Statement

Double counting

Section 75 debts/scheme funding obligations

October 2013

The Pensions Regulator

Executive summary

We are issuing this statement because it has become increasingly apparent that some trustees and employers consider that a payment under a Schedule of contributions[1] can settle a section 75 debt[2] (or the other way around).

'Double counting' of payments made towards these distinct obligations is not permitted by pensions legislation and presents avoidable and unnecessary risks to members of defined benefit (DB) schemes. Where we become aware of attempted double counting we will raise this with the trustees and expect it to be addressed.

Trustees should understand how a section 75 debt can be properly dealt with on the departure of an employer from a multi-employer DB scheme, and how employer departure and the treatment of the section 75 debt can be properly accounted for under the scheme funding framework. Trustees need to be mindful of the risk of double counting occurring and deal effectively with double counting where it has already occurred.

After an employer departure, trustees must give careful consideration to whether arrangements such as the investment strategy and funding plans remain appropriate, considering the changes to asset levels and covenant strength that the departure may have caused.

Introduction

This statement is aimed at trustees and employers of multi-employer DB schemes, and their advisers. These are the schemes where double counting is most likely to arise. It will also be of interest to trustees of other DB schemes.

This statement does not represent a shift in our stance. In our **Multi-employer schemes and employer departures guidance** we stated:

'The section 75 debt of an employer is a discontinuance debt and is distinct from ongoing funding obligations. Care should be taken not to double count deficit payments paid as part of a recovery plan as payments towards section 75 debts, or vice versa. A recovery plan should reflect the assessed covenant of the employer whereas a section 75 debt is often a result of an event that changes the covenant.[3]'

The legislative framework creates two distinct obligations for employers[4]:

- Section 75 debts are payable by departing employers (including on employer cessation, insolvency, or scheme wind up)
- Scheme funding[5] applies to remaining employers who have continuing obligations to fund an ongoing scheme.

This statement should be read in conjunction with the regulator's **Multi-employer schemes and employer departures guidance**; **Clearance guidance**; **Monitoring employer support guidance**; **Code of practice no. 3: Funding defined benefits**; and **Statement on identifying your statutory employer**.

Risks and implications of double counting

Generally, employers have two distinct obligations to schemes:

a. **Part 3, Ongoing scheme funding:** The obligation to support the scheme on an ongoing basis. This is in respect of the ongoing funding of a DB scheme where the relationship between the scheme and the employer(s) is continuing and requires employer contributions under a Schedule of contributions. The contributions include deficit repair payments, made in respect of any recovery plan. That deficit is decided based on the scheme's circumstances, including the strength of the employer covenant[6] which underpins ongoing risks to the scheme. Failure to pay scheme funding contributions triggers a statutory debt under the scheme funding framework[7]

b. **Section 75, Discontinuance:** The obligation to stand behind the full cost of members' benefits when that employer no longer supports the scheme on an ongoing basis. This applies where an employer departs from a DB scheme (including on insolvency) and a statutory section 75 debt is triggered[8]. This is a discontinuance debt, based on the costs of providing annuities to members (or, in a multi-employer scheme, the departing employer's share of those costs).

Discharging an obligation which arises under one of these categories does not extinguish an obligation that arises under the other. Instead, legislation provides specific ways in which the two categories of obligation interact, which reflects and preserves their different purposes[9].

The Section 75 debt(s) in relation to our scheme have arisen due to a group restructuring, surely all this doesn't apply to us because the group is in a better position now?

Some group companies may not be statutory employers and may have no other legal obligations to the scheme. Therefore, restructuring which does not affect, or even which improves, the financial strength of the group as a whole, could still have a detrimental impact on the employer covenant provided to the DB scheme (because covenant is usually only provided by statutory employers to the scheme). Consequently the risks highlighted in this statement relating to double counting may still arise. It is always important for trustees to have a clear understanding of which group entities have a legal obligation to fund the DB scheme and how the ability of those entities to support the scheme has changed as a result of the group restructuring.

Trustees that seek to double count payments of scheme funding obligations as payments of section 75 debts (or vice versa), may find that they have:

a. left a debt (under section 75 or the scheme funding framework) owed to the DB scheme unpaid, with detrimental impact to scheme assets and member security

b. avoided important statutory safeguards for DB schemes in the section 75 framework, which allows for modification of section 75 debts only where certain tests are met in respect of the impact of the employer's departure on the employer covenant[10]

c. failed to consider the impacts on the employer covenant following an employer departure, contrary to the scheme funding framework, which should take into account the true circumstances of the scheme and the risks that apply, including the strength of the ongoing employer covenant

d. failed to act in accordance with legislative requirements, including for knowledge and understanding[11]

e. risked ineligibility of the DB scheme for Pension Protection Fund (PPF) entry[12]; and

f. failed to act in the best interests of the members of the DB scheme in accordance with their fiduciary duties.

