

Abandonment of defined benefit pension schemes

Discussion paper

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Executive summary

The intention of this paper is to draw the issue of the potential abandonment of pension schemes to the attention of trustees of defined benefit occupational pension schemes. This is within the context of a developing market that is seeking to help transfer the risks inherent in pension schemes to third parties. While the Pensions Regulator welcomes innovation that helps employers and trustees better manage pension risks, we are concerned about arrangements that may result in the abandonment of the pension scheme.

The paper places an onus on trustees to identify and critically examine any arrangement that may result in the abandonment of their pension scheme, and to negotiate robustly to prevent such an arrangement or to seek an outcome that is in the best interests of members of their pension scheme.

What is meant by abandonment?

Abandonment can arise in a number of different ways. However, there are two key parts to any transaction that may mean it results in abandonment of the pension scheme. First, the covenant of the employer that remains with the scheme (or a section of the scheme or membership) may be nominal compared with the previous covenant. Second, the level of mitigation offered to the scheme is less than the full section 75 debt, which is intended to be the amount required to fully insure benefits with a regulated insurer.

A nominal employer can be one whose principal activity directly relates to the pension scheme (for example the administration of scheme benefits or management of scheme assets) or it could be an employer that has little or no value as a business, excluding the pension scheme. Arguably, where the employer does have some value, but the covenant is substantially weakened, this could be considered abandonment.

Identifying abandonment may be difficult in the context of the wide range of transactions that can impact a pension scheme, and some may result in abandonment even though there is an underlying commercial motivation, separate from the scheme, for the transaction to proceed.

What is expected of trustees?

Trustees should apply the guidance (as proposed in Chapter 6) to any arrangement that could result in abandonment or any transaction where the covenant is substantially weakened such that the outcome is similar to abandonment. The guidance builds on a number of key points, namely:

- A significant part of the value that is expected to be gained from such transactions will be through what can be achieved with the pension scheme. Trustees should therefore act as a main party to any such arrangement.

- The employer underwrites a significant amount of the risk of a defined benefit pension scheme and if the link with an employer of substance is broken then trustees would lose this protection. Trustees should form an independent and comprehensive view of the financial strength of the employer before and after the proposed arrangement.
- Trustees should understand the potential gain to other parties to any proposed arrangements and ensure that, in relation to this, any mitigation or security offered to the scheme is fair and in members' best interests.
- The UK funding system introduced by the Pensions Act 2004 works on the basis that the target funding level (technical provisions) combined with the employer covenant forms the basis of security for defined benefits. If the covenant is removed or marginalised, trustees should recognise that this should substantially increase the scheme's appropriate level of technical provisions, and they should reflect this potential change in negotiations and the mitigation they seek.
- Trustees should take their own independent advice.

The regulator's approach

Our view is that abandonment of a scheme is contrary to the intent of recent pensions legislation. We recognise that every employer's and scheme's situation is different, but we believe that in cases where there is an employer of substance, abandonment is not likely to be in members' best interests and could well prompt consideration of use of regulatory powers. Therefore, we would encourage early discussion between parties to any potential abandonment case and the regulator.

Participating in the discussion

We would like to hear from interested stakeholders on the issues raised in this paper and have set six questions that are given at the relevant points in this paper and summarised in Chapter 5. We would also be interested in any additional or further points that stakeholders may wish to raise on any aspect of this paper.

The deadline for submission of responses to this discussion paper is 9 February 2007.

Introduction

1. This discussion paper is published by the Pensions Regulator ('the regulator'), the body that regulates work-based pension arrangements. These comprise occupational pension schemes, stakeholder pension schemes and certain aspects of group personal pension schemes which have direct payment arrangements (that is, where the employer pays contributions on behalf of the employee).
2. The aim of the paper is to initiate a discussion on methods of managing risk in defined benefit pension schemes and to help trustees understand, identify, and respond to some arrangements that may result in the abandonment of the pension scheme by its sponsoring employer.
3. The Pensions Act 2004 gives the regulator a set of specific objectives. Two objectives relevant to this document are:
 - to protect the benefits of members of work-based pension schemes; and
 - to reduce the risk of situations arising that may lead to claims for compensation from the Pension Protection Fund.
4. In order to meet these objectives the regulator has been granted a number of powers. These include:
 - the power to prohibit, suspend and appoint trustees of pension schemes;¹
 - the power to issue contribution notices;²
 - the power to issue financial support directions,³ and
 - the power to wind up pension schemes.⁴
5. In the course of carrying out our responsibilities we have become aware of the increased prevalence of methods and products that seek to manage or remove risks associated with occupational defined benefit pension schemes. These typically involve transferring risk to a third party. A number of these provide the opportunity to decrease risk to both the members of a pension scheme and the sponsoring employer, which we welcome.
6. However, we have also become aware of proposed arrangements that seek to break the link between the sponsoring employer (in its current form) and the pension scheme in a manner that may expose scheme members to increased risk.

¹ Sections 3, 4 and 7 of Pensions Act 1995

² Sections 38 – 42 of Pensions Act 2004

³ Sections 43 – 51 of Pensions Act 2004

⁴ Section 11 of Pensions Act 1995

7. Regulatory changes made as part of the lead up to and the introduction of the Pensions Act 2004 had the clear intention of preventing employers from being able to walk away from their pension obligations without providing for benefits in full. The debt on the employer was changed to be an amount sufficient to buy out members' full level of benefits with a regulated insurer, as estimated by the actuary, and this debt (the section 75 debt) crystallises in situations where an employer no longer provides ongoing support to the scheme.⁵
8. The aim of some of the proposed arrangements we have seen is that the employer (in its current form) breaks the link with the scheme without meeting its section 75 obligation, and the scheme becomes supported by a nominal employer. The nominal employer may be the same employer after a significant restructuring.
9. Concern over such proposed arrangements has prompted us to issue this discussion paper and draft guidance to help trustees identify and deal with proposed arrangements that may break the link with the original employer and result in the scheme being effectively abandoned to a nominal employer.
10. This paper sets out our understanding of the market that aims to help trustees and employers manage pension risk by transferring risk to a third party. It then discusses in more detail the types of arrangement that can result in abandonment, which the regulator is concerned about. Our expectations of trustees and how we will be regulating this area are explained. Finally we set out a proposed guidance document to help trustees identify and respond to arrangements that could potentially result in their pension scheme being abandoned.

⁵ The Occupational Pension Schemes (Winding Up and Deficiency on Winding Up etc) (Amendment) Regulations 2004; the Occupational Pension Schemes (Winding Up and Deficiency on Winding Up and Transfer Values) (Amendment) Regulations 2005; and the Occupational Pension Schemes (Employer Debt) Regulations 2005

Chapter 1: Methods to transfer and manage defined benefit pension risk

1. Over the last five to ten years, there have been significant changes in the regulatory and economic environment impacting defined benefit pension schemes. The changes include increased debt on the employer on winding up defined benefit schemes, changes in the funding regime, increased awareness of deficits and pension risk (eg longevity) and changes in employer attitudes to defined benefit pension provision. We believe this has contributed to employers and trustees focusing more clearly on risk management, and has also prompted the development of new methods and products to manage pension risks.

Changes in the pensions environment

2. One of the most notable changes was when, in the run-up to the Pensions Act 2004, regulations significantly increased protection for members if an employer wanted to wind up its scheme or if trustees felt it in members' best interests to wind up a scheme. From 11 June 2003, any employer that is not insolvent has been required to fund the scheme to a level sufficient to buy out all liabilities with a regulated insurer if the scheme winds up. This was subsequently extended to insolvent employers from February 2005.⁶ The change was further extended to a participating employer withdrawing from a multi-employer scheme from 2 September 2005.⁷
3. A further important change was the replacement of the Minimum Funding Requirement (MFR) with a new scheme specific funding regime set out in the Pensions Act 2004. Scheme funding valuations after 22 September 2005 need to use technical provisions calculated on a prudent basis.⁸ If scheme assets are insufficient to cover technical provisions then the trustees need to draw up a recovery plan and discuss and, in most cases, agree this with the employer. It is expected that the new funding rules will generally result in increased levels of funding of occupational defined benefit pension schemes.
4. These changes have improved the negotiating position of trustees. Trustees are encouraged in the regulator's clearance guidance⁹ to act in the same way as any other unsecured creditor in relation to the employer, and are more involved in corporate activity and transactions that can impact the security of the pension scheme.

⁶ The Occupational Pension Schemes (Winding Up and Deficiency on Winding Up etc) (Amendment) Regulations 2004 and the Occupational Pension Schemes (Winding Up and Deficiency on Winding Up and Transfer Values) (Amendment) Regulations 2005

⁷ The Occupational Pension Schemes (Employer Debt) Regulations 2005

⁸ Sections 222 – 225 of Pensions Act 2004 and the Occupational Pension Schemes (Scheme Funding) Regulations 2005

⁹ Clearance Statements: Guidance from the Pensions Regulator, April 2005

5. These changes have come at a time when there has been an increasing acceptance that, due largely to economic conditions and increasing longevity, a majority of schemes are in deficit.

Funding levels and deficits

6. Since 2001, defined benefit pension scheme deficits measured using Financial Reporting Standard 17 (FRS 17) have been provided by employers sponsoring such schemes in the notes to their accounts, and it became mandatory to include these in primary financial statements from 2005. While FRS 17 is not a measure of technical provisions,¹⁰ it provides a snapshot of the level of deficits in defined benefit schemes that is reasonably transparent. The disclosure of FRS 17 information has helped to increase awareness of the impact that low interest rates, increasing longevity and equity market volatility over the last six to seven years have had on the potential cost of defined benefit pensions. Recently deficits measured using FRS 17 have decreased to a degree but still persist.
7. We estimate that there are around 10,800 private sector defined benefit occupational pension schemes in the UK.¹¹ The regulator has data on the funding level of 5,800 of these schemes, representing between 80% and 90% of total membership and pension scheme liabilities. This data is on an MFR basis and in some cases on the Pension Protection Fund's section 179 (s179) basis.¹² It does not provide information on how well funded schemes are in terms of technical provisions. Funding levels measured on technical provisions will only be fully known in 2009. However, by using this data and calculations carried out by the Pension Protection Fund (PPF) we have derived useful proxies relating to our triggers (as set out in guidance)¹³ for regulating scheme funding.
8. These triggers are the accounting funding level (based on FRS 17 or International Accounting Standard 19) and the Pension Protection Fund's s179 funding level. While these are triggers for regulatory scrutiny and not targets for scheme funding, the proxies calculated on these bases provide reasonable and comparable information on likely levels of current deficits. Chart 1 below shows estimates of funding levels on s179, FRS 17 and buyout bases at 31 March 2006 for the sample of 5,800 schemes.
9. Overall, for the sample, assets are around 90% of the value of liabilities on an FRS 17 basis and around 95% of s179 liabilities. Across all schemes the level of deficit on these bases may not be particularly large, but it appears from the distribution shown in the chart that there may be a significant number of smaller schemes that are poorly funded.

