Freshfields Bruckhaus Deringer

COVID-19

The impact on pension scheme funding and potential actions which employers and trustees can take

Key Highlights

- The Pensions Regulator (***TPR***) has issued announcements which recognise the potential impact of the coronavirus (COVID-19) pandemic on the funding, investment and covenant position of UK defined benefit pension (***DB***) schemes.
- The announcements contain new easements (initially for the period until 30 June 2020) which are intended to provide trustees and sponsors with additional flexibility on DB scheme funding.
- These measures potentially include (amongst other things) suspending or reducing deficit repair contributions (DRCs), suspending or reducing future service contributions (likely to be difficult to achieve in practice) and not taking enforcement action where sponsors and trustees need more time to conclude existing valuations. However, requests to release security will be very challenging and difficult to agree.
- Trustees will need to consider any relevant requests from sponsors in accordance with their fiduciary duties. However, provided trustees are being treated equitably compared to other creditors and are provided with suitable mitigation (if appropriate), we would expect most trustees to grant the sponsor additional flexibility in the circumstances.
- Whatever course of action is chosen, TPR recommends that sponsors and trustees should carefully document their decisions. This will help sponsors to manage the risk of any future regulatory action.

The coronavirus (COVID-19) pandemic is placing the funding, investment and covenant position of UK defined benefit pension schemes under huge pressure. Investment volatility and a sharp increase in deficits have coincided with the severe financial pressure the crisis is placing on many scheme sponsors across many companies and sectors. Revenues have fallen very rapidly given a collapse in trading volumes and in many cases forced the suspension of business operations. This is especially acute in sectors such as hospitality, travel, transport and retail but the severe effect of the pandemic is not limited to those businesses.

For many scheme trustees and their sponsors, the need to ensure the continued viability of the business in the short term, and how to reconcile this with ongoing pension scheme funding commitments, will now be a critical issue. In many cases, this is affecting all other stakeholders and creditors: employees are being furloughed or in some cases made redundant altogether, trade creditors and landlords are accepting deferrals or reductions in payments, and companies are looking to lenders and the Government for additional credit or waivers for breaches of banking covenants. Pension schemes cannot be exempt from this, as their funding commitments represent significant demands on cash that many companies cannot meet at present. However, given the complexity of issues faced by pension schemes and the particular duties to which scheme trustees are subject, the pension scheme funding system does not easily adapt to a crisis of this speed and depth.

Given that difficulty, it is welcome that the Pensions Regulator (***TPR***) has quickly responded to the crisis by issuing a series of announcements on actions which many employers and trustees will now be considering, and on how TPR will exercise its regulatory powers[1]. These announcements give some much-needed clarity on how TPR views the situation and on how parties should approach the crisis. Importantly, they also signal that relaxations in funding requirements are available for distressed employers, but also emphasise that trustees are subject to limits in the extent to which they can go in agreeing courses of action in the current climate.

Using TPR's announcements as a starting point, this briefing looks at some of the actions that employers and trustees can take in the short term, in particular:

- suspension or reduction of deficit repair contributions;
- suspension of future service contributions;
- release of security held by pension scheme trustees;
- keeping scheme trustees informed; and
- dealing with the implications for scheme valuations currently under way.

Our second briefing (to follow) will look at the implications of COVID-19 for forthcoming pension scheme valuations and the funding costs of employers, and what this may mean for the Pensions Regulator's approach to the regulation of valuations and the funding of deficits.

Suspension or reduction of deficit repair contributions

As an immediate action, many employers may be planning to request reductions or suspensions to deficit repair contributions (***DRCs***) to their pension schemes. Showing a welcome understanding of the extreme pressure that many businesses now face, TPR has said that trustees should be open to such requests. However, it has laid down the following guidelines:

