
7http://www.pensionprotectionfund.org.uk/Pages/PPF7800Index.aspx

Given the widespread use of existing mechanisms for dealing with employer debts, the number of "new cases" of employers using this option is expected to be low. Again based on discussions with contacts in the pensions industry, and in the absence of any other data source, it is estimated that the population eligible to use this option would be around 1 per cent of employers – 109 employers.

The measure is assumed to apply only to wholly owned United Kingdom companies; figures provided to the Department for Work and Pensions by the Department for Business, Innovation and Skills in Great Britain suggest that of all the subsidiaries of United Kingdom companies, around 75 per cent are wholly-owned. Because it is not known which of the 109 employers would take advantage of the easement, the adjustment is applied to the level of employer debt, rather than the number of employers. This yields 0.75*108.625*£45.1m = £3.7bn.

However, given that there are on average 5.5 employers in a multi-employer group, and typically only one in each group would be restructured in a way that could trigger an employer debt, the number of employers actually estimated to take advantage would be only (1/5.5) of the total. Again, because it is not known which employer within the group would restructure, this adjustment is applied to the level of employer debt, rather than the number of employers. This yields £3.7bn * (1/5.5) = £668m.

So the total Employer Debt that could be accidentally triggered in the absence of this proposal is £668m. Applying the adjustments above to the number of employers would give around 15 employers that would benefit from the measure (108.625*0.75*[1/5.5]). This shows that the number of employers expected to benefit is small.

For the purposes of calculating the monetised benefits of this proposal, it is assumed that all of these restructures will occur in year 1. Given the modest numbers involved, this seems a reasonable way of proceeding without knowledge of the future distribution of corporate restructures.

For the purposes of calculating the benefits of this proposal, the amount of the employer debt itself has not been counted as a saving. This is because amounts of the order of the employer debt may be paid when the scheme winds up and discharges its liabilities via a regulated insurance company. Instead the focus has been on employers' cash flow and an assumption that employers will have borrowed to meet the debt. However, a consequence of the debt no longer having been paid off is that sponsors will see a natural increase in their liabilities as a result of the unwinding of discounting – this increase would be equivalent to the discount rate, which on a full buy out measure would be an appropriate gilt yield. As an example, a debt of £10 million due to be repaid in 10 years would be discounted to £7.9m today (10 years of discounting at the assumed yield on 10yr gilts of 2.35% compounded).

With each year that passes, the debt increases by 2.35% due to one less year of discounting.

On this basis, the additional cost of borrowing to employers would be the interest on the debt. The monetised benefit to employers is calculated as the value of the interest payments that no longer have to be paid as a result of debt no longer being triggered net of the increase in liabilities that arise from the unwinding of discounting now that the debt is not paid off at once[8].

It is assumed that companies borrow by issuing 10 year corporate bonds and that their full buy out liabilities increase by the yield on a 10 year gilt. The current (August 2011) market yield on a10 year nominal gilt is 2.35%[9]. The current spread of 10 year AA bond yields over 10 year gilts is around 180 basis points. It is this spread that is relevant in calculating the estimated benefits, rather than the actual AA and gilt yields themselves, since the interest payments are based on the AA yield and the increase in liabilities is based on the gilt yield – and it is the difference between them that is the estimated benefit of the policy.

Based on the assumptions above, it is estimated that £668m of employer debt will no longer be triggered. Over 10 years the present value of aggregate real interest payments net of increases in liabilities will amount to around £92.2 million – with these interest payments now foregone following the introduction of the proposed policy option, net of the increase in future liabilities that arises as a result of the debt not being paid off, this figure now represents the benefit to employers. On the same basis the average annual real savings will amount to around £10.6 million – this is a simple average of the annual aggregate interest payments net of the increase in liabilities, expressed in real terms.

Although the number of “new cases” used in this costing is expected to be very low, it is possible that if the option was introduced, other employers would use it who would normally have used one of the existing mechanisms for dealing with an employer debt. This would be for scheme- or employer-specific reasons. However as the benefits and the costs for these employers of using option 1 would be broadly the same as for the existing mechanisms, these cases have not been included in the costing; they are instead classed as non-monetised costs and benefits.