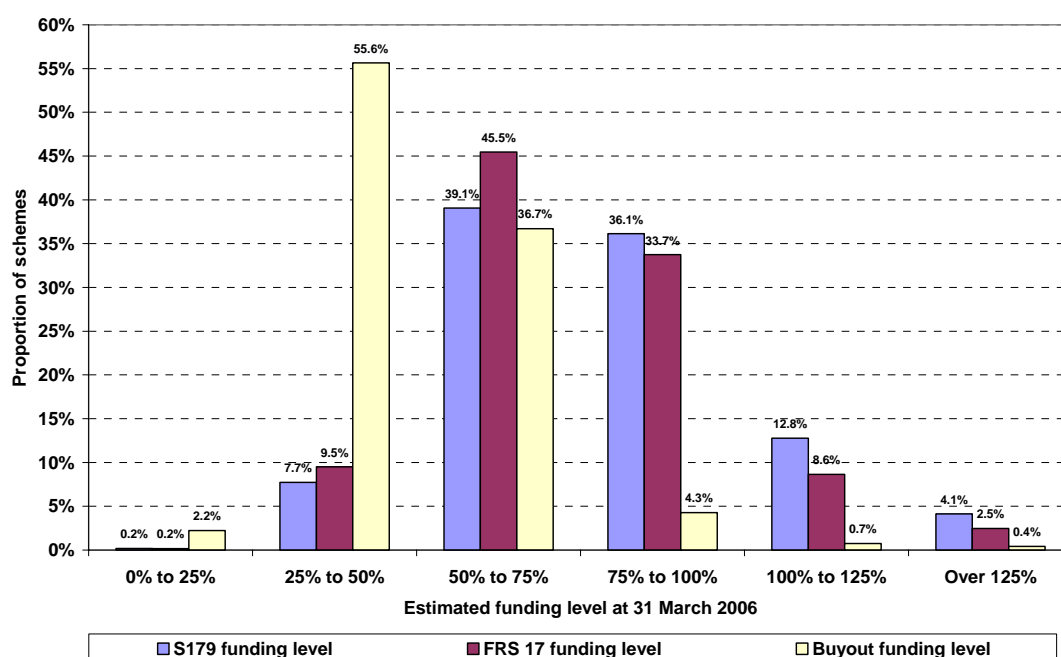
¹⁰ Sections 222 – 225 of Pensions Act 2004 and the Occupational Pension Schemes (Scheme Funding) Regulations 2005

¹¹ Estimate derived from the database of schemes that paid levies to the regulator over 2005/2006

¹² Section 179 of Pensions Act 2004

¹³ How the Pensions Regulator will regulate the funding of defined benefits, May 2006

Chart 1: Estimated distribution of s179, FRS 17 and buyout funding levels at 31 March 2006



Source: *The Pensions Regulator; annual scheme returns; Pension Protection Fund calculations*

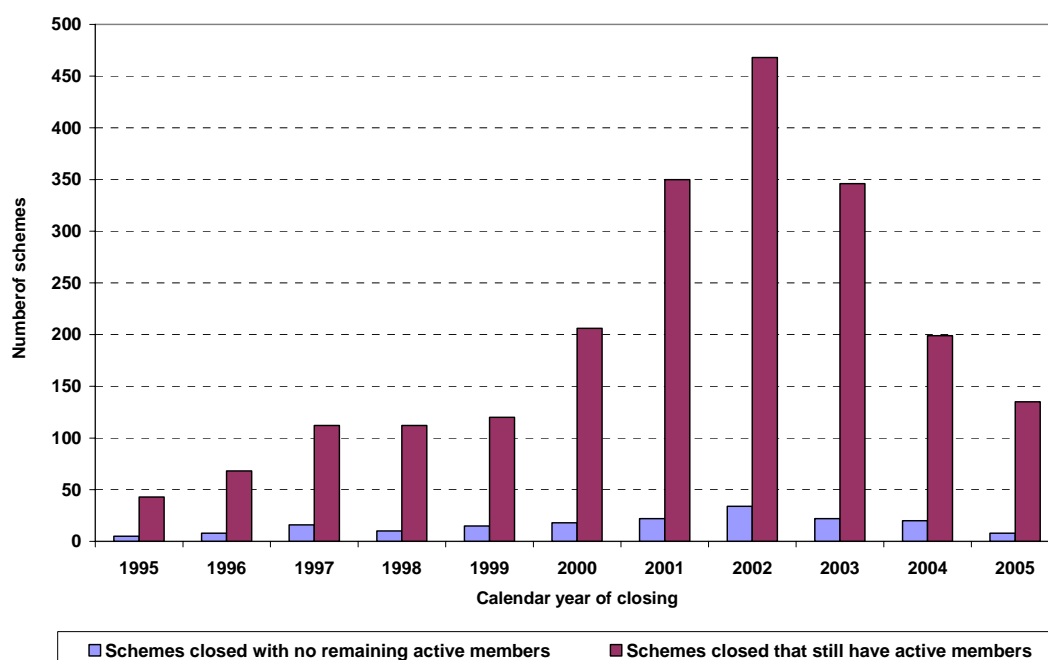
10. The estimates show only a small proportion of schemes are very poorly funded (8% are less than 50% funded on a s179 measure and 10% less than 50% funded on an FRS 17 measure). However, over 80% of schemes are funded below our trigger levels on both bases. Depending on the technical provisions that are established as appropriate for schemes relative to the employer covenant, it is reasonable to conclude that moving to the new rules for determining scheme funding, introduced by Part 3 of the Pensions Act 2004, is likely to have some degree of impact on employers through requiring increased contributions.
11. The proxy measures above and the funding regime introduced by the Pensions Act 2004 are based on an ongoing scheme with an ongoing employer. As mentioned above, if an employer wants to wind up a scheme to remove its exposure then it is the buyout cost that is relevant. Chart 1 above also shows the distribution of estimated buyout levels of the 5,800 schemes as at 31 March 2006. The total value of liabilities on a buyout basis (for the sample) is approximately 50% on average higher than the FRS 17 value of liabilities. The total funding level across all schemes on a buyout basis is 60%. An employer can remove its risk exposure to a scheme by buying out benefits with a regulated insurer. We believe that this is not likely to be an attractive solution in the short term to many employers as the immediate exit cost may appear high relative to other measures of the cost of liabilities with which employers are more familiar.

12. It is felt that over time, as schemes mature and pension scheme longevity assumptions are strengthened, there may be a narrowing of the gap between the ongoing measures and the cost of buying out liabilities with an insurer. In the meantime, we believe that a large number of employers will be looking for intermediate solutions to reduce risk in pension schemes at a cost lower than buying out liabilities with a regulated insurer.

Impact of changes

13. There has been an increasing trend on the part of employers to close defined benefit pension schemes either to new entrants or, going further, to future benefit accrual. Chart 2 below shows the trend in scheme closures for the 5,800 schemes on which we hold funding data. There has been a material increase in the number of schemes closing since 2000. The chart seems to indicate that there has been a slowing of closures since 2003. One interpretation of the decline shown in the chart may be that the employers to the schemes that remain open believe that these schemes are a relatively low risk to their business in comparison with those employers that have closed schemes. As a result, closing their schemes to limit costs has been lower on their agenda. However, anecdotal evidence suggests that scheme closures remain high on employers' agendas as they perceive the advantage of defined benefit schemes as a reward tool to be declining. Part of the decline shown in the chart is, therefore, expected to reflect a delay in the reporting of scheme closures as the administration process to achieve this is undertaken.
14. The chart shows that the majority of schemes have not yet closed to future accrual. Even fewer have moved to wind up the scheme, most likely due to the significant immediate cost involved relative to ongoing funding requirements.

Chart 2: Number of schemes closing in each calendar year



Notes: Schemes are shown relative to a base of 5,800 schemes.

Over the period around 600 schemes have also closed part of the scheme to new members or future accrual, but dates of closing the parts have not been provided to the regulator.

Source: The Pensions Regulator; annual scheme returns

15. Employers have also become aware of the potential for defined benefit pension schemes to impact on company value. As a result, managing pension risk has become important to employers in order to control the impact on company value.

16. In a report¹⁴ prepared in November 2005 for the regulator, it was estimated that around 75%, at least, of FRS 17 deficits was already factored into the share prices of listed employers. Estimates varied, however, depending on whether deficits were looked at net of tax or gross, and also on the degree of confidence in the estimate. The report concluded that deficits may be largely but by no means fully factored into share prices. This supports the view that any significant reported change in a pension scheme deficit in an employer's accounts is likely to impact on the market's assessment of the employer's value.

¹⁴ Paying off Pension Fund Deficits – Impact on company behaviour, share prices and the macro-economy, PricewaterhouseCoopers LLP, November 2005

17. This, along with the high cost of buyout and the realisation of an open-ended commitment (unless the buyout cost is paid), means that managing the risks of a defined benefit scheme has become a priority for the majority of employers. The same report confirmed in interviews with finance directors that the potential impact of schemes on employers' accounts was indeed a key concern. As a result, employers are believed to be looking for ways both to protect the company against pension risks and also to reduce the need to spend a significant amount of management time on the issue.

