

Managing A Closed Pension Scheme The Legal Aspects

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In this article we assume that you are the trustees of a final salary occupational pension scheme and the principal employer serves notice on you that it wishes to cease to contribute to the scheme.

What should you do next?

The first thing you need to check is whether the act of serving notice will trigger a winding-up of your scheme. The scheme's trust deed and rules will set out what happens when the principal employer gives notice that it wishes to cease to contribute.

If a wind-up is triggered, you should check whether your rules give you (as trustees) the power to defer the winding-up.

If you have the power to defer you must consider whether or not you should exercise it. If your rules do not contain this power, this is not the end of the matter for you. You will need to check whether section 38 of the Pensions Act 1995 applies to your scheme. This will broadly give you power to defer the winding-up where the winding-up has been triggered because the employer is insolvent.

We will assume here that there is the power to defer winding-up of the scheme.

Should Trustees exercise the power to defer winding-up?

If you decide to defer the wind-up you will be running the scheme as a closed scheme. There are many reasons why it may not be appropriate to exercise the power. Once an employer has given notice to the trustees that it wishes to terminate its liability to contribute to the scheme, generally it is no longer liable to contribute to the scheme for the accrual of future benefits (as the accrual of future benefits will usually stop once the notice expires).

The employer will therefore usually only be liable to pay contributions up to the minimum funding requirement ("MFR") in respect of accrued benefits (unless the scheme rules set out a more onerous obligation).

If the trustees decide to commence winding-up, they will be able to crystallise a debt equal to the value of the deficit in the scheme under section 75 of the Pensions Act 1995 (if any). The way this debt is calculated is based on the MFR (although please note that where the employer is not insolvent at the time of commencement of winding-up pensioners are valued on a buyout basis), so the trustees are faced with a choice of:

- (A) possibly collecting in the MFR deficit in instalments in the form of employer contributions (if they decide to defer winding-up); or
- (B) having the entire MFR deficit paid as a lump sum (if they decide to commence winding-up).

In many circumstances, option (B) would be the preferable approach because it is money up-front while deferring winding-up may put scheme trustees to the expense of paying running costs without this money up-front.

The expense of continuing to run the scheme is, more often than not, met by the scheme itself in this situation and when the scheme is in wind-up. This is a fact you will need to consider when deciding whether to continue the scheme as the deferral and wind-up itself can be a lengthy process. Trustees could come under considerable criticism if their scheme is underfunded, and the members perceive that their pensions are being further eaten away by the cost of administering the scheme, or the cost of obtaining the necessary advice to determine whether or not they should proceed to a wind-up.

There is also the risk that investment performance of the scheme's assets will deteriorate after a decision to defer winding-up, whereas a decision to wind-up immediately, lessens the duration of this risk. Any improvement in the funding position will only come about because the trustees have taken a gamble on investment performance which pays off. Generally, given their fiduciary responsibilities towards beneficiaries, trustees may not be able to justify taking such a risk unless the scheme is already well funded.

Therefore, if you are trustees of an underfunded scheme, you might have concerns about continuing the scheme given your fiduciary responsibilities in circumstances where the expenses of running the scheme on will eat into the money available to provide scheme members' benefits. Getting on with the wind-up at least crystallises the priority classes and avoids potential "priority drift", where more members over time become pensioners and move up the priority ladder in the rules. All the time during which the wind-up is deferred, the scheme remains subject to the MFR and the MFR position could be worsening. Once the wind-up commences then the MFR shortfall (if any) is addressed through the debt on the employer legislation.

Where might it be in members' best interests to defer winding-up?

There are, however, some situations where as trustees you might consider it in the best interests of beneficiaries to defer winding-up until a later date.

- Despite the potential downsides outlined, a well-funded scheme may be in a position to absorb volatility in funding levels and, taking the long view, the trustees may consider that they will be able to secure beneficiaries' benefits better by waiting for investment performance or annuity rates to improve.
- There are only a small number of insurance providers in the buy-out market (one firm of consulting actuaries recently suggested that there were only three). A common way of securing benefits on winding-up is by buying them out with an insurance company. Some providers have been known to stagger, or even refuse, buy-outs where a scheme is particularly large. Demand for immediate and deferred annuities is high, and, due to solvency and matching requirements, providers are obliged to invest in gilts or bonds. It may simply be that there are not enough gilts or bonds available on the market to support such demand. The trustees in this situation would have little choice but to defer winding-up (either in relation to the whole fund or, if an insurance company was prepared to take on the liabilities of part of the fund, partially).

