The Trustee toolkit downloadable

How a DB scheme works

Tutorial five: Implications of winding up a DB scheme

By the end of this tutorial you will better understand:

- what winding up a defined benefit scheme means
- who can wind up a scheme
- how winding up works for the scheme of a solvent or insolvent employer

This tutorial is part of Scenario three.

Glossary

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at www.trusteetoolkit.com

The Pensions Regulator

What is wind-up?

The winding up of a scheme is something that many trustees have never needed to do. However, situations can occur without warning which require the trustees to act quickly, so all trustees need some preparation.

Winding up is the process of closing down an occupational pension scheme. If the scheme is sufficiently well funded, this is usually achieved by purchasing insurance policies (annuities) for the beneficiaries.

If the scheme is less well funded, winding up might involve transferring the scheme's assets to the Pension Protection Fund (PPF) and paying compensation to members from that arrangement.

How does wind-up work?

A date is set (often referred to as the wind-up date) after which members no longer earn benefits under the scheme. The trustees of the scheme will then make a detailed assessment of the scheme's assets and liabilities.

The scheme rules will contain detailed provisions dealing with the winding up of the scheme, and the way that its assets should be distributed. Overriding legislation is also likely to apply. The trustees will need to take legal advice to ensure they comply with the requirements of both the legislation and their scheme's rules.

Who can wind up the scheme?

Each scheme has its own set of rules which explain how members' benefits should be calculated and the circumstances in which the scheme can be wound up. These will differ from scheme to scheme.

Trustees

The rules may allow the trustees to wind up if certain conditions are met (such as on the advice of the scheme actuary) or only with the consent of the employer. Trustees need to understand what the rules of their scheme say about winding up the scheme.

The Pensions Regulator (TPR)

TPR has the power to wind up occupational pension schemes in certain circumstances, including when TPR considers it necessary to protect the interests of the generality of members.

Notifying TPR

Depending on the circumstances of the wind-up, the trustees may be required to notify TPR, for example, if the wind-up is in connection with the insolvency of the employer, or is in connection with the employer's decision to cease trading in the UK.

Useful links
Read more about the notifiable events regime at www.tpr.gov.uk/code2.

When will a wind-up take place for a solvent employer?

The winding up of a pension scheme normally occurs when the company decides it no longer wishes to make the required level of contribution to the scheme (for example, on the grounds of cost) or is no longer able to do so (it may, for example, be insolvent).

If a pension scheme starts to wind up while an employer is still solvent, the value of members' benefits must be calculated using the cost of buying annuities to secure those benefits.

Insufficient funds?

If the scheme's funds are insufficient to secure benefits on this basis, the shortfall is treated as a debt due from the employer to the trustees.

The cost of securing benefits

The employer is used to thinking of the ongoing funding target as the 'cost' of providing the scheme's benefits, as this is used to set the employer's contributions.

However, when a scheme is wound up, the 'cost' to the employer is likely to be significantly larger. This is because the insurer will not risk its own solvency by running a risky investment strategy. Instead it will calculate the price of the annuities allowing for a low risk, largely gilt based, investment strategy. Because of the high cost for employers in winding up the scheme, most employers are reluctant to embark on it.

What if the employer cannot afford it?

Many employers cannot afford to make up the buy-out deficit as a one-off payment (or even in instalments). If the trustees trigger a wind-up of the scheme in that situation, the debt falling on the employer will push that employer into insolvency, and the scheme will not receive its debt paid in full. Therefore trustees have to carefully weigh up the consequences of winding up the scheme.

When will a wind-up take place for an insolvent employer?

The winding up of a pension scheme normally occurs when the company decides it no longer wishes to make the required level of contribution to the scheme (for example, on the grounds of cost) or is no longer able to do so (it may, for example, be insolvent). This section applies where an employer has already been declared insolvent, or is insolvent as a result of the trustees triggering the buy out debt.

Insufficient funds?

In these circumstances, it is likely that the proportion of the employer's assets available to the scheme (as one of the employer's creditors) will not be sufficient to cover the buy-out deficit.

The Pension Protection Fund (PPF)

The Pension Protection Fund (PPF) was set up in 2005 to pay compensation to members of eligible pension schemes whose employers are insolvent where the scheme has insufficient funds to pay members' benefits in full.

The PPF will check whether a scheme is eligible and, if so, will pay members compensation equating to a proportion of their promised benefits, subject to certain limits.

Useful links
Find out more about the PPF and the level of benefits it can secure at http://www.ppf.co.uk/our-members/what-it-means-ppf