Nature of the risks faced by defined benefit occupational pension schemes

18. There are a number of risks in relation to providing full benefits to members in a defined benefit pension scheme. Nearly all these risks are ultimately borne by the sponsoring employer, except the risk of the employer defaulting on the pension promises.

19. Table 1 below highlights the main risks. The table shows that there is a multiplicity of risks. A number of them interact, making management of these risks complex, requiring significant professional input and advice.

Table 1: Types of risk associated with defined benefit occupational pension schemes

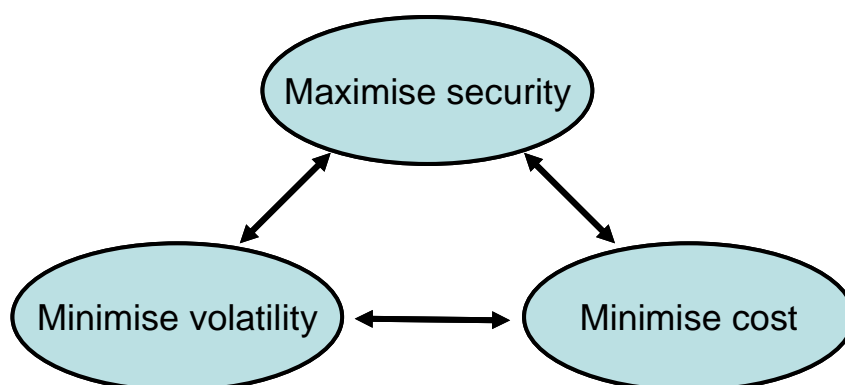
<i>Risk category</i>	<i>Comment</i>	<i>Who bears the risk?</i>
Investment	In a general context, investment risk is the risk that the assets of the scheme (including agreed future contributions) will ultimately prove inadequate to pay the promised scheme benefits.	Employer
Inflation	Inflation risk is complex. Superficially this is the risk that the cost of promised benefits will increase more than expected if inflation is ultimately higher than expected. However, inflation indexing of benefits is capped for a number of schemes and any changes in inflation will be linked to the performance of scheme assets and possibly the employer. These factors may offset the impact of inflation on the ultimate cost of benefits.	Employer

<i>Risk category</i>	<i>Comment</i>	<i>Who bears the risk?</i>
Longevity	<p>Longevity risk consists of both:</p> <ul style="list-style-type: none"> • specific longevity risk relating to the members of the pension scheme; and • population longevity risk relating to the general improvement in longevity in the population of occupational pension scheme members. <p>Longevity risk relates to members both pre- and post-retirement.</p>	Employer
Other demographic risk	<p>There are a number of other demographic risks including:</p> <ul style="list-style-type: none"> • withdrawal and early retirement patterns of individuals; and • number and type of dependants of scheme members. 	Employer
Basis or volatility risk	<p>‘Basis risk’ refers to the requirement to measure the liabilities and assets of the pension scheme on a regular basis for accounting and funding purposes. ‘Volatility risk’ means that any deficit or surplus of the assets relative to liabilities may fluctuate depending on the level of mismatch in the nature, term and currency of the assets relative to the liabilities. These fluctuations can impact on the cash flow, operations and market perceptions of the employer.</p>	Employer
Employer default	<p>Following changes to the law governing the amount of the section 75 debt, a solvent employer is required to meet the cost of insuring pension promises if it wants to wind up the scheme. However, an employer may become insolvent and default on paying all promised benefits. There is a risk that, as a consequence of the insolvency, the scheme will not be able to recover the full cost of insuring these benefits from the employer’s assets.</p>	Scheme members and levy payers via the Pension Protection Fund

Managing defined benefit pension risk

20. An overriding objective of recent regulatory changes in the pensions environment has been to seek to maximise security for scheme members. However, there have traditionally been a number of competing objectives in managing a pension scheme. These are highlighted in Figure 1 below.

Figure 1: Competing objectives in managing pension schemes



21. We believe that, traditionally, employers have taken advice on the most cost-effective way of providing defined benefits, recognising that historically some parts of the benefits (eg pension indexation) were more discretionary than guaranteed. This was reflected in significant equity exposures in pension schemes. At the same time the funding regime before the Pensions Act 2004 did not require funding plans to be set with consideration of an employer's covenant and its ability to underwrite the risks inherent in schemes having a large exposure to volatile asset classes.
22. Changes in the pension legislation, however, have sought to make maximising security a key objective. As a result employers and trustees are now facing more of a trade-off between minimising volatility and minimising costs.
23. We believe that more employers are now working with trustees to reduce volatility in pension schemes, particularly in the light of reporting requirements in employers' accounts. Reducing volatility benefits not only the employer but also scheme members and the Pension Protection Fund. The ultimate way to reduce volatility is to buy out liabilities with a regulated insurer. However, as discussed before, this may add in the region of 50% on average to the FRS 17 cost of liabilities, and we believe that many employers will look for other ways to reduce risk.
24. The regulator is keen to see innovative thinking applied to the way pension schemes are managed so as to reduce risks to members and to the sponsoring employer. We are aware that some market participants have introduced some methods (and are considering further methods) designed to do this, and we will be interested to see what further developments follow.

25. One method that is being used to provide security to pension schemes, and to help protect employers against possible overfunding, is the use of contingent assets provided by employers. Also, where the employer is part of a group, guarantees are being provided by other non-participating group companies. The regulator has issued previous guidance¹⁵ covering the role of contingent assets in scheme funding recognising the role these have to play in increasing member security. Our clearance guidance¹⁶ also sets out ways that security for a pension scheme may be improved using methods followed by lending banks. These include improving the priority of the pension scheme (which links into contingent assets); information gathering (for example, monitoring information on the employer's covenant); and negative pledges.
26. Employers and trustees are also able to modify the future accrual of benefits provided to employers in order to manage risks and costs. Doing so may form part of a scheme recovery plan, and this is discussed in the regulator's code of practice on scheme funding.¹⁷
27. The other main types of methods or approaches to manage risk of which the regulator is aware include:
- buying out some or all member liabilities with a regulated insurance firm;
 - deferred buyout of liabilities;
 - attempts to introduce products to reduce or manage longevity risk;
 - primary layer or excess of loss insurance of pension risks over finite periods;
 - derivative asset classes to better match the duration profile of scheme assets to scheme liabilities;
 - derivative asset classes to reduce or limit equity downside, or effect a change in the equity/bond mix of a scheme's assets; and
 - third party protection against employer default or insolvency, such as letters of credit or credit default swaps.
28. The suitability and value of each of the above will depend on each scheme's individual situation and risk profile and the strength of the employer supporting the scheme. The decision to implement these solutions rests in a large part with the trustees of the scheme and it is expected that they will carefully consider any of the above methods with the help of suitably qualified advisers.
29. There is very limited data available on the use to date by schemes of the above methods to manage risk. The form that the methods take can also

¹⁵ Guidance on the role of contingent assets in scheme funding

¹⁶ Paragraphs 101 – 107 of Clearance Statements: Guidance from the Pensions Regulator, April 2005

¹⁷ Paragraphs 109 – 113 of Regulatory Code of practice 03: Funding defined benefits, the Pensions Regulator, February 2006

vary depending on the provider and the extent of risk that these methods are looking to remove or manage.

30. Table 2 below sets out the regulator's current understanding of the types of methods and the extent to which they are being used.

Table 2: Types and prevalence of methods to manage pension scheme risk

<i>Type</i>	<i>Comment</i>	<i>Prevalence</i>
Buy out of all or some scheme liabilities with a regulated insurer	Buying out liabilities with a regulated insurance company may appear to be an expensive immediate exit cost relative to the cost to the employer of running the scheme on. In practice, this means the employer is implicitly providing capital from its business to cover the risks that an insurer has to provide explicitly. This depends on the appropriate technical provisions for a scheme linked to the financial strength of the employer, and the benefit and membership profile of the scheme.	Buyout is still predominantly linked to schemes winding up either above PPF level or prior to being eligible for PPF protection. However, many new entrants believe that this will change in the future.
Deferred buyout of liabilities with a regulated insurer	Some insurance companies are offering to take on schemes' liabilities in a phased approach. The aim is that benefits are insured gradually over time allowing the cost to be spread and the scheme risks to be managed towards buyout. Some market entrants are using this to target small to medium sized companies and schemes that may not have the available capital for a full buyout.	Not aware of wide scale use of such an approach but many entrants to this market believe there is potential growing demand.
Longevity risk products or securities	This covers a range of products or potential products. A discussion paper on these was presented to the Faculty of Actuaries in January 2006. ¹⁸ Existing and past products include over the counter mortality swaps from some insurance companies, mortality bonds limiting catastrophe risk over the short to medium term issued by a reinsurer to cover its own life insurance risk, and a longevity bond announced in November 2004 (subsequently withdrawn).	Data is sparse on use of longevity risk products. The Faculty paper suggests insurance companies are transacting swaps but it is not clear if any have been implemented for pension schemes.

¹⁸ D Blake, A J G Cairns and K Dowd, Living with Mortality: Longevity Bonds and other Mortality Linked Securities, Institute and Faculty of Actuaries, 2005

<i>Type</i>	<i>Comment</i>	<i>Prevalence</i>
Primary layer or excess of loss insurance of pension risks over stated periods	We are aware of proposals by some companies to insure certain risk experience within predetermined bands over a stated period which may be the funding recovery period. For example this may be to underwrite mortality and investment experience up to a stated level over the recovery period.	We believe that no schemes have used such products to date.
Interest rate and inflation derivatives	These are primarily over the counter swaps or pooled investment arrangements provided by investment banks and asset managers. The intention of these is to improve the match of the scheme assets to the measurement of the liabilities.	We are aware of a relatively small number of schemes (some with significant assets) that have implemented these products as part of a liability driven investment approach. Overall, there is evidence of significant pension fund interest in this market over the last year or so.
Equity derivatives	These usually involve combinations of share options and futures in order to limit exposure to falls in equity markets. The cost of these is usually also to limit the potential for equity gains. These may be used in combination with bond options or futures to effect a change in the equity/bond mix of the scheme assets.	We believe that there has been some use by a small number of schemes of these products. We believe, however, that these have more commonly been used to effect changes in the equity/bond splits of scheme assets.