- The trustees may be aware that the employer's financial circumstances are such that it is more likely to be able to afford a debt under section 75 of the Pensions Act 1995 at a later date. Perhaps, for example, the trustees are aware that the employer is due to be bought by a company which is prepared to fund the scheme (although, of course, a parent company would not necessarily be under any obligation to guarantee the debts of the company which it buys).
- The trustees might wish to wait until a dispute over entitlement to benefits has been resolved.
- There might be an area of legal uncertainty which the trustees would prefer to have resolved before winding-up the scheme. For example, the trustees might prefer not to equalise GMPs before the correct legal position is established. At the moment, it is not possible to provide the trustees with a definitive answer as to how GMPs should be equalised. Given the current uncertainties, trustees really need to consider how they should deal with GMPs in the context of their scheme if they are planning to wind-up the scheme. If the scheme is in surplus this may be easier than where the scheme is winding-up and there is a deficit. A scheme in surplus could, for example, afford to buy out GMPs on the most generous interpretation.

What should trustees of closed schemes do?

We have established above that if, as trustees, you are given notice by the employer that it wishes to terminate the scheme, the first thing you should do is consider whether or not to proceed with the wind-up of the scheme or exercise your power (if any) to defer the winding-up of the scheme. So assuming that you have taken the decision to defer the winding-up of your scheme and run it on as a closed scheme, what should you do next?

The steps you should take will include the following:-

1. You should review the terms of your trust deed and rules to check whether any events have occurred that will alter the balance of power between yourselves and the principal employer. If your employer is insolvent, an independent trustee could be

appointed. It will have the powers previously exercisable by your employer. If there is no employer insolvency then you may still need to work with the employer whilst the scheme runs on.

2. You should also check that all the powers under the scheme continue to operate. As trustees you may need the power of alteration and all powers necessary to continue to administer the scheme as a closed scheme.
3. Next you will need to consider your investment powers and current investment policy. In a situation where the employer is no longer contributing to the scheme and there will be no new members or future accrual of benefits the current investment strategy may no longer be appropriate as the age profile of the scheme will begin to change. In reviewing your investment powers and the current investment strategy, you will need to discuss with your investment adviser what impact closing the scheme will have, and how quickly the profile of the scheme will change if there are no new active members joining. What amounts to the best investment policy will, to a large extent, depend on the current financial strength of the scheme. A well funded scheme may be able to continue with a high proportion of equities but the trustees may prefer to play safe and match the liabilities of the scheme as closely as possible. The trustees of underfunded scheme may want to try to improve its funding position but they may be advised that they should closely match the liabilities of the scheme to avoid any worsening. Once you have made your decision about your future investment strategy with your advisers you must keep the position under review during the period of the deferral of the wind-up.
4. Given that pension schemes have such a high profile in the media, members may have very real concerns about their pension. As trustees, you should implement a good communication programme to let members know what is going on. If there is a short-term reason for the deferral of the winding-up, then you should consider informing members of this. This will not guarantee that you will not receive complaints in the future, but it could help to maintain a level of trust between the members and the trustees. Once the scheme proceeds to wind-up the Disclosure Regulations and regulations governing scheme wind-ups set out the information you must give to members.

Conclusion

Once you have carried out all the essential steps to ensure that the scheme is running smoothly, you may wish to start planning the eventual wind-up of the scheme. You will need to know how you can deal with the scheme's assets. If you are going to buy out benefits with an insurance company, early planning would be helpful. This will be especially the case if it is a large scheme which may be difficult to place in the current narrow annuity market. There may be some work involved in getting the scheme records up to date, depending on the profile of your scheme. This could be started now, to make the eventual wind-up proceed as efficiently as possible.

This article was prepared by partner Michaela Berry and solicitor Hugh Gittins of Sacker & Partners, for publication in the April 2003 edition of PMI Technical News.

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