Pensions – a roadmap for users

Samantha Bewick, KPMG LLP

The views and opinions expressed herein are those of the author and do not necessarily represent the views and opinions of KPMG LLP (UK). The information contained is of a general nature and is not intended to address the circumstances of any particular individual or entity.

Pensions has been talked about so much that we've forgotten how new the current regulatory regime is – it's only two years since the new Pensions Act 2004 burst on to the scene, supposedly threatening substantial financial uncertainty for companies having a defined benefit scheme. Much has been written about the powers of the Pensions Regulator (tPR), the safety net provided by the Pension Protection Fund (PPF), and we are becoming familiar with a whole new dictionary of jargon that previously resided solely on the bookshelves of the actuaries. But in all this complexity – what does it all mean?

Who's who?

The Employer (s)	The company (or sometimes companies) for which the employees within the Pension Scheme work. There may be a Principal Employer and Secondary Employer(s). In general the Principal Employer should be the company in which the majority of the pension fund members have worked.
The Members	Those people entitled to benefits from the pension scheme. Members fall into three main types: Current (employed by the Employer, and contributing to the Scheme); Deferred (no longer employed by the Employer or contributing to the Scheme, who will be entitled to a pension but have not yet reached the Scheme's normal retirement age); and Pensioner (receiving a pension)
The Trustees	The Trustees manage the Pension Scheme on behalf of the Members. The Scheme is governed by a trust deed and rules, which will set out how the Trustees and the Employer interact and their rights and responsibilities in relation to the Scheme. Trustees may be member nominated, company nominated, or independent of the members and the company. On insolvency, tPR will appoint an independent trustee.
The Scheme Actuary	The Scheme Actuary calculates the Deficit (see below) or surplus based on a set of assumptions about, inter alia, the ages of Members, their mortality rates, their current and future pay, the rate of inflation and the rate of return on the Scheme's investments, and recommends future contribution levels.
The Pensions Regulator (tPR)	tPR is responsible for monitoring the financial health of pension schemes and protecting the PPF (below) and Members. It needs to take into account the overall effect of its decisions on the Employer, including preserving businesses and jobs. tPR has wide powers to review corporate transactions which might be detrimental to the

	pension scheme and to seek contributions or financial support from entities who are parties to, or connected with parties to, the transaction. tPR is staffed by workout bankers, restructuring professionals and other private-practice accountants and pensions experts, *not* by civil servants.
The Pension Protection Fund (PPF)	The Pension Protection Fund is there to provide a safety net to Members whose pension scheme has been wound up without sufficient assets to provide the benefits which have been promised, due to the insolvency of the Employer. The PPF's staff also includes workout bankers, restructuring professionals and other commercially experienced people.

The deficit

There are several ways to calculate the deficit, but there are four which are regularly mentioned in pensions contexts.

Minimum Funding Requirement. (MFR)	Introduced by Pensions Act 1995, this provided a minimum level of funding in any scheme to meet pensions but proved inadequate in cases of insolvency. It is now being replaced by SFR (see below).
FRS17	The UK accounting standard for all companies with year-ends after 31/12/05. This is tPR's default test as to whether clearance for corporate transactions is needed – if there is no FRS17 deficit, at present tPR take a light-touch approach.
Scheme Funding Requirement (SFR)	Introduced by the Pensions Act 2004, this funding level is intended to be tailored to the scheme. It will be greater than MFR but less than buy-out basis. It should be the amount needed to fund the scheme prudently on a continuing basis. (i.e. assuming the scheme is not wound up)
S75/full buy-out	The amount required to purchase annuities from a commercial provider which would cover the full amount of the pension and other benefits promised by the scheme. This is the largest of the measures which are quoted.

The map

The decision trees shown take users through the basic steps for funding the deficit and/or considering transactions. There are many points at which restructuring professionals can (and often should) be involved.

Covenant review

Trustees are required to consider the financial strength of the employer at each actuarial valuation. Thus, the most basic requirement of a scheme is a review of the employer's covenant in circumstances where no transactions or restructurings are contemplated. This is

normally a review of the company on behalf of the trustees, in a similar way to a review of the company on behalf of the lender in an independent business review, and should be carried out by a restructuring professional. This assists the trustees to make decisions on the amount of scheme funding which the company can afford and the extent to which it might make one-off contributions, for example by selling surplus assets. The overriding principle is to balance the company's cash needs for investment and running the company, with the needs of the scheme.

Recovery plans

The recovery plan is the agreed level of contributions between the employer and the trustees which will fill the deficit over a period of time. The employer covenant review will form the basis for negotiations concerning the amount that the company can afford. If the recovery plan cannot be agreed, or if it is not successfully implemented, then the company may well require restructuring assistance or indeed a formal insolvency process.

Transaction assistance

Certain types of transaction, called Type A events (see box), should be notified to tPR. These are also events/actions for which clearance should be sought, otherwise the parties to them may become liable for a Financial Support Direction (FSD) or Contribution Notice (CN) .

Type A events
Change in priority – e.g. granting new or further security
Return of capital – e.g. large or unusual dividends or share buy backs
Change of control – e.g. where the new owner has a weaker covenant than the previous one.
Note these are only examples and there are other instances in each category which will be type A events. A larger transaction containing a type A event is also considered type A.

Before approaching tPR the employer and the trustees should, if possible, reach agreement on the position of the scheme and the steps to be taken to protect or improve its position. Clearly there is room here for advice to both sides – it is uncommon in our experience that trustees are content with merely receiving a copy of the advice given to the employer. Normally there is also scope for actuarial advice and assistance in negotiating a mutually acceptable outcome, as well as the employer covenant review. When a type A event is contemplated, the employer may seek a pre-emptive financial review to bolster its negotiating position with the trustee.

Both the trustees and the employer may need help in preparing their submission to tPR. Typically this could involve both financial and legal assistance.

Restructurings involving the Pension Protection Fund

Where the employer is in financial difficulty, the cost of the pension scheme may be a material contributor to the situation. It is easy to think that a solution would be to convince tPR and the PPF that the pension scheme should be accepted into the PPF. It is rather harder to convince them! Any proposal to rescue the company that involves the PPF accepting the pension scheme will need to be thoroughly thought through and assessed, agreed with the

trustees and convincingly argued. It will be necessary to show that the PPF will receive a materially better outcome than on an insolvency:

- A detailed liquidation analysis to compare to the offer that is being made to the PPF;
- A financial review of the employer and its forecasts to assess the viability of the business after the restructuring;
- A proposal to the PPF which is likely to be expected to include a cash lump sum, security; equity and possibly a future income stream.

Formal insolvency

If all else fails and the employer cannot afford its commitments, then insolvency may be the only option. On commencement of insolvency the PPF will take over the duties and rights of the trustees in relation to the scheme. They, and tPR, must be notified of the insolvency on the standard form. The PPF will act as the creditor and should receive all creditor communications. Its claim will be the full buy-out deficit of the scheme. However, when considering its claim the assumptions on which it is based should be carefully examined – actuarial advice may well be of assistance to help to ensure that these are reasonable. Final agreement of the claim for dividend purposes may be a matter for negotiation.

Conclusion

It is important to understand the key players and measurements in the pensions world. The trustees may not be experienced in financially stressed situations, but tPR and the PPF are staffed by experienced restructuring players and will not support propositions which do not cater adequately for the pension fund. If it comes to a formal insolvency, the PPF will take over the creditor position and will be likely to have a material, if not actually controlling, vote.

In a pension-related situation, it is critical to gain the trustees' agreement if at all possible and then approach tPR and/or the PPF.