<i>Type</i>	<i>Comment</i>	<i>Prevalence</i>
Protection against employer default	Examples of third party insurances include letters of credit and credit default swaps. A letter of credit provides an amount to the scheme in the event of employer default as defined in the agreement. A credit default swap, generally, operates as for a letter of credit but is a tradable market instrument.	Our understanding is that there has been little to no use of credit default swaps. It appears that letters of credit are sometimes used in transactions to provide a temporary level of security to the scheme ahead of agreeing updated technical provisions or other compensation to the scheme.

31. The regulator expects that it will form a more comprehensive and detailed view of methods to reduce risk as more companies submit details of their Part 3 valuations.¹⁹ While use of the above methods to control risk is not widespread, the regulator is encouraged that employers, schemes and advisers are looking to find innovative ways to decrease risk to both members of the schemes and the employer. It is up to trustees along with competent advisers to assess and use these methods when and if appropriate for their pension scheme.

32. The attached draft guidance does not cover the above methods of controlling risk. We do not believe it appropriate, at this stage, to issue guidance to cover such a wide ranging area and one that is likely to change and develop with time. However, there is a core set of issues that trustees should consider if they wish to use methods to reduce risk, and these should form part of trustees' risk reduction strategies. We believe that considering the use of methods such as those highlighted above will become a more natural part of managing a pension scheme as part of its risk reduction strategy.

33. We believe there are a number of important steps involved in developing a scheme's risk reduction strategy:

- Trustees should establish a risk control framework as described in the regulator's code of practice on internal controls.²⁰
- The risk assessment framework should include a robust set of documented risk management objectives.

¹⁹ Part 3 of Pensions Act 2004

²⁰ Code of practice: Internal controls: Consultation document, the Pensions Regulator, September 2005

- Using these objectives, trustees should identify and categorise risks, implement plans in respect of those risks, and monitor risks.
- Part of categorising risks would involve developing an understanding of the likelihood and severity of each risk and the extent to which it is possible to rely on the employer to underwrite the risk.
- Trustees should work with the employer on managing and reducing risks, but with an understanding of the implications for the security of members' benefits of any risk reduction strategies that are proposed by the employer.

34. The regulator believes that, with the understanding gained from the steps above, it will be easier for trustees to work with employers to implement risk reduction strategies that are desirable. The characteristics of a desirable strategy are that it is:

- relevant to the scheme and employer;
- commensurate to the likelihood and potential severity of each risk; and
- understood by the trustees in terms of benefit and cost.

35. A vital element is that the risk management strategy does not break the link with an employer of substance (in its current form) in a way which may result in the scheme being abandoned.

Question 1: Are there any other products or methods that have been introduced to manage pension risk that are not covered in this chapter?

Question 2: What level of take-up of such products by schemes are you aware of or do you expect to see?

Chapter 2: Potential abandonment of defined benefit pension schemes

1. While the regulator welcomes innovation that helps employers and trustees better manage pension risks, we are concerned about arrangements that may result in the abandonment of the pension scheme.
2. The regulator is starting to see proposed corporate transactions or arrangements involving pension schemes where a main intent behind the transaction or outcome is for the employer to abandon the pension scheme. We have also been informally approached by pension scheme advisers proposing mechanisms that result in the significant weakening of the employer covenant. Such arrangements aim to move the scheme to a new vehicle with a nominal employer or restructure the current employer into a nominal employer in such a way that the existing employer would, in practice, no longer be responsible for the potential cost of members' benefits. The arrangements avoid the need to meet the section 75 debt or prevent any section 75 debt crystallising, and decrease the likelihood that any such debt could be recovered if it crystallised in the future.
3. Abandonment can arise in a number of different ways. However, there are two key parts to any transaction that may mean it results in abandonment of the pension scheme. First, the covenant of the employer that remains with the scheme (or a section of the scheme or membership) may be nominal compared with the previous covenant. Second, the level of mitigation offered to the scheme is less than the full section 75 debt, which is intended to be the amount required to fully insure benefits with a regulated insurer.
4. The covenant of an employer is defined in the regulator's code of practice on scheme funding²¹ as the employer's financial position and prospects as well as its willingness to continue to fund the scheme. An important part of assessing the covenant is the employer's ability to underwrite (to an extent) the risks that may result in the technical provisions ultimately proving inadequate.
5. A nominal employer can be an employer whose principal activity directly relates to the pension scheme (for example the administration of scheme benefits or management of scheme assets) or it could be an employer that has little or no value as a business, excluding the pension scheme. Arguably, where the employer does have some value, but the covenant is substantially weakened, this could be considered abandonment.
6. It is also expected that it will be an objective of the arrangement to remove or limit the responsibility towards a pension scheme of an employer or any associated or connected company. In most cases it is expected that there

²¹ Regulatory Code of practice 03: Funding defined benefits, the Pensions Regulator, February 2006

will be significantly reduced value in the proposed arrangement to other parties if this responsibility were not removed.

7. We do not consider that abandonment of a scheme by its ongoing employer is likely to be in the best interests of scheme members. Our position remains that the best means of delivering pension scheme members' benefits is for the scheme to have the continued support of a viable employer which is capable of meeting the scheme liabilities. This is because the employer underwrites the majority of risks in the pension scheme, as highlighted in Chapter 1. Once the link to any employer of substance is removed, trustees will have lost an important backstop to protect scheme members if the pension scheme runs into difficulties in the future.
8. It is also the regulator's viewpoint that the application of Part 3 of the Pensions Act 2004 could make it difficult for a scheme with a nominal employer to fund what may be an appropriate level of technical provisions over any reasonable period. This is because the UK defined benefit funding system works on the basis that the target funding level (technical provisions) combined with the employer covenant forms the basis of security for defined benefits. As mentioned in Chapter 1, most schemes with an ongoing employer may be able to set technical provisions below the cost of buying out benefits. Consequently, in the context of such arrangements, schemes with a nominal employer may have to be able to reach a buyout level during a finite period potentially through expectations in investment outperformance alone. This may not be achievable, and the high level of technical provisions which is expected to attach to a nominal employer covenant potentially places significant obstacles in the way of abandoning a scheme.

Risks the employer underwrites

9. The value of the employer's covenant is that the employer underwrites risks to the scheme beyond those that have been provided for in prudent technical provisions. By comparison, in an insurance company the underwriting of risks takes the form of capital requirements resulting in higher buyout costs for pension liabilities.
10. Employers underwrite the investment risk in the scheme. All schemes will have an element of mismatch between the assets and the liabilities of the scheme. The extent of this mismatch can vary considerably between schemes. If the mismatch, taking account of any insurances the scheme has, results in the assets ultimately proving inadequate to provide for the scheme benefits, the only recourse in order to secure members' full benefits is the employer. To an extent (as covered in Chapter 1) these risks can be managed, and methods and products are being introduced to try to achieve this.
11. A significant risk the employer underwrites is the risk that members live longer than expected. There is currently considerable uncertainty in

relation to the longevity of occupational pension scheme members. This uncertainty is reflected in the range of assumptions that UK employers are using in reporting their pension liabilities in company accounts. Research carried out by KPMG in 2006,²² based on assumptions used by 207 companies, showed that there was a wide disparity between life expectancy assumptions. There was a range between the highest and lowest assumptions of over nine years for present retirees in non-financial sectors and five years for present retirees in the financial sector.

12. While the profile and location of each scheme's membership will differ, such widely differing assumptions are unlikely all to be right. The regulator estimates that each additional year members live beyond that assumed could add 3 – 4% to the value of liabilities. If the research by KPMG is indicative of the range of assumptions used by all schemes, there is a significant risk that pension costs may increase for a number of schemes. If there is no longer an employer of substance associated with the scheme that can meet these costs, there is an increased risk that members will not receive their promised benefits.
13. Employers also underwrite a number of other demographic risks including retirement patterns, eligibility for dependants' benefits, age discrimination issues, sex equality issues, and withdrawal patterns. To an extent employers may be able to control some of these risks (eg retirement patterns). However, the circumstances for each scheme will differ, and trustees and their advisers should have an understanding of the exposure of the scheme to these risks and the value of the employer's support in underwriting them (as discussed in Chapter 1).

Intent of pensions regulation

14. The Pensions Act 2004 and enabling legislation had the clear intention of preventing employers from acting to avoid meeting their pension obligations. The key changes to achieve this were:
 - Altering the amount of the section 75 debt (when an employer or the trustees wind up a scheme, or when an employer becomes insolvent) to be an amount equivalent to the cost of insuring benefits with a regulated insurance company, as estimated by the actuary.²³
 - Providing that where an employer ceases to participate in a multi-employer scheme on or after 2 September 2005, a section 75 debt falls due on the employer based on that employer's share of the cost of insuring benefits under the scheme with a regulated insurance company (unless an arrangement is approved by the regulator whereby one or more guarantors guarantee all or part of the amount due).²⁴

²² 'Higher life expectancy costs UK quoted companies £20bn over 2005', KPMG News, May 2006

²³ The Occupational Pension Schemes (Employer Debt) Regulations 2005

²⁴ The Occupational Pension Schemes (Employer Debt) Regulations 2005

- Providing the regulator with the power to issue a contribution notice against a person who was a party to an act or a deliberate failure to act, where the regulator is of the opinion that one of the main purposes was to prevent the recovery of a section 75 debt; or otherwise than in good faith, to prevent such a debt becoming due, to compromise or otherwise settle such debt or to reduce the amount of such debt that would otherwise become due.²⁵
- Providing the regulator with the power to issue a financial support direction against an employer or connected or associated companies in cases where an employer associated with the scheme is a service company or is insufficiently resourced.²⁶

15. Our view is that abandonment of a scheme is, in concept, contrary to the aims of the above provisions. We recognise that every employer and scheme's situation is different but we believe that in cases where there is an employer of substance, abandonment is not likely to be in members' best interests and could well prompt consideration of use of regulatory powers.