Where trustees attempt to use double counting to discharge section 75 debts that have not yet triggered, but may arise in the future, this reduces the chance that trustees can properly assess the impact on the employer covenant, and take appropriate action in the interests of the scheme. Agreeing to treat section 75 debts in a particular way without knowing the circumstances in which the debts will actually arise and the impact on the scheme could also fetter the proper exercise of the trustee's discretion.

Because double counting does not discharge both obligations (under scheme funding and section 75), in some circumstances departing employers may continue to be liable as a statutory employer of the scheme[13]. Employers and trustees will need to consider the implications of this.

The correct approach

The trustees need to consider the impact of the employer departure on the overall risk profile of the scheme[14].

We suggest that the trustees approach their considerations in the following stages, with various options for the trustees and employer within each stage:

Stage 1 – assess impact of employer departure and deal with section 75 debt

a. In most cases, an employer departing a DB scheme represents a change to the employer covenant[15]. At the time of the employer's departure trustees should carry out appropriate analysis of the impact on employer covenant to the scheme

b. As a starting point, the trustees should consider whether the departing employer should pay its full section 75 debt[16].

c. If the trustees reasonably believe that, because of the particular circumstances of the employer's departure, payment of the employer's full debt is not necessary or possible, then instead of seeking to double count with scheme funding payments, the trustee may consider legislative mechanisms which modify certain section 75 debts or can even prevent them from arising (including retrospectively)[17]. Whether these mechanisms are available and appropriate will depend upon the circumstances at the time, including the impact on employer covenant[18].

d. Whether or not the employer's section 75 debt is paid in full, trustees may conclude that an employer departure is detrimental to the scheme, and may require mitigation over and above the payment of its section 75 debt[19]. The trustees should discuss this with the employers.

Stage 2 – assess net impact of employer departure and consider ongoing funding

a. Once the trustees have assessed the impact of the employer departure, and any mitigation received (including payment of the section 75 debt), they may consider that there is still a net detriment to the covenant strength, which will affect the overall risk profile of the scheme.

b. The trustees need to consider whether the investment strategy and funding plans are still appropriate, considering both any increase in the scheme's assets (resulting from the payment of the section 75 debt or other mitigation) and any deterioration in covenant. This may lead to a decision to revise the existing recovery plan, Schedule of contributions and/or statement of funding principles[20]. In some cases (but not necessarily all) it may also be appropriate for the trustees to call an early valuation[21].

Will I always have to complete a new valuation and/or reconsider the overall risk profile of the scheme and in particular the investment strategy?

No, this will depend on the trustees' assessment of the impact of the employer departure on the covenant and whether and how far this has been mitigated.

In considering the two stages above, trustees will often need to engage independent advisers to ensure they take into account all relevant considerations. In considering options available, the overriding principles remain that the trustees will need to ensure that:

a. only the remaining employers who are obliged and continuing to support the scheme should be taken into account in assessing the ongoing employer covenant; and

b. section 75 debts which arise are either paid in full or modified in accordance with the section 75 framework[22] as appropriate to the particular circumstances at the time, including the impact on employer covenant caused by the employer's departure and whether it is mitigated.

It is not always possible to mitigate detriment to the covenant caused by an employer's departure with payments from the remaining employers, who are already liable to support the DB scheme anyway[23]. Any mitigation agreed is distinct from the trustee's obligations in relation to scheme funding[24].

Whenever section 75 debts are triggered we expect trustees to deal with them as appropriate in the circumstances at the time of the employer's departure, in accordance with the section 75 legislative framework, as outlined above. If employers do not pay their section 75 debts for an unreasonable period this could be a 'type A event' for clearance purposes[25].

Isn't this all just a timing issue? Even if it is double counting now, it will all come out in the wash at the scheme's next valuation when we update the asset position and so there's no real risk here.

Double counting is not permitted by pensions legislation and presents avoidable and unnecessary risks to members of DB schemes. Loss of employer covenant may be irreversible. It is not always possible to mitigate detriment caused by an employer's departure with payments from the remaining employers. If the trustees do not deal with employer departures and section 75 debts when they arise they may miss the opportunity to prevent deterioration of covenant, with detrimental impact to scheme assets and member security[26].

Which steps are appropriate and proportionate for the scheme will depend on the circumstances, including the size of the section 75 debt relative to the scheme assets and liabilities, the strength of the remaining employer covenant, and the impact of the loss of covenant.

What if my scheme has used double counting in the past?

This statement applies equally to past occurrences of double counting.

Our approach to double counting

Where we become aware of attempted double counting we will raise this with the trustees and expect it to be addressed.