- Suspensions or reductions should be agreed for no longer than three months, if the trustees are not able to fully assess the employer's position. It is helpful that TPR recognises that an "emergency" suspension may be needed in circumstances where it may not be possible for an employer to provide a trustee with all of the information needed to make a rounded assessment of the position, or to negotiate a balanced package with all affected stakeholders. In practice, for many companies a short term suspension may simply buy time to negotiate and put in place longer-term measures, as discussed in the next bullet point.
- A suspension or reduction of contributions that goes beyond three months may be appropriate where other creditors are willing to commit to support the company for that longer period, and where the extended suspension of DRCs is necessary to ensure such creditor support. TPR's view is that an extended suspension period will need to be supported by a business case, and should ideally be underwritten by any available protections (for example, for the deferred amount to be collateralised by security over assets or backed by guarantees from stronger companies in the group). This may require multi-party negotiations between the company, different groups of lenders and the pension scheme trustee, with TPR input as appropriate.
- The pension scheme should be treated fairly compared to other stakeholders. For instance, TPR is clear that no dividends or other distributions should be made by an employer where contributions are being reduced or suspended. Such restrictions should be supported by legally binding commitments that would be entered into as part of the agreement to suspend contributions. However, TPR allows that extraordinary and essential intra-group payments may be permitted, in exceptional circumstances, for example, where the employer needs to make inter-company loans for the purposes of liquidity or ensuring that the group can continue to trade. Similarly, trustees should assess whether other creditors are being supportive of the business, either through the provision of finance or the reduction or deferral of other payment obligations. Where other creditors are seeking security, the scheme should be given a fair share.
- The suspended contributions should be repaid within the current recovery plan timeframe, as TPR (in line with its normal regulatory approach) considers that an existing deficit recovery plan should not be lengthened unless there is sufficiently reliable covenant visibility.
- TPR states that actuarial advice should be taken on the effect of any reduction/suspension of DRCs. Legal advice should also be taken, to understand and document the method of reduction or suspension and to avoid any unintended consequences arising (such as the triggering of the winding-up of the scheme or the reduction of member benefits, which under some scheme rules can occur when contributions are suspended).
- For some schemes the position of the Pension Protection Fund (***PPF***) will have to be considered. For example, where schemes are in a PPF assessment period by reason of their employer being in the midst of a restructuring process, the PPF may have direct rights to decide whether DRCs can be deferred or reduced. The PPF has its own priorities, in particular the protection of its fund and levy payers from assuming additional risk and the cost of PPF drift over time, and will not necessarily follow the approach outlined by TPR.

In practice, scheme funding legislation allows sponsors and trustees to agree to amend the schedule of contributions to reduce or suspend contributions. However, trustees must in each case consider whether any such request from the sponsor is consistent with their fiduciary duties, particularly if the sponsor is not offering any form of mitigation. Trustees should

also take actuarial, covenant and legal advice on any such proposal including on the implications flowing from such a proposal under any funding or security arrangements in respect of the scheme. However, in practice, provided the trustees are being treated equitably compared to other creditors and provided with mitigation (if appropriate) then we would expect most trustees to grant the sponsor additional flexibility in the circumstances given the easements outlined in TPR's announcements.

Suspending contributions to schemes open to future accrual

Many schemes remain open to future accrual of benefits and contributions meeting the cost of future service accrual are still being paid, a cost which the employer may expect to be able to meet in normal trading conditions. TPR has said that requests to suspend or reduce future service contributions should be treated in the same manner as for DRCs. However, such requests may raise more difficult legal issues. For example:

- It may be difficult for a trustee, from the perspective of seeking to comply with its legal duties, to permit continued accrual during a period in which future service contributions are not being paid, something which the scheme rules may not allow in any event. If the employer has opted into the Government's job retention scheme and furloughed a large part of its workforce, that scheme will only cover minimum automatic enrolment contributions for such employees.
- Sponsors would also need to carefully consider whether suspending contributions might inadvertently trigger the winding-up provisions in the scheme rules or result in an employment cessation event in respect of the scheme. Legal advice would be required to manage the risk of the sponsor triggering the "nuclear option" by mistake.
- It may also be the case that "pausing" future accrual, as can sometimes be done in normal circumstances for individuals on unpaid leave, is difficult to achieve for the whole member population. One potential issue is that a requirement to consult employees may arise in circumstances in which the statutory consultation process, which has a minimum 60-day period, will not be feasible. TPR suggests that a pause in accrual is unlikely to be a viable option.

Given these potential issues, TPR recommends that legal advice is taken on the feasibility of such an approach.

Release of security held by the scheme

It is increasingly common for pension scheme trustees to hold security in respect of employers' funding obligations to the scheme, especially where lenders also hold security. Where additional finance is needed, companies may be considering asking trustees to release such security in order to increase their finance capacity. This would be a difficult decision for trustees.

TPR discourages this approach, though it does not rule it out completely. It says that a release of a pension scheme's security is unlikely to be in the best interests of members. This is because there is a possibility the employer fails to recover, and so the scheme will have lost access to a (potentially) valuable asset. Therefore, a request for a release of security will need to be supported by a business plan and forecasts. A trustee would need to take detailed legal and financial advice, understand how the release of security will affect the employer covenant, and (where possible) request some other form of mitigation from the employer.