16. We recognise that the definition of abandonment may not be clear-cut in every case. Identifying abandonment may be difficult in the context of the wide range of transactions that can impact a pension scheme, and some may result in abandonment even though there is an underlying commercial motivation, separate from the scheme, for the transaction to proceed. Also the level of covenant of the existing employer may already be very weak. While we believe that such transactions are unlikely to be in the best interests of members, trustees should follow due process in reaching their own conclusions for their scheme in the context of any proposed transaction. Therefore, we believe that guidance is needed not only to help trustees identify arrangements that may result in abandonment but also to guide them on types of factors to assess in reviewing the merits of the transaction for the scheme members.

Question 3: Do you agree with the analysis and reasons why abandonment can rarely be justified?

Question 4: Do you have knowledge about types or formats of transactions involving pension schemes that may be classified as abandonment as described in this paper? If so, what form do these take?

²⁵ Section 38 of Pension Act 2004

²⁶ Section 43 of Pension Act 2004

Chapter 3: Factors trustees should consider in cases of potential abandonment

1. Trustees have the prime responsibility for safeguarding members' interests. Their powers and duties are set out in statute, trust law and the scheme's trust deed and rules. As part of this responsibility it is expected that trustees will not wish to take any action that may expose members' benefits to increased risk and will use their powers to block any actions that introduce uncompensated risks.
2. In reducing risk, trustees may consider a number of the methods discussed in Chapter 1. Whether these are appropriate will depend on the details of the method and the circumstances of each scheme and its employer. The regulator is not endorsing any of the approaches and would expect trustees, along with sufficiently qualified and experienced advisers, first to consider the appropriateness and effectiveness of any method in the context of their risk management framework before using it.
3. However, for reasons set out in Chapter 2, we expect trustees to place an especially high level of scrutiny on any arrangement that breaks the link with the current employer. This expectation also applies to any transaction where a restructuring of the employer or group of companies associated with the employer significantly reduces or removes the covenant provided by the employer to the scheme.
4. As trustees may be approached with seemingly plausible arguments to support abandonment, we have decided it is appropriate to issue guidance to help trustees when considering such proposals. The draft guidance is set out in Chapter 6.

Factors to consider when faced with a potential abandonment transaction

5. Trustees will need to form a judgement based on the employer's financial strength (before and after the arrangement) and the level of mitigation offered to the scheme for any reduction in security. Therefore, we believe that it would not be helpful only to provide guidance that helps trustees to identify potential abandonment. The factors discussed below are aimed at helping trustees to give due consideration to any proposed transaction and to arm them to make decisions about the transaction which are in the best interests of scheme members.
6. It is important for trustees to recognise that the scheme is a central component in such an arrangement. Our reasoning is that, in potential abandonment arrangements, a significant part of the value to the parties in the arrangement can be created through what is achieved with the pension scheme.

7. Given this, we believe that trustees should carry out an independent, comprehensive and rigorous review of the financial aspects of the employer and the arrangement. Trustees should ensure that they are provided with adequate disclosure from the employer to carry out such analysis and should also take appropriate independent advice. Clearance guidance from the regulator already provides guidance to trustees on negotiating over proposed transactions.²⁷
8. In summary, the factors below aim to form an explicit framework for trustees to consider any proposed arrangement, helping them to focus on relevant points and form an independent view. As such arrangements potentially have a significant financial benefit to other parties, this will arm trustees to ensure the best interests of the scheme members are considered.
9. We believe that trustees should examine the following factors as a minimum:
 - the mechanism by which the link to the current employer is reduced or removed and whether it triggers a section 75 debt;
 - the covenant of the current employer;
 - the nature and structure of any group associated with the current employer and the potential for additional security this provides;
 - the covenant of the replacement employer (which may be a significantly restructured existing employer);
 - the nature and structure of the group of companies, if any, associated with the replacement employer and the ultimate owners of the replacement employer;
 - the potential risk and reward profile for parties to the deal other than the pension scheme, including the potential gain relative to any capital committed;
 - the security or form of mitigation being offered to the pension scheme, if any;
 - the appropriate level of technical provisions after the proposed arrangement reflecting the reduction in employer covenant;
 - potential implications for the scheme's PPF levy and potential funding for this levy;
 - the scheme's investment strategy before and after the proposed arrangement;
 - the structure of the scheme's trustee board before and after the proposed arrangement; and
 - any possible alternatives to the proposed arrangement.

²⁷ Paragraphs 77 – 94 of Clearance Statements: Guidance from the Pensions Regulator, April 2005

Why the regulator believes these are factors trustees should examine

10. An arrangement which results in the abandonment of a pension scheme must have some mechanism by which this can be achieved. As a first step, it is appropriate to determine the powers that the scheme's governing documents provide to trustees in relation to this mechanism. This is expected to have a direct impact on trustees' negotiating position. For example if the governing documents require the trustees' agreement to the mechanism this will give trustees a stronger negotiating position. The trustees' negotiating position may also be strengthened if the mechanism being used causes a section 75 debt to crystallise.
11. We believe that a key part in considering any proposed arrangement is to review the impact of the arrangement on the employer covenant. The employer covenant is critical to the security of members' benefits (as highlighted in Chapter 2). It is also one of the main building blocks for setting technical provisions and recovery periods.²⁸
12. Linked to assessing employer covenant, trustees are encouraged to review the nature and structure of any entities associated and connected with the current employer and the employer going forward. In respect of the new employer this may be a special purpose vehicle designed to isolate the new employer from its ultimate owners. We believe that it is important for trustees to understand what other security or potential future funding, if any, they may have a right to through this structure. In most cases it is expected that there will be none.
13. Adequate mitigation is important in any arrangement that may worsen the standing of the pension scheme as an unsecured creditor. Such mitigation should reflect the change in covenant of the employer. For this reason, we believe that it is important for trustees to review the potential gain to all parties involved in the arrangement and ensure that any mitigation is commensurate with both the loss in covenant and the potential gain to other parties. That is, trustees should look to achieve a fair deal for the scheme if there is potential upside to other parties in any proposed arrangement.
14. Trustees should consider the impact on technical provisions of any proposed arrangement that reduces the covenant. If this is not factored in early to any arrangement then schemes may not be able to meet their statutory funding objective introduced by the Pensions Act 2004.²⁹ As discussed in Chapter 2, the combination of technical provisions and employer covenant forms the basis for providing security to defined benefit schemes in the UK. A consequence of this is that the level of technical provisions is expected to change given a change in covenant, and any mitigation to the scheme may need to reflect this change. Related to

²⁸ Paragraph 57 of Regulatory Code of practice 03: Funding defined benefits, February 2006

²⁹ Section 222 of the Pensions Act 2004

funding of the scheme is the payment of the PPF levy. This is levied on the scheme but the employer usually provides funding for this. The trustees may wish to assess the potential change in the levy and should ensure payment of this does not become a risk to the scheme's funding level.

15. Related to the above, clearance guidance states that the new statutory funding objective might in due course become the right calculation to determine if any transaction is financially detrimental to a scheme.³⁰ There are very few valuations that have been completed under the new statutory funding objective. However, we expect this will become a more appropriate measure than FRS 17 to determine whether a transaction is financially detrimental to a pension scheme, particularly as technical provisions are intended to reflect the covenant of the employer.
16. As mentioned in Chapter 2, the employer underwrites the investment risk in a scheme's investment strategy. If the covenant changes it may no longer be appropriate to maintain the current investment strategy of a scheme.
17. Following any transaction, an associated or connected party may look to benefit from carrying out administration or asset management for the pension scheme. While the third party may be the best provider to the scheme, we are concerned that any such commercial relationship may prevent trustees from appointing the most competent managers and follow the most appropriate investment strategy for the scheme. We believe that trustees should therefore carefully consider any proposals as to the composition of the trustee board following the transaction and ensure that the balance of power in the trustee board serves the best interests of scheme members at all times. For instance trustees need to bear in mind that the delegation of investment management only secures a trustee indemnity from legal liability to the extent that the manager acts in accordance with a scheme's investment principles.³¹
18. It is unlikely that trustees will be proposing any such arrangement. Therefore, it is expected that the design and terms of the arrangement will initially be fashioned to be in the best interests of other parties to the arrangement. We believe that a significant part of the value in such arrangements will be derived from what can be achieved with the pension scheme. Trustees should therefore consider what alternatives may be available to the employer's initial proposal and whether more mutually desirable outcomes can be achieved.

³⁰ Paragraph 32 of Clearance Statements: Guidance from the Pensions Regulator, April 2005

³¹ Section 34(4) of Pension Act 1995

19. While guidance on the above factors relates to arrangements that may result in abandonment, trustees are encouraged to consider whether it is appropriate to consider the above factors in any transaction that may be financially detrimental to the scheme. In particular, a commercial transaction where the employer covenant is significantly reduced may have an outcome the same as an overt abandonment. If trustees are unsure whether the transaction borders on abandonment, they are encouraged to follow the guidance on factors to consider.

Factors that should not be treated as primary benefits when faced with potential abandonment

20. The proposals we have seen that will lead to abandonment often include a list of benefits to the scheme as a result of the arrangement. We believe that some of these benefits are potentially misleading, as trustees' agreement to abandonment is not necessarily required in order to gain access to such benefits.

21. For this reason, we believe that guidance should also discuss factors that trustees should not accept as primary reasons to agree to an arrangement that may result in abandonment. Such factors include any benefit that could also be achieved without breaking the link with, or a substantial reduction in the covenant of, the current employer.

22. Examples of promises of benefits to the scheme and members which it may be possible for the scheme to obtain without breaking the link with the current employer include:

- access to improved investment management;
- access to improved scheme administration;
- access to more knowledgeable and experienced advisers; and
- increased or earlier payment of contributions from the current employer's existing resources.

Question 5: Chapter 6 sets out draft guidance to trustees to help them identify and deal with proposed transactions that could result in abandonment of pension schemes. Do you find the guidance relevant and helpful?

Question 6: Do you have any feedback on the content of the proposed guidance on abandonment?