Where double counting is not addressed, we may consider the use of our powers, for example relating to moral hazard, scheme funding and governance, including the removal or appointment of trustees. Any action taken will depend on the particular circumstances of the DB scheme, the steps the trustees have taken, the effect of the attempted double counting, the risks presented to members and any other relevant factors.

We consider that attempts to double count are reportable matters[27] and some may also be notifiable events[28].

This statement must be read in conjunction with the relevant legislation. It does not override the legislation or provide a definitive interpretation and trustees should seek their own legal advice.

Footnotes

1. The Schedule of contributions specifies employer contributions in accordance with Part 3 of the Pensions Act 2004. This includes deficit repair payments made in respect of any recovery plan put in place under Part 3, to meet a funding shortfall on the technical provisions basis.

2. A statutory debt triggered and owed by a departing or insolvent employer to the trustees of a multi-employer DB scheme under section 75 of the Pensions Act 1995. Further information about how these debts arise is contained within our **Multi-employer schemes and employer departures guidance** (see paragraph 34).

3. See paragraph 71 of our **Multi-employer schemes and employer departures guidance**.

4. An 'employer' is, as the context requires for the purposes of this statement, defined in section 124(1) of the Pensions Act 1995 as may be extended under section 125(3) of that Act for former employers, including: (a) for section 75 purposes by regulations 9 and 13 of the Occupational Pension Schemes (Employer Debt) Regulations 2005 (as amended) (the 'Employer Debt Regulations'); and (b) for scheme funding purposes by paragraph 3 of Schedule 2 to the Occupational Pension Schemes (Scheme Funding) Regulations 2005 (as amended) (the 'Scheme Funding Regulations').

5. Under Part 3 of the Pensions Act 2004.

6. The **Monitoring employer support guidance** defines covenant at paragraph 5 as 'the legal commitment of the relevant employer to support the scheme. This includes statutory obligations and obligations to make payments under the payment schedule as well as its ability to do so.' That guidance explains at paragraph 8 that the 'covenant effectively underwrites the risks to which the scheme is exposed including existing underfunding, longevity, investment and inflation now and in the future.' Legislative obligations under section 75 and scheme funding generally apply to the 'statutory employers' as explained in our **Statement on identifying your Statutory employer**.

7. Section 228 Pensions Act 2004.

8. See paragraph 34 of our **Multi-employer schemes and employer departures guidance** for further information.

9. For example, the Scheme Funding Regulations (i) require trustees to keep separate records of actions taken to recover section 75 debts (regulation 11(2)(b))); and Employer Debt Regulations take into account ongoing scheme funding matters in the funding test that applies to many of the modifications of s.75 debts (regulation 2(4A).

10. The legislative framework for modifying section 75 debts is contained in the Employer Debt Regulations. Guidance on each mechanism is contained in our **Multi-employer schemes and employer departures guidance**. The Employer Debt Regulations provide that some modifications are also notifiable events for the purposes of section 69 Pensions Act 2004.

11. As required under s247 and 248 of the Pensions Act 2004.

12. Eligibility for PPF compensation may be jeopardised, for example, where double counting amounts to a legally enforceable agreement to reduce the amount of a section 75 debt due to the scheme, under (see regulation 2(2) of the PPF (Entry Rules) Regulations 2005).

13. See paragraph 35 of our **Multi-employer schemes and employer departures guidance**. Further information is also available in our **Statement on identifying your statutory employer**.

14. See paragraph 15 of our 2013 **Annual funding statement**.

15. See paragraph 84 of our **Multi-employer schemes and employer departures guidance**.

16. See paragraph 85 of our **Multi-employer schemes and employer departures guidance**.

17. See footnote 10 above.

18. See paragraph 86 and Section 4 of our **Multi-employer schemes and employer departures guidance**.

19. See paragraphs 89 and 70 of our **Multi-employer schemes and employer departures guidance**.

20. See paragraphs 137 to 141 of the **Code of practice no. 3: Funding defined benefits**.

21. See paragraphs 134 to 136 of the **Code of practice no. 3: Funding defined benefits**.

22. See footnote 10 above.

23. For example, see paragraph 94 of our **Clearance guidance** or paragraphs 132 and 161 of our **Multi-employer schemes and employer departures guidance**.

24. For example, see paragraph 86 of our **Clearance guidance**.

25. See paragraphs 65 and 7 of our **Clearance guidance**.

26. For further information, refer to paragraph 84 of our **Multi-employer schemes and employer departures guidance**.

27. Under section 70 of the Pensions Act 2004 and our **Code of practice no. 1: Reporting breaches of the law**.

28. Under regulations 2(1)(a) and 2(2)(a) of The Pensions Regulator (Notifiable Events) Regulations 2005, as amended. For further information, refer to our **Code of practice on notifiable events** and the **Code-related guidance on the notifiable events framework**.

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