# CFG Call for Evidence Response:

## Section 75 Employer Debt in Non-Associated Multi-Employer Defined Benefit Schemes

Department for Work and Pensions
May 2015

### About Charity Finance Group

Founded in 1987, Charity Finance Group is the charity that works to improve the financial leadership of charities, promote best practice, inspire change and help organisations to make the most out of their money so that they can deliver the biggest possible impact for beneficiaries. CFG has over 1350 members and they manage over £21 billion in charitable income. Our members work at the heart of the strategic development of their organisations, and are at the forefront of delivering sustainable and efficient charity sector.

On 7th May, Charity Finance Group hosted a Pensions Forum bringing together pensions experts, charities and lawyers to discuss this and other issues on the charity pensions landscape.

As part of work we have met and spoken with numerous charities negatively impacted by the current rules and we have outlined case studies which reflect the problems that are typically encountered across the sector.

This response also draws from CFG's recent publications *Navigating the Pensions Maze* and *Pensions Manifesto* which support charities in making pension decisions and make policy recommendations to improve the pension system for charities.

For more information on this response contact: policy@cfg.org.uk or Andrew O'Brien, Head of Policy and Public Affairs on 020 7871 5477.

# Executive summary

- Section 75 rules have created perverse incentives encouraging employers of all kinds (including charities) to continue to accrue debt that they cannot afford in order to avoid triggering immediate payment of cessation debt.
- Numerous charities have reported being trapped in such schemes and in some cases, the inability to prevent the accrual of additional liabilities and the increase in debt repayments that has caused has led to the insolvency of charities.
- **Charities are not looking for special treatment or exemptions, but wish to see S75 reformed so that more flexible repayment plans can be implemented and the automatic triggering of S75 debt when an employer ceases to have active employees in the scheme removed.**
- This reform would have a positive impact on charity employers, who would be able to get on top of their liabilities and reduce future exposure. This will strengthen their financial position and make it more likely that the promises of scheme members will be kept.
- We also believe that this is an opportunity to consider the effectiveness of current exit debt valuations in the Local Government Pension Scheme, which currently follows the S75 rules. These rules are not appropriate to the scheme and we urge the Department for Work and Pensions to work with the Department for Communities and Local Government to consider how this can be better communicated to fund actuaries.
- We do not believe that there is any evidence to suggest that this would create a negative impact on pension schemes or pension scheme members.
- Given the consensus that exists for reform, combined by the evidence outlined here and by others, we believe that there is a strong case for the government to prioritise reform to S75 and help thousands of charities and employers across the country.
- Charity Finance Group stands ready to work with the government in the development of detailed legislative proposals on reform of S75 and on how to improve the operation of the Local Government Pension Scheme, which has thousands of charity members.

# Introduction

Charity Finance Group supports the decision by the Department for Work and Pensions to call for evidence on reform of section 75 (S75) debt rules. We have been working with charities on pension issues for over a decade, and concerns around multi-employer defined benefit schemes have been of significant problem for the sector over recent years.

We have consistently engaged with the Department, with the pensions industry, pension experts, lawyers and charities on this issue and we believe that there is a consensus around reforming S75 so that rules are changed to better help employers manage their liabilities, without undermining the viability of the pension schemes.

We believe that S75 rules have created perverse incentives encouraging employers of all kinds (including charities) to continue to accrue debt that they cannot afford in order to avoid triggering immediate payment of cessation debt. It is important that no reforms damage the provision of pensions to scheme members, but we believe that there are a number of steps that could be taken that would help make scheme more sustainable, support employers and maintain the best interests of scheme members.

Ultimately, the best way to protect members' pension promises is to ensure financially robust and sustainable employers, and reforming S75 is one way that the government can achieve this. So we urge the government to take this opportunity to reform S75 and resolve this long-standing issue.