As with requests to suspend or reduce DRCs, TPR's focus is on the scheme being treated equitably with other creditors. But it is clear that TPR will apply additional scrutiny to any requests to release security, and will start from the position that such a request is likely to be inappropriate.

Providing information to trustees

It is vital for employers to inform trustees of the impact of COVID-19 on their business and of the steps being taken to address it. TPR states that a condition of any agreement (to suspend or reduce contributions or to take other steps) should be full and ongoing provision, in a timely manner, of financial information that enables the trustee to monitor the employer covenant. TPR recommends that Trustees ask employers to confirm how the pandemic is expected to impact on demand, cashflow, other creditors, and the business continuity plan. However, TPR will clearly need to be realistic about what information can be provided and how forward-looking this can be, given the level of market uncertainty.

Employers should also inform trustees of the financial and business continuity effect of any COVID-19 Government support initiatives which the business makes use of.

Scheme valuations currently under way

Most actuarial valuations already under way would have effective dates that precede the economic turbulence caused by COVID-19. Hence, the fall in asset values and the change in yields should not directly flow through into such valuations. However, there is some scope for post-valuation date events to affect the overall valuation and funding package, for example the views taken as to the prudence of certain economic assumptions, or the degree to which investment outperformance can be factored into deficit recovery plans. These would have the potential to affect funding costs.

It is therefore helpful to employers that TPR states that changed economic conditions since the effective date of the valuation do not need to be factored into the actuarial assumptions. However, TPR recommends that trustees consider post-valuation experience when agreeing recovery plans, and in particular recognise that the employer's ability to afford DRCs may now be highly constrained. This is sensible and realistic guidance and signals that TPR will find it acceptable to agree longer recovery plans and, possibly, plans where DRCs are initially being paid at a reduced level.

Legislation requires that an actuarial valuation and attendant recovery plans be finalised within 15 months of its effective date. If an employer's business is severely disrupted by the pandemic, an immediate practical issue may be that management are unable to devote the necessary time to progressing valuation discussions. Even if that is not the case, the need to revisit the recovery plan due to affordability concerns could easily delay sign-off. It is welcome that for schemes close to their valuation deadline, TPR has said that although it cannot waive trustee's statutory obligations it will not take regulatory action on delays in submission of valuations and recovery plans by up to three months.

It is expected that TPR will address issues relating to ongoing valuations in its Annual Funding Statement for 2020, which is expected to be released later this month.

Good governance

Whatever course of action is chosen, TPR recommends that employers and trustees should document their decisions. TPR rightly says that this may assist any future engagement with TPR. In addition, in challenging circumstances good practice in company and scheme governance is vital in evidencing compliance with directors' duties and trust law duties, and in helping to demonstrate proper consideration of the interests of the pension scheme in the event of any later TPR investigation. A proper documentary trail would also help sponsors to manage the risk of TPR seeking to use its moral hazard powers against the sponsor or its directors in future where it is alleged (with the benefit of hindsight) that the trustees were unfairly pressed into agreeing a reduction or suspension of contributions or other actions which may adversely impact the employer covenant supporting the scheme.

Further information

For further information on the employment and pensions auto-enrolment issues arising under the government's Job Retention Scheme (JRS) and the COVID-19 crisis more generally please click on the below links to our additional briefings on this topic.[2]

[1] The Pensions Regulator has issued three announcements on 27 March 2020, building on earlier announcements from 20 March 2020. Links to each announcement are provided below.
- **DB scheme funding and investment: COVID-19 guidance for trustees** (27 March 2020)
- **DB scheme funding: COVID-19 guidance for employers** (27 March 2020)
- **DC investment: COVID-19 guidance for trustees** (27 March 2020)
- **COVID-19: an update for trustees, employers and administrators** (20 March 2020)
- **Guidance for DB scheme trustees whose sponsoring employers are in corporate distress** (20 March 2020)

[2]
- **UK Job Retention Scheme – conserving take-home cash for furloughed employees** (31 March 2020)
- **The UK self-employment income support scheme – a shift in the legal and political landscape?** (27 March 2020)
- **The UK Coronavirus Job Retention Scheme: practical questions for employers** (23 March 2020)
- **COVID-19 – managing the impact on UK employee share plans** (18 March 2020)

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