ICA 2014 CIA WASHINGTON DC
LEARN INTERACT GROW

Unmanageable UK Pension Debts

This note summarises the key aspects of my talk on unmanageable UK pension debts. My aim is simply to introduce you to, or potentially just remind you of, the key disciplines surrounding a decision of whether a pension debt is or is not manageable. The areas covered are investment, employer covenant, actuarial, governance/regulatory and legal. I also add some references to further reading and regulatory action.

Investment

Trustees, as custodians of the pension promises, are expected to fund defined benefit (DB) pension arrangements on a "prudent" basis. The degree of prudence is dictated by The (UK) Pensions Regulator (TPR) via a scale of "gilts+" investment returns varying with the strength of the employer covenant. The stronger the employer covenant, the more optimistic the investment return allowed. Strictly speaking the scale is aspirational but ignoring regulators is not recommended. In practice investment risk and return are inextricably linked (more return ⇔ more risk) and attention to investment volatility is increasingly common. Flexibility is provided through "appropriate" recovery plans. Pension scheme cash flows play a major part in the necessary analysis and projection of recovery plans. The debt is unmanageable when even the most heroic investment return assumption doesn't result in an affordable contribution.

Employer Covenant

Independent employer covenant or analysis of the sponsoring, participating, parent or other group companies will generally be central to any decisions on whether the pension debt is manageable or not. Company strength will depend and vary in respect of company assets and liabilities (and net assets), profitability, cash flow, ownership, industry, business prospects and competition. Other company and/or scheme specific factors may also be important.

The strength of the sponsor is frequently assessed on a scale of 1 – 5, ranging from weak to strong. Note the link to the investment optimism assumed in the funding calculations and the impact of any movement in the covenant assessment. A weakening of the covenant theoretically requires a strengthening of the funding target which, all other things being equal, requires additional cash contributions. In practice the trustee position has direct comparisons with banks and an increasing proportion of schemes have funding plans involving security for the normally or otherwise unsecured debt on wind up. Funding difficulties are also giving rise to innovative "asset-backed" funding solutions involving company products or other balance sheet items.

Employer covenant advice will also be important in considering the balance of available funds being allocated to (1) dividends, (2) investment in the business and (3) debt servicing. Regulatory attention will undoubtedly be focused on any disproportionate payments to the former, whilst H M Government is keen to ensure investment and jobs are not too impaired by the latter. The debt is unmanageable when 100% of available company cash isn't sufficient to service the competing demands of investment in the business shareholder return and servicing the pension debt.

Actuarial

The assumptions underlying actuarial valuations are crucial in determining the monetary amount of the pension liability and hence the potential deficit. These assumptions are financial and statistical. The most debated statistical assumption is mortality, split between (1) a starting or base position (usually assessed via postcodes or other profiling techniques) and (2) allowance for future improvements in longevity.

Actuarial analysis and projection is important in considering (1) the sensitivity of the results to variation in individual assumptions (now a compulsory professional requirement), (2) the projection of scheme cash flows and (3) future liabilities on some (or all) of the funding basis, solvency costs or Pension Protection Fund (PPF, ⇔ PBGC) liabilities. The latter is termed "S179 drift" and increases in such liabilities may influence other stakeholders. The debt is unmanageable when heroic actuarial assumptions (or internal actuarial Chinese Walls) become totally untenable.

Governance/Regulatory Issues

The governance framework of a pension scheme can be hugely important. TPR will certainly initially focus on three key aspects – trustee conflicts of interest, trustee knowledge and understanding, and independent employer covenant assessment.

Unmanageable UK Pension Debts

Advice in this area will also be crucial in setting "affordable" contributions, the initial amount, the "shape", increases in future contributions and any business or profit related aspects of such. If restructuring (debt for equity swap) is involved it will be safe to assume that such expert restructuring/corporate finance input and liaison with the PPF will take centre stage. The debt may become unmanageable when the lack of governance leads to operational farce.

Legal

Any individual Trust Deed & Rules will contain crucial powers in respect of pension debt management. The power of amendment may be initially suggested as key, however, in individual circumstances, who sets the employer contribution rate, who can hire and fire trustees, who can cease future benefit accrual or augment benefits, or who has the power of wind up etc. can be just as significant.

TPR also influences corporate behaviour, the funding target (technical provisions) and recovery plans. TPR's "moral hazard" powers are arguably draconian; To date however they have been rarely used. The threat of Contribution Notices and Financial Support Directions has arguably been sufficient to influence many actions, inactions and deal structures.

When pension debts become unmanageable it is preferable for the directors of the sponsoring employer to take the necessary action towards insolvency. Occasionally however shareholders and/or management may be in denial and trustee action is required to force the situation. Wind up of the pension scheme and a S75 debt is a powerful catalyst but the power to wind up may not be available (and TPR may wish to leave the process to the trustee(s)). In such circumstances a court debt petition is required and unpaid expenses or default on an existing Schedule of Contributions is quicker and less costly than a S75 claim which requires audited accounts and actuarial valuation and certification. The pension debt is unmanageable when TPR liaison results in the use of Regulator powers.

Conclusion

Pension deficits are increasing with low real and nominal interest rates and improving longevity. Deficits are straining already struggling companies who may be contracting because of competition, technology or globalisation. Decisions around whether any pension debt ultimately becomes unmanageable will be a delicate balance of investment, legal, actuarial and covenant considerations. Time may often be the deciding factor as fears or just perceptions of a "zombie company" emerge – one existing only to service historic pension debts. The debt is unmanageable when the trustee has to force the insolvency of the sponsoring employer in order to fulfil their fiduciary duties. Is it any wonder that virtually all DB pension schemes are closed to new members and most are closing to future accrual?

Further Reading

Those interested in further reading on insolvency, conflicts of interest, unmanageable pension debts and previous restructurings are referred to (in no particular order) -

- TPR S89 Reports on Kodak, M F Global, UNIQ, UK Coal, Bonas, Great Lakes (Chemtura Group), British Midland, Sea Containers, Box Clever Pension Scheme (ITV), Polestar, Pittards, SR Technics (Swissair), Telent (GEC Marconi), Hugh Mackay Retirement Benefits Scheme and G P Noble Trustees Limited www.pensionsregulator.gov.uk (search S89 or company name)
- Press comment on Readers Digest and Dawson International.
- The Department for Business, Innovation & Skills (the old DTI) report on M G Rover http://www.bis.gov.uk/files/file52782.pdf
- The PPF guidance on acceptable compromise (S5.3) http://www.pensionprotectionfund.org.uk/DocumentLibrary/Documents/insolvency_guidance.pdf
- SIP No. 16 (Statement of Insolvency Practice) for licensed Insolvency Practitioners re. pre-packaged sales in administration http://www.icaew.com/~/media/Files/Technical/Insolvency/regulations-and-standards/sips/england/sip-16-e-and-w-pre-packaged-sales-in-administrations.pdf

For future developments and evolving practice, watch out for future S89 reports court reports and appeals. If the private sector pension promises aren't enough then watch out for further scrutiny of UK public sector promises where the public sector discount rate (reduced to CPI+3% in April 2011) is crucial to inter-generational equality.

*Contact via **(0044)7714 064964** or via allan@acmca.co.uk or www.acmca.co.uk*

Allan Martin **November 2013**