The option would maintain the security of members’ benefits. In addition members will benefit from the additional flexibility this option gives to employers to run their businesses in a more efficient manner.

8This treatment of liabilities has been chosen following guidance from the independent Regulatory Policy Committee.
9Source: Bank of England. Data on gilt yields available to download from http://www.bankofengland.co.uk/mfsd/iadb/index.asp?Travel=NIxIRx&levels=1&FullPage=X4051&FullPageHistory=X4051&Nodes=X4051X4052X4053X4054&SectionRequired=I&HideNums=-1&ExtraInfo=true&B4054XBMX4051X4052X4053.x=7&B4054XBMX4051X4052X4053.y=7

Risks and assumptions

The monetised benefits shown in this Regulatory Impact Assessment derive from a dataset holding funding details for PPF-eligible defined benefit schemes as estimated at the end of February 2009, with a further estimate made of assets and liabilities at the end of July 2011. The estimated benefits are critically dependent on scheme funding positions. Defined benefit scheme assets and liabilities are measured on a mark-to-market basis[10] and can fluctuate significantly over very short time periods. The estimated benefits of this measure could therefore themselves fluctuate significantly. In fact, since the Impact Assessment accompanying the formal consultation was published, scheme funding positions have deteriorated significantly, on the back of falling gilt yields and asset prices resulting from concerns over the state of the global economy and the effects of the European sovereign debt crisis. As a result employer debts have grown significantly, and consequently, the estimated benefits of this measure, which are positively correlated with the size of employer debts, have grown too. This is a good illustration of why caution should be exercised when considering the estimates in the Impact Assessment.

A further important assumption is the spread of AA corporate bond yields over gilts. Both AA corporate bond and gilt yields and hence the spread between them, are market-determined figures. So in principle the estimated benefits are also sensitive to this yield. Since the Impact assessment accompanying the formal consultation ended, the spread between AA corporate yields and gilts has widened from 150 basis points to 180 basis points – again reflecting wider economic concerns – and this also acts to increase the estimated benefits, although only by a relatively small amount – the sensitivity to scheme funding levels is far greater.

The other key assumption affecting the size of the estimated benefits is on the proportion of “new cases” - employers who would make use of the easements where previously they would have paid the debt or taken steps to avoid a debt triggering. This is extremely difficult to gauge, but a modest assumption has been used, based on discussions with the industry. If the number of employers making use of the easement turns out to differ significantly from this assumption, then the benefits could also differ significantly. Again, this suggests that caution should be exercised when considering these estimates.

Finally, the safeguards put in place under this option are assumed to be effective such that the group guarantee proposal should not increase the risk to the PPF and, more widely, should not increase, or introduce new risks, to members’ benefits or to the viability of schemes.

There are however a number of risks associated with the proposal, which were articulated by respondents to the informal consultation referred to above. With a guarantee, the trustees of the pension scheme would be giving up their right to an

10 Their values are determined in the financial markets.

immediate payment of the employer debt in return for the right to a payment in the future. The risk is therefore on the trustees and pension scheme members rather than the guarantors. Steps could be taken to mitigate the risks: for example, the trustees would need to be satisfied about the resources of the guarantors; they would also need to monitor the financial health of the guarantor on an ongoing basis. There would also be a risk to trustees and the pension scheme if the guarantor were located outside the United Kingdom.

From the perspective of the guarantor, the risk would be that the trustees would take the opportunity of calling in payment of the guarantee on the occurrence of a material adverse change. Some respondents to the informal consultation were of the view that guarantee arrangements would not be entered into with this level of uncertainty about when payment would be demanded.

Policy Option 2: Apportionment Arrangements Proposal

The Employer Debt Regulations already make provision for apportionment arrangements. This option would extend those arrangements. Under the existing arrangements, where an employer ("Employer A") undergoes an employment-cessation event an employer debt is calculated; the debt is then passed over or apportioned to another employer ("Employer B"), (with their agreement) and the consent of the trustees of the pension scheme. The trustees in particular have to be satisfied that the apportionment will not have any adverse effect on the future funding of the scheme (they have to carry out the funding test).