# Charities perspective

According to the latest NCVO Civil Society Almanac 2014, in 2011/12 the sector has pension liabilities of £1.5bn, with 80% of these liabilities concentrated in the largest 533 charities, with an annual income of over £10m. Analysis of our 1360 members has found that they have around £1.43bn in pension liabilities, indicating that the sector's liabilities as a whole have risen substantially since 2011/12.

Many of these are related to multi-employer defined benefit schemes and some of the charities are household names. It is important not only for their beneficiaries, but also for public confidence in the sector that charities are able to effectively manage their pension liabilities.

However, small charities are not immune to the problems of pension liabilities and it is common for them to be part of multi-employer defined benefit schemes, which can appear to offer reduced risk and minimise administration and overheads. But the financial crisis which led to a collapse in asset values, combined with increased longevity have generated substantial deficits in many schemes and these are threatening the long term sustainability of charities that would otherwise be in a healthy financial position.

We have seen a number of cases in recent years where multi-employer pension deficits have caused the closure of charities. At the start of 2015, skills development charity, Skills for Logistics, was forced to close due to an unsustainable non-associated multi-employer pension deficit, with the loss of thirty four full time equivalent staff. An inability to stop the accrual of debts was a central factor in its closure, as it was unable to stop to the gradual increase in recovery payments which undermined its financial health.

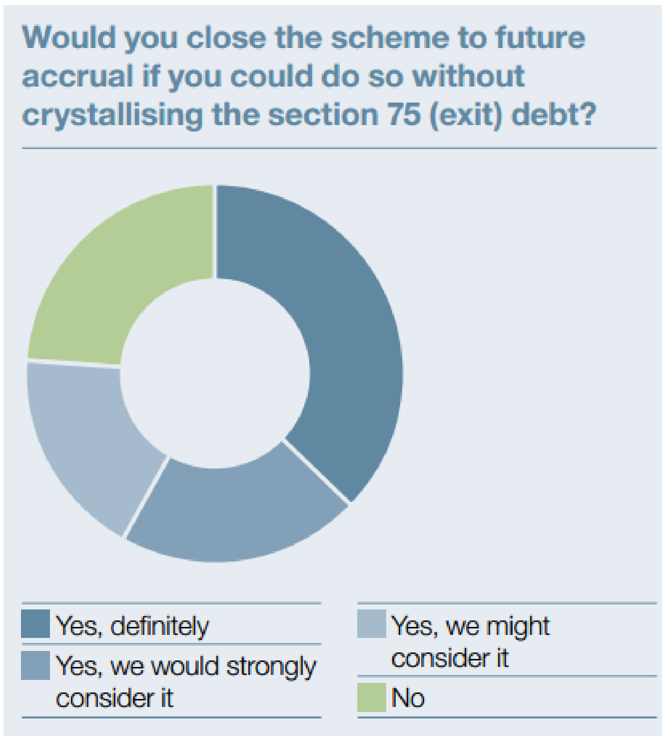
Similarly in 2012 and 2013, respectively, the charities People Can and the Spirit of Enniskillen Trust were forced to close because of unsustainable pension deficits in multi-employer defined benefit schemes. These two charities led to the loss of hundreds of jobs and put more pressure on those employers remaining in their pension schemes. Again, S75 rules were a factor in their closure and prevented them from taking early action to manage their liabilities.

These are not isolated cases, and we have spoken with many charities with non-associated multi-employer schemes that are trapped in these schemes with rising contributions and increasing orphan debt that they cannot afford but that they cannot leave due the cost of crystallising S75 debts. Moreover, charities are having to divert more of their income from serving their beneficiaries towards paying off their pension deficits. As employers fail, with rising pension costs often a factor in these failures, the burden on the remaining scheme members increases. Reform to S75, by helping employers to prevent the accrual of excessive pension liabilities, could help to reduce the amount of orphan debt and make the overall non-associated multi-employer defined benefit pension system much stronger.