Chapter 4: How the Pensions Regulator is regulating potential abandonment

1. The regulator has established a statutory clearance procedure as required by the Pensions Act 2004.³² Guidance sets out principles that we follow in reviewing any application that comes to us for clearance.³³ In essence, we wish to be informed about all events having a materially detrimental effect on the ability of an employer to meet its obligations to the pension scheme.
2. Key principles in respect of our approach state that:
 - our preferred outcome is a properly funded defined benefit pension scheme with a solvent employer;
 - we will deploy our resources in a risk-based manner;
 - we will seek to strike a balance between reducing the risk to members' benefits and not intervening unnecessarily in the conduct of employers; and
 - we will be consistent in the exercise of anti-avoidance powers and the operation of clearance.
3. There may be similarities between an arrangement that results in abandonment and a normal commercial transaction that impacts on a pension scheme. In particular, techniques and approaches that may normally be used during a commercial transaction could be used to facilitate an outcome that results in abandonment. We will, therefore, regulate potential abandonment cases using the procedures and processes already set up in respect of transactions that may require clearance. This means we will apply the principles above as set out in clearance guidance.
4. We consider that in potential abandonment cases it may well be reasonable to use our anti-avoidance powers. We would therefore urge that all such cases consider applying for clearance.
5. Even if they do not come to our attention through clearance procedures, we expect to become aware of significant cases through notifiable events, scheme returns, whistleblowing, Part 3 valuations, or through the ongoing environmental monitoring which forms part of our risk-based approach.
6. We will critically assess any such arrangements that come to our attention. This assessment will consider the individual facts and circumstances of each scheme, its employer and the form and type of arrangement. The factors that we will look to review will be similar to those that we will guide trustees to review and which are set out in Chapter 3.

³² Sections 42 and 46 of the Pensions Act 2004

³³ Clearance Statements: Guidance from the Pensions Regulator, April 2005

7. Depending on the outcome of any such assessment there are a number of ways in which we might respond to such transactions. In particular:
- We may engage with the scheme's trustees with the aim of acting as a referee, providing feedback and suggestions to trustees on the approach they have taken and the extent and suitability of the advice they have received in relation to the transaction. In extreme cases, where we do not believe that trustees have acted or are able to act in the best interests of members of the scheme, we may appoint an independent trustee or remove trustees using our trustee powers.³⁴
 - We might also seek to use our anti-avoidance powers. If, following consideration of the facts and circumstances of any transaction involving abandonment, we conclude that the employer (or any associated or connected party) is deliberately avoiding liabilities, we may issue a contribution notice against the appropriate parties if it is reasonable to do so.³⁵
 - If any sponsoring employer becomes insufficiently resourced as a result of an arrangement, then we might consider imposing a financial support direction on any suitably resourced entity associated with the new employer or the previous employer.³⁶
 - We will also carefully review the impact that any transaction may have on the appropriate level of technical provisions and the implications for Part 3 valuations and the recovery period.³⁷ We will consider whether as a result of the transaction it would not be possible for any recovery plan to ensure that funding up to the appropriate level of technical provisions is achievable. If we conclude that it is not, we might consider whether it is appropriate that the pension scheme be wound up.³⁸
8. We wish to act in the best interests of members and would rather not be forced to pursue the options described above. Therefore, we would encourage early discussion between parties to any potential abandonment case and the regulator to identify whether abandonment is involved and what should be done to scrutinise what is being proposed.

³⁴ Sections 3 – 9 of Pensions Act 1995

³⁵ Section 38 of Pensions Act 2004

³⁶ Section 43 of Pensions Act 2004

³⁷ Part 3 of Pensions Act 2004

³⁸ Section 11 of Pensions Act 1995

Chapter 5: Participating in the discussion on risk management, abandonment and proposed guidance

The regulator would like to hear from interested stakeholders on the areas covered in this discussion paper. We would welcome feedback in general on the paper but in particular are interested in comments on the following areas:

1. Are there any other products or methods that have been introduced to manage pension risk that are not covered in Chapter 1?
2. What level of take-up of such products by schemes are you aware of or do you expect to see?
3. Do you agree with the analysis and reasons why abandonment can rarely be justified?
4. Do you have knowledge about types or formats of transactions involving pension schemes that may be classified as abandonment as described in this paper? If so, what form do these take?
5. Chapter 6 sets out draft guidance to trustees to help them identify and deal with proposed transactions that could result in abandonment of pension schemes. Do you find the guidance relevant and helpful?
6. Do you have any feedback on the content of the proposed guidance on abandonment?

We welcome comments and views from individuals or collectively from organisations. If you are responding on behalf of an organisation, it would be helpful if you could make this clear in your response. Comments can be sent in by email or by post.

By email:

DBpaper@thepensionsregulator.gov.uk

By post:

Co-ordinator, DB abandonment paper
The Pensions Regulator
2nd Floor, Napier House
Trafalgar Place
Brighton BN1 4DW

The deadline for submission of responses to this discussion paper is **9 February 2007**.

We may need to share the feedback you send us within our own organisation or with other government bodies. We may also publish this feedback as part of our response to the discussion paper. If you wish your comments to remain anonymous please state this explicitly in your response.

Chapter 6: Proposed guidance on abandonment

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About this guidance

An arrangement involving the sponsoring employer³⁹ of a defined benefit pension scheme may result in a reduction in the covenant of the employer. In some cases these arrangements may result in the scheme being supported by a nominal employer. In effect the scheme would be abandoned. Trustees need to be able to identify arrangements that may result in the scheme being supported by a nominal employer and respond appropriately when asked to consider such arrangements.

This guidance tells trustees about:

- how to recognise arrangements that may result in abandonment;
- what factors to take into account when considering such arrangements and deciding on what action to take;
- what factors trustees should not take into account as primary factors in deciding what action to take; and
- the Pensions Regulator's desire for trustees to consult us at an early stage if they believe an arrangement could result in abandonment.

The guidance is aimed at trustees and advisers involved in any arrangement that may result in the pension scheme being abandoned. It is also relevant to employers considering such arrangements, to make them aware of the factors that we are guiding trustees to consider.

³⁹ 'Employer' is intended to refer to all types of employer that can be associated with a scheme including one, some or all employers to a multi-employer scheme.

Introduction

1. As a trustee of a defined benefit pension scheme, you may be asked by the employer supporting the scheme to consider the transfer of the liabilities in whole or in part to another employer. You may also be asked by the employer to consider a change in control, or significant restructuring, of the employer or group of companies associated with the employer that results in the substantial reduction in the financial strength of the employer who will in future sponsor the scheme.
2. The above arrangements can be the result of a range of commercial activities – for example, from the acquisition of the whole or part of the current employer by another company not associated with the current employer for an evident business reason with a fair consideration being paid. These arrangements can be materially financially detrimental to the pension scheme and, as set out in our clearance guidance,⁴⁰ trustees are expected to negotiate robustly and seek adequate mitigation.
3. One of the results of some arrangements may be for the current employer to abandon the pension scheme (or a section of the scheme or membership) without meeting its obligations when ceasing to sponsor the scheme. In a case like this, the scheme moves to a nominal employer (see paragraph 14) without being funded to a level sufficient to insure members' benefits with an insurer regulated by the Financial Services Authority. In other words, the scheme would not be able to meet the cost of buying out the full level of benefits with a regulated insurer. Alternatively the existing employer may be restructured so that it becomes a nominal employer.
4. Trustees need to be able to recognise such arrangements that can result in abandonment. These are unlikely to be in members' best interests in terms of improving the chances of securing members' benefits in the short or long term. The arrangement may expose members to an increased risk that their benefits will not be provided in full. The weakened employer covenant may also mean there is an increased risk of entry to the Pension Protection Fund, with the consequent possibility of some members receiving less benefit than they would in an ongoing scheme.
5. The Pensions Regulator ('the regulator') expects that trustees should take the starting position that any arrangement that breaks the link with the existing employer is not in members' interests, unless the full section 75 debt (the full amount necessary to insure members' benefits with a regulated insurer) is paid, or unless the scheme remains supported by an employer of substance and is suitably compensated for any change in the employer's covenant.
6. The regulator recognises that this is a difficult area. Any proposal or arrangement that will result in breaking the link between the scheme (or a significant proportion of scheme members) with the current employer must

⁴⁰ Clearance Statements: Guidance from the Pensions Regulator, April 2005

be considered on its individual merits. This guidance does not, therefore, set out fixed rules on when a proposed arrangement will or will not result in abandonment. It rather provides guidance to help trustees identify potential abandonment and factors that trustees should take into account when reviewing the merits of such arrangements.

7. The guidance is applicable to all cases where an arrangement could result in the employer breaking the link with the scheme (or a significant proportion of the members of the scheme) without payment of the section 75 debt. It is also applicable where there will be a restructuring of the employer or group of companies associated with the employer such that the scheme is no longer supported by an employer of substance.
8. In all such cases trustees are expected to consider the guidance on recognising potential abandonment of the pension scheme. If trustees believe that any proposed arrangement may result in abandonment then they are expected to consider the remainder of the guidance included here.
9. The guidance is intended to operate together with clearance guidance.⁴¹

Recognising arrangements that could result in abandonment

10. There are a number of ways in which an arrangement can be structured so that the end result is the abandonment of the pension scheme by the existing employers. Consequently, whether an arrangement will result in abandonment is best judged by reviewing the substance of the likely outcome for the scheme of any arrangement rather than just the form or legal structure of the arrangement. In particular, mechanisms that could result in abandonment may be the same as those that would otherwise be considered normal commercial transactions, and trustees should be aware of this.
11. If the full section 75 debt (the full amount necessary to insure members' benefits with a regulated insurer for the whole scheme or affected section of the scheme) is paid as part of any arrangement then the arrangement cannot be viewed as abandonment, but rather a settlement of the employer's obligations to the scheme, as paying such a debt should allow the scheme to be bought out with a regulated insurer.
12. If the section 75 debt is not paid in full then trustees are expected to consider the substance of the outcome of any proposed arrangement to determine whether the arrangement may result in abandonment. This applies whether the arrangement relates to the scheme as a whole, a section of the scheme, or a portion of the membership of the scheme.