Pension schemes' trustees and advisers have for some time commented that the existing apportionment arrangements are quite limited. One particular issue is why an employer debt needs to be calculated immediately, when, if it is apportioned, it may not be payable until many years in the future. This is particularly an issue because the calculation of an employer debt can be a costly matter.

To address these issues, option 2 would introduce a new flexibility into apportionment arrangements. Under the option an employer debt would not be calculated. Instead the liabilities of the departing employer (as above, Employer A) would be reattributed to another employer remaining in the group (Employer B). Commonly this is described as Employer B "stepping into the shoes" of Employer A. (Employer B as part of a corporate group would be willing to undertake this obligation because it would be for the benefit of the group overall.) The effect of this reattribution of liabilities would be that if, at some future time, Employer B ceased to participate in the scheme and its employer debt had to be calculated, it would be calculated by reference to the service of the members of the scheme Employer B had actually employed plus those members who had been employed by Employer A. (It should be noted that this reattribution would only be for employer debt purposes – it would not affect a scheme member's benefits or their employment record.)

Under this option, an employer debt would not be triggered on an employment-cessation event (and hence no debt would need to be calculated) provided that the following conditions were satisfied:

- the funding test was satisfied. Where there were a number of related employment-cessation events, perhaps as part of a corporate restructuring, only one funding test would be needed;

- all of the pensions liabilities of the departing employer were reattributed to another employer remaining in the group; and

- the trustees were content with the arrangements.

The advantages of this option would be that an employer debt need not be calculated for each employment-cessation event. In fact a debt might only need to be calculated when one of the employers became insolvent or when the scheme wound up. Provided scheme records were maintained in proper order the calculation of the amount of the employer debt should be straightforward. The option would build on existing apportionment procedures which are familiar to pension scheme trustees and advisers. Whereas with option 1 a guaranteed debt could be called in for payment on the occurrence of a material adverse change, this requirement would not apply to option 2. This would also give greater certainty to employers. Under this option, a corporate group could undertake restructuring exercises safe in the knowledge that an employer debt would not be triggered unexpectedly.

Costs and benefits of Apportionment Arrangement Proposal

The option would mean that instead of paying an employer debt to the pension scheme immediately, the pensions liabilities of the departing employer would be passed to another employer remaining in the scheme. If at some future date that employer underwent an employer debt event, it would be required to pay a debt representing its own liabilities and the liabilities it had taken on from the departing employer. If at that future time, the quantum of the new employer debt amount could not be paid, it is possible that there could be a cost reflected in a reduced level of scheme funding, which would have implications for members' pension benefits. However, given the very small number of employers to which this option would apply, and the fact that the new debt event might not occur for many years, it is not possible to estimate how many employers might fail to meet their obligations in the future, although this will be small and further reassurance is provided through trustees having to be content with the arrangements.

A shortfall in funding could also mean that an eligible scheme had to be admitted to the PPF. The PPF is funded by means of a levy on pension schemes, so potentially there could be a cost, reflected in an increase in the levy payment. But, as it is not possible to estimate the number of employers who will fail to meet their obligations in the future, so it is not possible to estimate the number of schemes that might ultimately be admitted to the PPF for that reason, but it is expected that this will be small for the reasons outlined above.

In terms of administrative costs, as with option 1, there would be some one-off administrative, legal and actuarial costs and these are similarly estimated to fall in the range of £40,000 - 60,000. In order for the apportionment arrangements to be effective, it would be necessary for scheme records to be maintained to a good standard, so that the move of responsibility for liabilities from one employer to another could be tracked. However this is part and parcel of good scheme administration and is something that trustees should be doing anyway. Trustees' responsibilities in this area are already set out in extensive guidance from the Pensions Regulator. No separate cost has therefore been included for this item.

This option uses the same methodology as option 1 for calculating the benefits. However two of the assumptions about take up have changed. Firstly it is assumed that the eligible population for this option would be around 2 per cent of employers in multi-employer schemes – 217 employers. (The equivalent assumption in option 1 is 1 per cent.) The reason for this higher assumption is that option 2 can be used in relation to any kind of employment-cessation event (whereas option 1 can only be used where the employment-cessation event occurs as a result of a corporate restructuring). The second assumption that has been changed is that option 2 is not restricted to wholly owned United Kingdom companies; the option can be used by employers in any kind of multi-employer pension scheme. The effect of these two different assumptions is that the estimate for the number of employers who could benefit is around 40. As with option 1, these assumptions err on the side of caution. The flow chart below sets out the assumptions underlying this.