Unlike businesses, charities are under a legal obligation to make decisions in the best interests of their beneficiaries and their charities. Unlike businesses, they are not able to increase levels of reserves over time unless that goes towards meeting their charitable objectives. Moreover, in the current financial climate, with high levels of competition for diminishing forms of unrestricted sources of income such as grants, charities are not always

in a position to increase their levels of reserves to balance against their liabilities. This makes reform of S75 even more important for charities.

If reforms were made to S75, we have strong evidence to suggest that they would be used by charities. In 2014, we conducted a survey of our members in multi-employer defined benefit schemes for our *Navigating the Charity Pension Maze* publication. For example, if the automatic trigger of S75 when the last active employee was ended, 37% of charities that responded would definitely close their scheme to future accrual. 21% of respondents would strongly consider closing their scheme and 18% might consider it. Only a small minority of respondents would not consider closing their scheme. This level of response, we believe, justifies the Department committing time to implementing the reform proposals outlined in this call for evidence.




## Sustainable pensions

Charities, like all employers, have an interest in a sustainable pensions system. Charities employ over 800,000 people and compete with the public and private sector for staff. Good pension provision is an important part of attracting staff and charities would not wish to see reforms made to the pensions system which made schemes weaker and staff more concerned about future pension provision.

We have discussed with pension experts, pension providers and charities about the proposals for reform. We disagree with the suggestion in the call for evidence that changes to S75 to stop the automatic triggering of debts with the loss of the last active employee would lead to a disconnect between employers and the scheme. If this proposal was implemented, employers would still be liable to the scheme and the scheme trustees would still retain the ability to impose S75 debt up to the point where a final cessation payment is made. We believe that this would provide a strong level of control for trustees

and ensure a balanced negotiation between scheme trustees and employers. We also do not believe that this proposal would enable employers to 'walk away' from their liabilities.

In discussion with charities, we have not encountered any charities that wish to 'walk away' from their liabilities. Charities will continue to play an active interest in their schemes, even if they no longer have an active employee in the scheme, because they are still responsible for the liabilities. Charities wish to see reforms that will enable them to meet their liabilities in a sustainable way and avoid triggering of debts at a time when they will be unable to play.

As mentioned above, the best way to create a sustainable pensions system and ensure that scheme members get their pension provision that they have been promised is through financially strong employers. The current S75 rules create instability and prevent charities, and all employers, from putting in place plans with scheme trustees to meet their liabilities in a managed way.

We have spoken to pension providers who have not indicated any difference between the engagement of employers with and without active employees in pension schemes. There is long experience of this in stand-alone schemes, where inactive employers have not ignored their responsibilities to schemes.

We do not believe that there is any evidence to suggest that reform to the current rules would weaken the bonds between employers and their pension schemes, and this should not be a barrier to much needed change to S75. In fact, once an employer has entered a situation in which they are unlikely to be able to meeting their future liabilities, there is no interest for them to be constructive members of the scheme or to meet their repayment obligations. Given this, it would be better for the government to implement proposals for reform to S75 that would help employers within schemes to avoid this situation.

# Case studies

In order to demonstrate the challenges that Section 75 rules can create, we have outlined three case studies which highlight the typical problems faced by charities. These have been anonymised in order to protect the identity of the organisations.

## Case Study 1 – A barrier to restructure

Charity A is a large charity and member of a long standing non-associated multi-employer defined benefit pension scheme. The scheme has a low number of active members and a very high number of pensioner and deferred members. It currently has a pensions deficit running into the hundreds of millions of pounds.

In order to prevent the accrual of future debt, Charity A has reduced the amount of active employees in the scheme to one person. However, this one individual is now preventing a much needed restructure of the charity which would help it to be more effective and make better use of its resources. Given the current size of the deficit, Charity A does not have the resources to pay S75 debt should that employee decide to take voluntary retirement. As a consequence, the charity is now trapped in a position where it cannot afford to restructure but is also not in a position to achieve maximum impact for its beneficiaries.