⁴¹ Clearance Statements: Guidance from the Pensions Regulator, April 2005

13. In particular it is the substance of the employer sponsoring the scheme (or affected part of the scheme or membership) pre and post the arrangement that is important. If as a result of the arrangement an employer of substance is replaced by a nominal employer (without the full section 75 debt for the scheme or affected section of the scheme being paid) then the arrangement would result in abandonment of the pension scheme.
14. A nominal employer can be an employer whose principal activity directly relates to the pension scheme (for example, the administration of scheme benefits or management of scheme assets) or it could be an employer that has little or no value as a business, excluding the pension scheme. Where the employer does have some value, but the covenant is substantially weakened, this could be considered similar to abandonment.
15. If, following the above guidelines, trustees believe that any proposed arrangement could result in abandonment, or if they are unsure as to whether a proposed arrangement could result in abandonment, they are encouraged to follow the remaining guidance in this document when considering the merits of the arrangement and any mitigation offered to the scheme.
16. In all cases trustees are also expected to consider the regulator's clearance guidance.⁴²

Factors trustees should take into account

17. The overriding message of this guidance is that trustees' starting point in considering any arrangement that results in abandonment of the scheme (or a part of the scheme) should be that it is not likely to be in the best interests of members. Trustees should therefore apply a high level of scrutiny to the proposed arrangement.
18. Trustees will need to carry out due diligence in deciding whether the above conclusion is correct for their scheme and circumstances. In carrying out due diligence it is expected that trustees will consider a number of factors before rejecting or agreeing to any proposed arrangement. Arrangements involving abandonment, by their nature, are expected to create value for the parties involved through what can be achieved with the pension scheme.
19. The regulator therefore expects trustees to carry out appropriate, commensurate and rigorous due diligence covering the factors set out in this section when they give due consideration to a proposed abandonment arrangement.

⁴² Clearance Statements: Guidance from the Pensions Regulator, April 2005

20. The factors highlighted below are expected to be reasonably comprehensive but this does not remove trustees' responsibility to consider any other factors that may be relevant. Trustees should satisfy themselves that their review of the proposed arrangement is comprehensive.

The mechanism by which the link to the current employer covenant is reduced or removed

21. Trustees should establish whether the mechanism crystallises a section 75 debt. If a debt is crystallised, trustees' negotiating position may be significantly strengthened.
22. Trustees should understand whose debt is crystallised and their ability to pay this debt. If the debt remains contingent, and trustees are asked to reappportion the debt, they should carefully consider the value that is reappportioned and the impact that any request for them to reappportion has on their negotiating position.
23. Any review should consider the interaction of the mechanism with the scheme's governing documents, and whether trustees' agreement to the arrangement is required. If their agreement is not required then trustees may wish to consider other powers that they have which may inform their negotiating position, for example wind-up powers, powers to request a new funding valuation and investment powers.

Current employer's covenant

24. Under any arrangement resulting in abandonment, the scheme (or a part of the scheme) will lose any protection provided by the covenant of the existing employer. The existing employer underwrites the risks that the scheme is exposed to including longevity risk, investment risk and inflation risk. It is highly unlikely that the loss of this protection will be justifiable unless there are serious doubts about its future sustainability or it is already of little value.
25. Trustees should therefore form an independent opinion of the value of the covenant of the existing employer to the pension scheme.
26. The methodology and presentation of any assessment of the value of the covenant to the scheme is expected to vary depending on the approach and adviser used. Notwithstanding this, trustees are expected to form a view on the ongoing financial strength of the employer and its future viability.
27. Relevant factors to consider in analysing the ongoing viability of the employer include the nature and prospects of the industry in which it operates, the employer's competitive position and relative size within that industry, management ability and track record, the financial policy of the employer, its profitability, capital structure, cash flow, and financial

flexibility. The employer's credit rating (if any) may have some bearing on these considerations but the rating score on its own should not be seen as a substitute for independent review, unless the detail of the analysis behind the rating is made available and is acceptable to trustees.

28. Trustees should be focused on the likelihood of failure of the employer. It may also be relevant to consider the consequence to the scheme of the employer's failure, but this should be analysed in context. If failure of the employer is unlikely (taking account of the employer's obligation to the scheme) then recovery analysis is expected to be less relevant to consideration of the proposed arrangement.
29. In addition, trustees are expected both to review the ability of the employer to meet any current shortfall in technical provisions and to form a view on the extent to which it could restore the position of the pension scheme if costs increased substantially. Such increased costs may result from adverse experience in relation to the main risk factors faced by the scheme. These risk factors are expected to include longevity risk, inflation risk and investment risk. There may be significant risks unique to a scheme (for example outstanding sex equalisation issues) and trustees should satisfy themselves that they take account of all significant risks against which the employer provides protection.
30. Trustees should also review the nature and structure of any group associated with the current employer if this exists. The aim should be to establish any possible additional security that may be available to the scheme from such a group which may potentially be lost as a result of the transaction.

Replacement employer's covenant

31. The term 'replacement employer' is used to refer both to a new employer to the scheme (or section of the scheme or membership) and to the existing employer following a restructuring.
32. Trustees should carry out a similar analysis of the covenant of the proposed replacement employer to that carried out for the current employer. In practice, where a nominal employer is being proposed, it is likely that no value can be assigned to the covenant.
33. Trustees should compare and contrast the respective covenants. The aim should be to form a view on the change in the exposure of the scheme and members and the loss of any support provided by the employer to the scheme. Carrying out such an analysis is important for all transactions affecting the pension scheme, not just abandonment.

Nature and structure of new employer group and ultimate owners

34. An arrangement involving abandonment to a replacement employer is expected to involve a number of other parties to the deal. In concept, these can be defined as the replacement employer group and the ultimate owners of the replacement employer group.
35. The replacement employer group includes the replacement employer as defined in the scheme's documents and any associated legal group. In some cases this may be a special purpose vehicle, the aim of which is to protect the ultimate owners of the replacement employer. For this purpose, the ultimate owners should be understood as the ultimate shareholders of or providers of capital to the legal group of which the replacement employer forms part. Together these make up the entities connected and associated with the replacement employer.
36. Trustees should analyse and understand the implications of the legal structure of the replacement employer group. In particular, trustees should aim to establish:
- the legal domicile of companies within the group;
 - any restrictions or limits on capital and cash flows within the group, and the risk this creates in terms of preventing potential additional funds from being available to the scheme;
 - what additional funds, if any, exist within the replacement employer group that the scheme may have recourse to, either through a financial guarantee or other legal right; and
 - what additional covenant, if any, is provided by the replacement employer group and whether the structure of the replacement employer group adds strength to the covenant of the replacement employer.
37. Trustees should also analyse the ultimate owners of the replacement employer group. In particular trustees are encouraged to review:
- the legal domicile of the ultimate owners;
 - the investment timeframe of the ultimate owners, covering the manner in which they will extract returns on any capital invested, and particularly whether they will wish to remain invested over the timeframes which the trustees need for their investment strategy – and if not, whether the ultimate owners are taking on any legal commitments to guarantee the scheme investments over the timeframe they will remain invested; and
 - the potential for the scheme to have access to additional funds from the ultimate owners, the aim being to establish whether there is any risk capital that the owners would legally be required to pay to the replacement employer and the scheme to improve the funding position of the scheme in defined circumstances.

Potential gain by parties to the deal other than the pension scheme

38. It is important for trustees to review the potential gain to all parties involved in the arrangement and to ensure that any mitigation is commensurate with both the loss in covenant and the potential gain to other parties. That is, trustees should look to achieve a fair deal for the scheme if there is potential upside to other parties in any proposed arrangement.
39. The main parties to the deal other than the scheme are expected to be the current employer, the owners of the new employer group that the pension scheme is to be supported by, and the creditors of the existing and possibly new employer group. These parties will in all likelihood be looking to gain commercially from the arrangement.
40. Information on the potential gain to the current employer may already be obtained through analysis of the employer covenant and its business case for carrying out the arrangement. Trustees, however, should expect the employer to clearly set out its case for the proposed arrangement. As discussed in the section on possible alternatives to the proposed arrangement (paragraphs 65 – 67), trustees should consider other options open to the scheme and these should be viewed in the context of whether these options can also meet the employer's needs.
41. Trustees should make every effort to understand the potential gain to ultimate owners of the new employer group by which the pension scheme will be supported. Ideally, trustees should obtain access to documents prepared by these parties setting out their costing and expected income and profits as a result of the arrangement.
42. Trustees should also understand the potential gain to other creditors of the current employer. Together with this, trustees should determine the priority of the pension scheme relative to the current employer's other creditors.
43. The aim of carrying out such assessments is to help trustees assess whether the arrangement results in a fair deal for the pension scheme and is in the best interests of its members.

Security or other mitigation provided to the pension scheme

44. The result of any abandonment arrangement is to leave the pension scheme supported by a nominal employer. It is therefore reasonable for the trustees to seek mitigation of equivalent or better value than the protection provided by the current employer.
45. If the full section 75 debt (for the scheme or affected section of the scheme) is not paid, trustees should consider other forms of mitigation which may be available. These may take the form of additional funds provided to the pension scheme; contingent assets; and covenants or guarantees provided by non-participating companies in the new employer

group or by the ultimate owners. The regulator's clearance guidance⁴³ sets out ways in which pension scheme security may be improved, and trustees are encouraged to refer to these examples.

46. In deciding on a package to mitigate the impact of any potential abandonment arrangement on the scheme, trustees should take account of:

- the covenant of the existing employer;
- the covenant of the new employer;
- the covenant of the new employer group;
- any security provided through the ownership structure of the new employer group;
- the potential gain to the current employer and the owners of the new employer group;
- the potential impact on the appropriate level of technical provisions (see paragraphs 49 to 55); and
- the level of new money, if any, that is being provided to the scheme.

47. 'New money' is defined as additional funding to the scheme that can only be made available as a result of the proposed arrangement. The current employer may propose increasing or making an early payment of agreed employer contributions. Whether this represents new money depends on how the current employer is now able to make additional funding available to the scheme. If the additional funding is promised out of the employer's existing resources then it can be argued that the scheme is not gaining if it subsequently breaks the link with the employer. In such cases the employer will be crystallising only a part of the covenant that it already provides to the scheme. Trustees may be able to treat new contributions as new money if the resource to provide these only became available as a result of the arrangement (for example, by using a loan facility that would not otherwise have been granted). Trustees should also bear this in mind when considering any mitigation or security provided as part of the arrangement.

