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## **SCHEME ABANDONMENT: DISCUSSION PAPER AND GUIDANCE ISSUED**

### **1 INTRODUCTION**

Prompted by concerns over employers walking away from their underfunded defined benefit (DB) pension schemes, the Pensions Regulator (TPR) has issued a discussion paper on scheme abandonment, together with draft guidance on the issue for pension scheme trustees. Consultation on the documents runs until 9 February 2007.

### **2 KEY POINTS**

- The paper places an onus on trustees to identify and critically examine any arrangement that may result in the abandonment of their pension scheme.
- The guidance assists trustees in identifying arrangements which may result in scheme abandonment and directs them as to the types of factors to assess in reviewing the merits of a transaction for the scheme members.
- In TPR's view, where there is an employer of substance, abandonment is not likely to be in members' best interests.

### **3 WHAT IS ABANDONMENT?**

TPR explains that abandonment can arise in a number of different ways. However, it considers that there are two key parts to any transaction that may mean that it results in abandonment of the pension scheme.

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First, the covenant of the employer (the employer's financial position and prospects as well as its willingness to continue to fund the scheme<sup>1</sup>) that remains with the scheme may be nominal compared with the pre-transaction covenant. Second, the level of mitigation offered to the scheme is less than the full section 75 debt (i.e. the amount required to fully insure scheme benefits with a regulated insurer).

### **4 THE DRAFT GUIDANCE**

The draft guidance builds upon the issues raised in the discussion paper. It provides trustees with detailed information on the following:

- How to recognise arrangements that may result in abandonment;
- What factors to take into account when considering such arrangements and deciding on what action to take;
- What factors trustees should not take into account as primary factors in deciding what action to take; and
- TPR's desire for trustees to consult them at an early stage if they believe an arrangement could result in abandonment.

It also emphasises that trustees should take independent advice before agreeing to any proposed abandonment arrangement and that they should bear in mind that they need to reach a decision with the other parties that is in the members' best interests.

### **5 WHAT SHOULD TRUSTEES BE DOING?**

TPR recognises and welcomes the innovations that are helping employers and trustees better manage the risks inherent in DB pension schemes. While it requires trustees to give due consideration to such proposals which include,

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<sup>1</sup> TPR's Code of Practice No. 3: Funding Defined Benefits

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for example, buying out some or all member liabilities with a regulated insurance firm and the use of contingent assets, it is arrangements that may result in the abandonment of the pension scheme that draw its focus.

TPR expects trustees to place an especially high level of scrutiny on any arrangement that breaks the link with the current employer or that significantly reduces or removes the covenant provided by the employer to the pension scheme. In the discussion paper TPR sets out a list of factors it believes trustees should examine as a minimum. These include:

- The mechanism by which the link to the current employer is reduced or removed and whether it triggers a statutory debt to the pension scheme;
- Forming an independent opinion of the covenant of the current employer (by considering, amongst other things, the type and prospects of the industry in which the employer operates and its competitive position);
- The nature and structure of any group associated with the current employer and the potential for additional security this provides; and
- The covenant of the replacement employer (which may be a significantly restructured existing employer, together with the nature of its group);
- The security or form of mitigation being offered to the pension scheme (if any); and
- Any alternatives to the proposed arrangement.

## **6 TPR'S APPROACH**

TPR is keen, as noted in paragraph 4 above, for trustees and employers to report to it and consult with it on any arrangement that may result in the abandonment of the pension scheme at an early stage in the process.

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Essentially, TPR will approach potential abandonment transactions in the same way that it deals with clearance applications. In fact it urges the parties in such cases to consider making an application for clearance. Although it notes that it may well be reasonable for it to use its anti-avoidance powers in certain cases, for example issue a contribution notice against an employer who is deliberately avoiding liabilities, it stresses that entering into early discussion with it regarding the proposals may prevent such action being necessary.

While TPR's preferred outcome is a properly funded DB pension scheme with a solvent employer it will seek to strike a balance between reducing the risk to members' benefits and not intervening unnecessarily in the conduct of employers.

## **7 ALL CHANGE?**

In issuing these documents TPR is not really breaking any new ground. Although it states that its intention is to draw the issue of potential abandonment of schemes to trustees' attention, most trustees are already applying similar principles when faced with transaction proposals from their employer.

However, given the frequency with which trustees are now faced with such proposals, guidance from TPR on the approach they should be taking is to be welcomed. It is also helpful, from an employer's viewpoint, to have an explanation of how TPR will regulate this area.