Removing the automatic triggering of S75 debts when the last active member leaves the scheme would enable this charity to restructure and would have no material impact on its ability to contribute to the scheme. It would also enable the charity to improve its performance both as a charity and potentially financially in the future, strengthening its bond with the scheme and better protecting the long term interests of members.

## Case Study 2 – Forced to accrual additional debt

Charity B is a small charity which is a member of a large multi-employer defined benefit pension scheme, which is currently in deficit. Only a small number of staff are member of the scheme and contributions have increased over recent years.

The charity's section 75 debt is around a third of the organisation's annual income which means that it is unable to exit. The charity can make the current repayments, but would like to stop accrual of more debt and put in a plan to fully fund the scheme.

The charity has found that this is a barrier to partnership and collaboration with other organisations and has not been able to take forward some projects. Resources are being diverted from the charity's core purpose to repay the scheme and if it continues to accrue debt, the charity may become unsustainable in the future.

Reform to S75 through the removal of the automatic trigger and flexibility in repayment would help the charity to manage this situation and would reduce the likelihood of insolvency and the charity leaving behind orphan debt.

### Case Study 3 – A barrier to merger

Charity C is a medium sized charity which is a member of a large multi-employer defined benefit scheme containing mainly other charities. It was considering merger with another medium sized charity.

The scheme has a substantial deficit and the automatic triggering of S75 debts would have outweighed the cost savings to both organisations through restructuring and rationalisation of staff. As a consequence of S75 debts, both charities decided against merger of their organisations as a consequence of the size of their pension debts.

At a time when charities are operating in a difficult financial climate, and when merger can be a better way for charities to pool their resources and continue their work, S75 rules are a barrier to such actions. In this case, the inability to merge could have potentially significant financial risks for the charity. Reform of S75 rules could have enabled this merger to take place which would have strengthened the finances of the organisation and protected the long term interests of scheme members.

We also refer to the scenario put forward by Spence & Partners in its submission to this call for evidence. This generic, but not atypical scenario, demonstrates how the problems that S75 rules can create. Although in this scenario, there are only four charities, as mentioned in Spence & Partners submission, many charities are in much larger schemes and co-ordination between employers is difficult. Reform to S75 debt rules would create an opportunity for charities to stop the unsustainable accrual of debts, which reduce the likelihood of insolvency and damage to the future promises of scheme members.

## Changes to existing easements

The call for evidence suggests the possibility of reforming existing easements to make them more effective. In our experience, charities find the current arrangements difficult to navigate and costly. They also do not deal with the central problem of preventing the accrual of additional liabilities. We do believe that changes to the existing easement measures would be the best way to make multi-employer defined benefit schemes more sustainable or make protect promises to members.

Extension of the most commonly used easement, the period of grace, while it would provide some benefit to charities that do have access to the resources to pay off their debts

or could add another member to the scheme, does not benefit the vast majority of charities in the situations outlined above. Reform rather than easement is required.

## Greater flexibility around repayment

We recommend that the government encourages greater flexibility in terms of repayments, but this is not merely a question of granting additional time for the repayment of S75 debts. In some schemes, repaying the technical provisions could take decades and a similar period of time to repay the cessation debts.

Flexibility would therefore not only need to provide the ability for employers to pay down their liabilities over a long period of time but would also need to avoid the triggering of cessation debts at artificial points in the future, so that employers would be able to trigger cessation debts at the optimal moment. This would not only benefit employers, but would also benefit scheme members as the likelihood of insolvency and orphan debts would be significantly reduced.

We do not believe that this would be any different than the current state of many stand-alone schemes, where the interests of scheme members and the understanding that a strong employer provides security for members.

## Amending the provisions so that ceasing to employ active members does not trigger employer debt

We believe that this proposal is essential to any proposed reform of S75 debt rules and urge the government to implement this proposal.