48. The ideal starting point is that mitigation should be payment of the amount necessary to buy out the scheme benefits with a regulated insurance company.

Technical provisions

49. In general, a scheme's technical provisions and any recovery plan should reflect the covenant of the employer. If the covenant changes as a result of any proposed transaction, trustees should review the adequacy of both the technical provisions and the recovery plan.

⁴³ Clearance Statements: Guidance from the Pensions Regulator, April 2005

50. It is expected that there will be a significant change in covenant as a result of any abandonment arrangement. Trustees should ascertain, as far as they can, any potential change to the technical provisions taking account of the change in covenant. They should consider this in the light of the form and type of mitigation being offered as part of the arrangement.
51. Trustees should ensure that a situation does not arise where it would not be possible for the scheme to meet its technical provisions using any reasonable recovery plan, given the covenant of the replacement employer.
52. Following on from this, trustees should be critical of the presumption that if the scheme does not have a deficit on an accounting basis (namely Financial Reporting Standard 17 or International Accounting Standard 19), then the abandonment will not be financially detrimental to the scheme.
53. Trustees are reminded that the regulator's current clearance guidance states that the new statutory funding objective might in due course become the right calculation to determine whether any arrangement is financially detrimental to a scheme.⁴⁴ Very few valuations have so far been completed under the new statutory funding objective. However, our view still remains that this may become a more appropriate measure than FRS 17 to determine whether an arrangement is financially detrimental to a pension scheme. It is the estimated technical provisions appropriate to the covenant of the employer post-arrangement that will be relevant.
54. If, following any abandonment arrangement, the required technical provisions and the covenant of the employer are such that no recovery plan that would meet the appropriate technical provisions is affordable to the new employer, then the arrangement will be detrimental to the security of members' benefits. Trustees should ensure that any mitigation and structure of the scheme going forward prevents such a situation from arising.
55. Similarly, trustees should also consider the costs of paying the Pension Protection Fund levy. Where possible, they should try to assess the likely effect of the arrangement on the levy, and satisfy themselves that the scheme will have adequate funds or funding to meet this outcome.

Scheme investment strategy

56. Trustees should consider the impact of the proposed arrangement on the appropriate investment strategy for the scheme assets.
57. Following the reduction in or removal of the employer covenant, the scheme would have lost an important backstop to protect it against investment risks. It is expected that the investment strategy should reflect

⁴⁴ Paragraph 32 of Clearance Statements: Guidance from the Pensions Regulator, April 2005

the increased exposure of the scheme and the limited protection that it has against these risks.

58. This will interact with any mitigation provided to the scheme as part of the arrangement and the need to consider the technical provisions. It may be that the appropriate investment strategy with a nominal employer prevents the opportunity to achieve the funding of the appropriate technical provisions. This would be a strong argument for trustees not agreeing to the arrangement.

Structure of trustee board

59. While discussion and negotiation on any proposed abandonment arrangement is ongoing, trustees should critically examine the make-up of the trustee board and any potential and real conflicts that exist for individual members of the trustee board.

60. These conflicts are expected to include (but are not limited to):

- a company nominated trustee who is conflicted between the interests of the company proposing the arrangement and the members' interests;
- a member nominated trustee who may be conflicted between their own interests based on their class of membership and the interests of other classes of membership; and
- a member or company nominated trustee who is an employee of the company and may be conflicted between their interests as an employee and their interests as a member and trustee of the scheme.

61. The regulator's clearance guidance provides guidelines to trustees on conflicts of interest and managing these conflicts during any negotiations.⁴⁵ In particular, if any trustees identify a real conflict it is appropriate that they are not directly involved in any decision taken by the trustee board on the arrangement.

62. If there are perceived conflicts, trustees should put processes and mechanisms in place to manage and communicate on these conflicts.

63. It is expected that if the arrangement goes through, the new employer group may look to change the composition of the trustee board going forward. Trustees should consider whether it is appropriate for the trustees to control any change in the structure of the board if the arrangement goes forward. The aim of any such change would be to prevent the employer from having undue influence on the executive management of the pension scheme going forward.

⁴⁵ Paragraphs 88 – 91 of Clearance Statements: Guidance from the Pensions Regulator, April 2005

64. If any proposal provides the employer with undue influence, trustees should usually resist agreeing to the arrangement.

Alternatives to the proposed arrangement

65. As previously highlighted, the pension scheme is expected to be a main focus and source of value of any proposed arrangement that results in abandonment. Trustees should therefore consider a full range of possible alternative options that may be open to the scheme and that may help achieve the employer's objectives without resulting in abandonment of the pension scheme.

66. Such alternatives may include (but are not limited to):

- changing benefit accrual;
- managing investment risk;
- managing inflation risk;
- managing longevity risk;
- buying out benefits with a regulated insurance company;
- using third party insurances;
- winding up the pension scheme; and
- introducing more risk-sharing with the members of the pension scheme.

67. It is not reasonable for trustees to be forced to accept, at face value, abandonment as the only option open to the scheme in response to the circumstances or standing of the employer.

Factors trustees should not treat as primary benefits of abandonment

68. There are a number of factors that parties to the deal may present to the trustees of the scheme as reasons to agree to any proposed abandonment arrangement.

69. Trustees are advised not to treat certain factors as primary arguments for agreeing to any proposed abandonment arrangement.

70. In deciding whether any factor is a primary argument for allowing an abandonment arrangement, trustees should determine whether they would be able to achieve the proposed benefit of this factor without breaking the link with the current employer. If the scheme could access the benefit outlined without breaking the link with the employer, then trustees should not give primary importance to this in reaching any decision.

71. Examples of factors that trustees should not regard as primary reasons for agreeing to abandonment include:

- *Access to improved investment management.* The new employer group may offer promises of access to better and newer asset management techniques that improve management of risk and promise better asset returns. It is likely that trustees will still be able to negotiate access to alternate investment managers and investment products if they do not break the link with the employer. In all cases, trustees should fulfil their trust duties in relation to investment at all times.
- *Access to improved scheme administration.* The new employer group may offer access to improved administration of the pension scheme, for example through record cleaning, use of more up-to-date information technology, or introducing economies of scale to reduce costs. While some administration providers may not make pure administration services available to a scheme as a free-standing service, it is likely that trustees could come to a commercial agreement with a provider without breaking the link to the employer.
- *Access to more knowledgeable and experienced advisers.* The advisers to the trustees should act in the best interests of their clients at all times. It is unlikely that an unconflicted adviser will only offer to provide services to the trustees if they allow the abandonment as a precondition to providing this service.
- *Increased or earlier payment of contributions from the current employer.* The current employer may propose increasing or making an early payment of agreed employer contributions. Whether this is a factor that trustees should take into account depends on how the current employer is now able to make the additional funding available to the scheme. Trustees should determine whether the additional funding is new money that would otherwise not be available to the scheme (see paragraph 47).

Seeking advice

72. Trustees should take independent advice before agreeing to any proposed abandonment arrangement. The advice should be appropriate and commensurate to the arrangement being proposed. In most cases commensurate advice is expected to result in a thorough review of the proposed arrangement and of the implications for the scheme, covering the factors set out in this guidance.

73. Before any work is done by advisers, trustees should scope and cost such advice. The trustees should expect that the costs would normally be paid by the employer or party looking to implement the arrangement, and should obtain confirmation of this. Trustees should not agree to any proposed abandonment arrangement without suitable advice, and should not agree to consider the arrangement without ensuring they have secured

the resources to finance the advice without jeopardising the scheme's security.

74. Trustees should seek their own independent advisers. However, this does not preclude each party's set of advisers relying on work produced by one firm, provided the scope and nature of that work is common to all parties and the advisers confirm that they are not conflicted or constrained.
75. Trustees should remember that advisers themselves can be conflicted where corporate transactions are involved. Trustees are encouraged to seek disclosures, if necessary, from employer's advisers but should be mindful that the same advisers will be subject to conflict and that trustees should not accept advice from them.
76. Trustees are encouraged to consult with scheme members and make them aware of the type and extent of advice they have obtained.

Interaction with the Pensions Regulator

77. The Pensions Act 2004 gives the regulator a set of specific objectives. Two objectives relevant to this guidance are:
 - to protect the benefits of members of work-based pension schemes; and
 - to reduce the risk of situations arising that may lead to claims for compensation from the Pension Protection Fund.
78. In the light of these objectives, the regulator will consider any arrangement that may result in abandonment on its merits and take any action as appropriate.
79. The regulator has been granted anti-avoidance powers to meet its objectives. These include the ability to issue a financial support direction in cases where the employer associated with the scheme is insufficiently resourced;⁴⁶ and the ability to issue a contribution notice against a person who was a party to an act (or failure to act) one or the main purpose of which was to prevent the recovery of a section 75 debt – or, otherwise than in good faith, to prevent such a debt becoming due, to compromise or otherwise settle such debt or to reduce the amount of such a debt that would otherwise become due.⁴⁷ The regulator also has powers to prohibit, suspend and appoint trustees of pension schemes,⁴⁸ and to wind up a pension scheme.⁴⁹
80. In the light of this, trustees and employers are encouraged to report to and consult with the regulator on any arrangement that may result in the abandonment of the pension scheme at an early stage in the process.

⁴⁶ Section 43 of Pensions Act 2004

⁴⁷ Section 38 of Pensions Act 2004

⁴⁸ Sections 3, 4 and 7 of Pensions Act 1995

⁴⁹ Section 11 of Pensions Act 1995

81. Trustees are reminded of other relevant guidance and legislation that may require them or the current employer to bring any proposed arrangement to the attention of the regulator. This includes:
- notifiable events regulations, code of practice and guidance;
 - whistleblowing requirements; and
 - scheme funding reporting requirements.
82. Trustees are encouraged to persuade the employer to seek clearance from the regulator on any arrangements that may lead to abandonment.
83. However, it is important for trustees to bear in mind that they need to analyse any proposed arrangement and reach a decision with other parties that is in the members' best interests. The regulator can act as a referee in any such arrangement but cannot actively participate in decision-making concerning the proposed arrangement.