Breaking free

Further change is expected to the section 75 debt of multi-employer schemes, which have created a financial nightmare for small businesses and charities. But will it solve the system's problems asks Graham Buck, or could it even create new ones?

Summary

- Concerns about the section 75 debt rules applicable to multi-employer schemes go back many years, but the problem has attracted wide publicity only in the past year.
- Companies in the non-associated multi-employer (NAME) scheme must pick up the bill for pension debt, or orphan liabilities, left by past employers who have gone bust or exited the scheme. This unintended consequence of the section 75 debt rules has hit small plumbing firms in the scheme the hardest.
- The DWP issued proposals last April for a new section 75 (s75) easement called a deferred debt arrangement (DDA), but few regard it as a satisfactory solution to the problem.

The story broke last December and had a suitably Dickensian ring to it. As Christmas approached hundreds of small firms in the plumbing trade faced potential ruin, due to a steady deterioration in the finances of the industry's pension scheme. The government was urged to act and save them from bankruptcy.

This alarming scenario is behind the ongoing review of section 75 debt in non-associated, multi-employer (NAME) defined benefit pension schemes. The main benefit of NAME schemes is that they have enabled small firms to enjoy the resulting economies of scale and offer otherwise unaffordable DB pensions to their workforce.

However, since the financial crisis a downside has emerged in the tougher post-2008 business environment. Those wanting to exit a NAME scheme are required to pay a cessation on a buyout basis, but the cost can prove impossibly high for many smaller firms. As employers have gone bust their scheme debt has fallen on the remaining sponsors.

The problem appears to be a uniquely UK one, not replicated even by those other European countries with DB schemes. Germany doesn't have similar multi-employer schemes to the UK, while the Netherlands has the option of reducing scheme benefits in cases where there is underfunding.

A long-gestating problem

Former Pensions Minister Baroness Ros Altmann is among those concerned by the emerging 'pension scandal'. Small firms faced personal bankruptcy "because the law forces them to pay for pensions of people who never worked for them," she wrote. "Many are family-owned businesses with no limited liability protection and will lose their homes and everything they have."

The current employer debt regime, of which section 75 is part, came into effect on 6 April 2008 – although some believe the seeds of today's problem were first sown by the 2004 Pensions Act and the onset of exit charges, or even as far back as the Social Security Act 1990, which pre-dates the introduction of the minimum funding requirement.

Amendments to the regime were introduced in 2010 and 2012, with possible further changes currently under consideration, says Norton Rose Fulbright senior knowledge lawyer Lesley Harrold. Generally, employer debt under section 75 can arise in two situations.

The first is when a DB scheme starts to wind up – often because the scheme's sponsoring employer has become insolvent. In this case the employer debt is equal to the buyout deficit in the scheme, as estimated by the scheme actuary; a very costly measure and one that an employer would seek to avoid.

The second scenario is when a participating employer in a multi-employer occupational pension scheme stops participating, but the scheme remains ongoing. The employer debt will be calculated as the departing employer's share of the buyout deficit, unless he/she enters into an alternative arrangement to reduce their liability.

In March 2015 the Department for Work and Pensions (DWP) issued a call for evidence on proposals to introduce easements from the current employer debt requirements for multi-employer schemes containing non-associated employers. The employer debt regime has had a particularly adverse impact on NAME schemes, leading to calls for the rules to be eased.

There followed a lively debate between respondents over whether any further alleviation should apply only to NAME schemes or to all multi-employer schemes. The DWP proposals, eventually issued last April, were based around introducing a new option for managing an employer debt that would apply to multi-employer schemes with associated and non-associated employers alike.

The new option would permit a departing employer to enter into a 'deferred debt arrangement' (DDA) and sit alongside several existing options, of which flexible apportionment arrangements and scheme apportionment arrangements (FAAs/SAAs) have proved the most popular, says Freshfields Bruckhaus Deringer partner Dawn Heath.

A DDA would allow an employer to defer the requirement to pay an employer debt on the occurrence of an employment-cessation event, provided several conditions are satisfied: primarily, the 'funding test' applicable in relation to an FFA or SSA would have to be satisfied once the DDA came into effect.

A DDA would come to an end following a number of events, including the deferred employer employing an active member of the scheme or failing to comply with its scheme funding obligations, or an insolvency event occurring to the deferred employer. The provisions regarding DDAs would be incorporated by amendments to the employer debt regulations, a draft of which the DWP published for consultation alongside its call for evidence.

Far from perfect

However, few regard the proposed solution as satisfactory. "The DWP proposals are prefaced on the idea that the debts will eventually be repaid, but another major financial crisis would set this date even further back into the future," says Charity Finance Group head of policy and engagement Andrew O'Brien. "The big question is how we deal with this legacy in a way that's sustainable."

Heath, who is also a member of the Association of Pension Lawyers' (APL) legislative and parliamentary committee, says the APL was among the bodies that responded to the DWP consultation. The association questioned whether it was always essential to automatically trigger section 75 debt, suggesting that if an employer departing from a multi-employer scheme proves willing to 'stay on the financial hook' for their liabilities it was worth considering letting them do so.

It had been expected that the revised Employer Debt Amendment Regulations 2017 would be issued this autumn. However, "since the proposals were issued for consultation, they appear to have disappeared into the long grass; the original planned date of introduction – 1 October 2017 – has come and gone," says Heath. "The delay could be partly due to the DWP being preoccupied with other issues; it's also possible that a pensions white paper will be issued in early 2018, which will address section 75 debt."

Indeed, DWP director, private pensions and stewardship, Charlotte Clark, recently confirmed that a white paper outlining various options for the UK's defined benefit pension sector is scheduled to appear in late February – although actual legislation is further down the track and unlikely before 2020.

For the embattled plumbing industry, the problem has been partially alleviated via a £560 million buy-in purchased from Legal & General over the summer by the Plumbing & Mechanical Services (IK) Industry Pension Scheme. Otherwise, the section 75 debt problem persists.

"The individuals who I was most concerned about, those desperate to retire; have been forced to keep on working as they'd otherwise crystallise a debt that they can't afford," reports Altmann. "The proposed reform of a DDA doesn't solve the problem as they'll still owe the debt."

Could the problem extend to firms in other industry sectors? "It's likely there are also a number of charities affected," she suggests. "But nobody wants to speak up. I've had hundreds of letters from small businesses that are desperate, but don't want their customers to know in case they spread the fear of bankruptcy.

"These people have done nothing wrong – they're not Philip Green – and they've paid their contributions but the scheme trustees failed to inform them what was going on."

Altmann adds that she was alerted to the problem during her term as Pensions Minister in 2015-16 and attempted to develop a solution with MPs. However, the reluctance of vulnerable firms to go public means that any sense of urgency is absent.

She regards the DWP's proposed changes as merely "a fig leaf" and adds: "We need to work out a full resolution, so that these businesses are forced to pay the full annuity debt. This might involve some schemes going into the Pension Protection Fund (PPF)."

Alternatively, were the scheme buyout basis to become cheaper it would help alleviate the problem, suggests Slaughter and May partner and head of pensions Charles Cameron. "If gilt yields were to become more attractive, then section 75 debt would be improved; indeed some corporates appear to be pinning their hopes on this happening.

"The introduction of FAAs in 2012 represented a positive step forward, but the main drawback is that it's never been too clear what The Pensions Regulator's (TPR) attitude towards them is," he adds. "The TPR hasn't offered any clarification and needs to be rather more forthright."

Written by Graham Buck, a freelance journalist