Flowchart showing calculations of estimated benefits for apportionment arrangement

1,975 Multi-Employer Schemes (MES), average of 5.5 employers per scheme, so 1,975*5.5= 10,862.5 employers in MES

↓

Employer Debt (ED) for 10,862.5 employers = £490bn

↓

Average per-employer ED = £490bn/10,862.5 = £45.1m

↓

2% of employers take-up = 2%*10,862.5 = 217.25 employers taking up

↓

Average of 5.5 employers in a MES, and only one restructure per ME group. Because we do not know precisely which employer in the group would restructure, we multiply the total ED by (1/5.5). So total accidentally triggered ED would be 217.25*£45.1m*(1/5.5) = £1.8bn

↓

Estimated number of employers would be, following the steps above, 217.25*(1/5.5) = 39.5.

↓

The estimated benefits are the foregone real interest payments on the £1.8bn of ED that would be accidentally triggered in the absence of this option net of the increase in liabilities that arises from the debt no longer being paid off in full. These are

The other parts of the costing methodology are unchanged. Based on the assumptions above, it is estimated that £1.8bn of employer debt will no longer be triggered. Over 10 years, the present value of aggregate interest payments will amount to around £245.9 million. On the same basis the average annual savings will be around £28.3 million.

As with option 1, whilst the number of “new cases” used in this costing is low, it is expected that if the option was introduced, other employers would use it who would normally have used one of the existing mechanisms for dealing with an employer debt. This would be for scheme- or employer-specific reasons. However as the benefits and the costs for these employers of using option 2 would be broadly the same as for the existing mechanism, these cases have not been included in the costing; they are instead classed as non-monetised costs and benefits.

Risks and assumptions

The caveats about the assumptions used in option 1 also apply to this option.

The main risk attached to this option is that all of the pension liabilities of departing employers would be apportioned to a single remaining employer, who had insufficient resources to support them. The safeguard against this happening is that the trustees would have to be satisfied about the ongoing funding of the scheme (ie the funding test must be satisfied at each apportionment). In addition, if the trustees still have cause for concern, they can refuse to give their consent to the proposed apportionment. Another risk is that the liabilities would be reapportioned to another employer in the group who was not participating in the scheme, and therefore had no statutory responsibilities towards it. This will be addressed by a requirement in the Regulations that any employer to whom liabilities are apportioned must be a participating employer.

Policy Option 3: Period of Grace Proposal

Regulation 6A of the Employer Debt Regulations provides for “periods of grace”. The “period of grace” is a provision whereby an employer ceasing to employ an active member of the pension scheme does not trigger a debt if he tells the trustees he intends to employ an active member within 12 months (and in fact does so).

The proposal is that the period could be extended beyond 12 months at the discretion of the trustees. Regulations would however limit the trustees’ discretion to extend the period. The limit would be in terms of a maximum period for the period of grace of 36 months from the date of the original employment-cessation event.

As now, the employer in respect of whom the period of grace applied would continue to be an “employer” as required by regulation 6A(2) of the Employer Debt Regulations.

A further variant on this option was also considered in which there would be no trustee discretion to extend. An automatic extension of 36 months would be allowed in all cases. However, this has been rejected on the grounds that the increased risk to members’ benefits would be unacceptable.

Costs and benefits of the Period of Grace Proposal

There are no costs to this proposal. It does not impose anything on employers or require them to do anything differently.

The benefits of this proposal are unquantifiable, but are likely to be small. The proposal has been made in response to representations from faith groups. Very small employers are the type of employer most likely to benefit from this proposal. Faith groups have informed government that they find it difficult to borrow to pay an accidentally triggered debt – they would have to resort to forced asset sales to pay their debt. In doing so they would incur unnecessary transaction costs as well as the opportunity cost of selling those assets (ie the benefit of retaining them). So there are clear benefits of this measure for such employers.