As outlined above, the ceasing to employ active members in a scheme does not threaten the sustainability of the scheme, but it does mean that many charities are forced to continue to accrue debt that they may not be able to pay in the future because they do not have the ability to pay section 75 debts. Moreover, there are numerous situations where employers, which can meet deficit repayment obligations over the long term, are unable to meet section 75 debts and are dependent on one member of staff remaining in their organisation to avoid triggering the debt.

The current rules are not an effective mechanism for ensuring the sustainability of pension schemes and meeting the promises of scheme members, and reform would benefit all parties. We do not believe that there is any evidence to suggest that this reform would have a negative impact on pension schemes and their members, but would significantly benefit employers.

## Change the way liability is calculated

We recommend that the government removes the automatic triggering for S75 debts upon ceasing to employ active members in the scheme. For conventional multi-employer schemes involving charities, we do not believe that changes to calculation are necessary as the aim of schemes will be to buy an annuity in order to secure benefits for scheme members.

However, we believe that there is a strong case for reform of the Local Government Pension Scheme (LGPS), of which around 2-3,000 charities are members.

Although the LGPS is not subject to S75, it has been heavily influenced by S75 rules and the fund actuary often adopts the same approach to assessing the debt when employers exit the LGPS.

Yet, there is no reason for exit debts to be calculated in this method given that the benefits will continue to be provided from the fund and the exit debt is effectively a subsidise other employers remaining in the fund. While there may be a need for payments to ensure that remaining organisations have limited risk of having to pick up the liabilities; a gilts-based strategy for de-risking is not appropriate given that the aim is not to secure the benefits through an annuity. Instead we endorse a more realistic scheme orientated approach outlined by Spence & Partners, which takes into account the discount rate applied in the LGPS on-going funding valuation plus a discontinuance margin.

There should be flexibility in repayment so that trustees and employers are able to create plans which enable schemes to recoup any deficit up to the on-going level without damaging the employers.

Greater flexibility in repayment, as outlined above, in S75 would help to many charities in LGPS if it is adopted by the fund actuary. However, we also believe that reform to S75 is an opportunity for the Department for Work and Pensions to work with the Department for Communities and Local Government on ensuring that the operation of scheme is designed in a way that is tailored to its needs.

Better communication of the role of S75 to the fund actuary and guidance for local authorities would be an important part of this process.

## Conclusion

Charities do not wish to avoid paying their liabilities or to reduce the pension provision of scheme members. However, it is clear that the current S75 debt rules do not meet the objective of protecting the interest of scheme members and, in fact, make it more likely in some cases that charities will fail and leave behind orphan debts – damaging the long term sustainability of schemes.

It also impacts on the financial sustainability of charities, which are unable to exit their schemes because of the size of their S75 debts but would like to reduce their future exposure to the scheme in order to keep future repayments manageable.

The damage to pension funds due to the financial crisis and the increasing longevity of the population means that this is a reform needs to take place now, so that charities, and other employers, can effectively manage their pension deficits. This will not only enable scheme members to be better protected but will ensure that charities are able to reduce their long term liabilities and focus more of their resources on achieving their charitable objectives.

We do not believe that there is any evidence to suggest that this would create a negative impact on pension schemes or pension scheme members. We have produced surveys and case studies that provide strong evidence on the potential positive impact of reform.

We also believe that there is an opportunity for clarification of practice in the operation of the Local Government Pension Scheme so that it exit rules better meet the need of employers and reflects the nature of the scheme.

Given the consensus that exists for reform, combined by the evidence outlined here and by others, we believe that there is a strong case for the government to prioritise reform to S75 and help thousands of charities and employers across the country. This is an opportunity that this new government should not ignore.

Charity Finance Group stands ready to work with the government in the development of detailed legislative proposals to reform S75 and to work with the Department for Communities and Local Government to improve the operation of exit rules for the LGPS.