No data is available on the employer debts of the affected faith groups; nor is anything known in advance about the likelihood or timing of employment-cessation events which lead to debts being inappropriately triggered. There is no past data on these employment-cessation events which could be applied to estimate the likelihood of any such events occurring in the future. Given this lack of data it is not possible to quantify the benefits but it is expected they will be small with any additional risks being mitigated by this option being available at trustee discretion. Scheme members will continue to see their benefits well protected; trustee discretion over the extension of the period of grace ensures that they will not see any increase in the risks to their benefits. They may even benefit from the increased security of their employer as a result of the change.

Risks and assumptions

There will be no material increased risks from this proposal to the PPF.

Policy Option 4: Do Nothing

There are already a number of mechanisms in the Regulations for deferring the payment of employer debt. However the pensions industry continues to press government for greater flexibility. Albeit that the immediate savings on "new cases" are small, it is likely that either option 1 or 2 would be useful as an alternative to the existing mechanisms. On balance therefore, the "no change" option is not considered the preferred way forward.

In the case of the extended period of grace proposal, government considers that the current rules are unnecessarily restrictive and could lead to faith groups having to resort to forced asset sales to pay off their unnecessarily-triggered employer debts. A relaxation of the rules would be an improvement - it is possible to make these employers better off without making members any worse off. For this reason doing nothing on the period of grace is not considered a preferred way forward.

Costs and benefits of the do-nothing option

There are no additional costs and benefits of this option.

Risks and assumptions

There will be no additional risks to members or the PPF.

Summary

Options 1 and 2 address the situation where an employer undergoes an employment-cessation event and does not intend to re-employ an active member of the pension scheme. Under both options, the trustees forego an immediate payment of an employer debt for an arrangement whereby the debt is paid at some time in the future. The gain for employers is financial, in respect of the savings they make from not having to pay interest on borrowings to meet the employer debt. The gain for pension schemes, particularly their members, is indirect. If their employer is stronger, it will be better able to support the pension scheme; and a stronger employer can also lead to greater job security.

Option 1, group guarantees, would introduce new guarantee arrangements into pension schemes. Although trustees are familiar with guarantees, they may well have concerns about entering into the complex legal arrangements that they can involve. Trustees may have concerns that once the arrangement is entered into, employers can continue to undertake further corporate restructurings without any employer debt being payable. Trustees may also be concerned that the guarantor can be a body that is not participating in the pension scheme, for example the principal employer who may be based abroad. On the other hand, employers will be concerned about how trustees interpret the requirements on “material adverse change” to call in the payment of the employer debt.

Option 2 will be more familiar to trustees and employers in that it builds on the existing apportionment arrangements which are the most commonly used method of addressing employer debt. The obligation to pay the employer debt will remain with another participating employer in the scheme, which will reassure the trustees about the arrangement. Trustees will also like the opportunity to consider each debt event separately and to carry out a funding test to determine whether a reapportionment will have any effect on the scheme. Employers and trustees will both welcome the fact that a single funding test can be used where there is a group of related employment-cessation events, perhaps on a restructuring.

The preferred option is option 2 because it gives trustees and employers increased flexibility within known boundaries. Option 1 on the other hand would mean a significant change to the way that schemes deal with employer debts and would introduce new uncertainties.

The proposals are permissive, and would complement (rather than replace) the existing options for dealing with employer debts. Although the “new cases” would be limited, it is expected that, for scheme specific reasons, some of the schemes who would normally use one of the existing mechanisms for dealing with the debt would use option 2.

Where an employer temporarily ceases to employ an active member of the pension scheme, the proposal in option 3 is to extend the period of grace from 12 months to a maximum of 36 months. The safeguard in the option is that the extension to the period of grace would be at the discretion of the trustees.

The preferred options are therefore options 2 and 3.

These Regulations give effect to options 2 and 3, the aim is to bring the Regulations into effect in January 2012.

IMPACT TESTS

Competition

There are no implications for competition policy.

Small firms

There are no specific impacts on small firms.

Health and well-being

There are no implications for health.

Human rights

There are no implications for human rights.

Legal aid

There are no implications for legal aid.

Rural proofing

There are no implications for policy on rural issues.

Sustainable development, carbon assessment, other environmental impact

There are no implications.

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed for the Department for Social Development

Anne McCleary

4 January 2012

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