

A PENSION SCHEME WIND-UP: LEGITIMATE ACT OR SMASH-AND-GRAB?

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“Perfection is probably unattainable.”

Buckley J.
(In re George Newnes Group Pension Fund)

1. INTRODUCTION

Precedents

1.1 THE last paper on the winding-up of pension schemes was presented to the Institute by Gilley in March 1972.⁽¹⁾ Since that time it has justifiably been the standard work on the subject and it has only recently been withdrawn from the Institute's examination syllabus. This paper is an attempt to up-date Gilley's work and to describe a complex and practical field of actuarial operation.

1.2 Since 1972 there has been a substantial amount of pensions legislation which has inevitably changed the detailed procedures involved in a pension scheme dissolution. Nevertheless, many of the general considerations and ideas expressed in Gilley's paper are still valid today.

The Need for Discussion

1.3 The rapid growth in the accumulated funds of occupational pension schemes during recent decades has meant that the manner in which those funds may be disposed of when a scheme is discontinued assumes an ever-increasing importance. In their 1981 Report⁽²⁾ the Occupational Pensions Board stated that they had received evidence which “deplored the fate of members whose schemes had been wound-up and who had been forced to accept the status of early leavers even though they continued to be in the same employment”. Bearing in mind the unfavourable publicity the actuarial profession received during the debate on early leavers it is perhaps appropriate that we should consider the scope for further criticism arising from an increased public awareness or perception of the inequities that may result when a pension scheme is wound-up.

1.4 The economic recession of the early 1980's produced the last surge in the incidence of pension scheme wind-ups. Government legislation in the wake of the 1985 Fowler Inquiry might conceivably produce another; particularly if there is a move from defined benefit to defined contribution pensions provision. In the circumstances we believe the subject should be re-opened for discussion.

Structure of the Paper

1.5 In § 2 of the paper we consider the circumstances which usually give rise to a winding-up and in §§ 3 to 9 we describe the mechanics of dissolving a self-administered contracted-out final-salary pension scheme. Many of the procedures and points of detail will be equally applicable where the scheme was operated on an insured basis. The discontinuance of various other types of pension arrangement is considered in § 14.

1.6 This paper does not cover public sector schemes which operate for employees of central and local government, the nationalized industries, public boards and similar bodies. Such schemes are usually regulated by Acts of Parliament and Statutory Instruments rather than Trust Deeds and Rules and they could not be wound-up without authorization from the Government. The possibility of winding-up is usually considered to be remote.

1.7 In most winding-ups the Trustees are called upon to exercise their discretion in deciding how to apportion the scheme's assets between the beneficiaries of the scheme (including the Principal Employer and the participating employers). The manner in which they exercise that discretion will dictate the beneficiaries' eventual shares of the scheme's assets. The Trustees may come under external pressures and influence in exercising their discretionary powers due to the conflicting interests of the parties involved. In § 12 we discuss how these external pressures may leave the Trustees impotent and unable to exercise their discretion properly. In § 13 we consider how the unenviable position of the Trustees in such cases might be improved.

The Title

1.8 If the Trustees fail to exercise their discretion "with an entire absence of individual motive, with honesty of intention, and with a fair consideration of the subject"⁽³⁾ their actions might be contestable in the Courts. If the requisite standard of care is not met, then irrespective of whether an action is actually brought (and at present few are because of the prohibitive expense in time and money), the winding-up of the pension scheme may be *prima facie* negligent. Thus, although the act of winding-up a scheme will invariably be legitimate the manner in which the winding-up proceeds may not be.

1.9 Where the Principal Employer is able to precipitate the winding-up (break the shop window) and manipulate the Trustees (outwit or tie up the security guards) to maximize his share of the trust assets (the jewels) a pension scheme dissolution can have all the characteristics of a smash-and-grab. Regrettably the deprived beneficiaries face far greater difficulties in trying to make good their losses than a robbed but adequately-insured shopkeeper.

Partial Winding-ups

1.10 We do not deal in detail with partial winding-ups. Such situations occur where a company ceases to participate in a centralized scheme but the scheme itself continues. Although the Trust Deed and Rules will often deal with partial

winding-ups under the winding-up rule we consider that it is more appropriate to have a separate reconstruction rule. The winding-up rule would then only be required to cover the situation where the Principal Employer is reluctant or unable to maintain his contributions to the scheme. The reader is warned that Appendix A is not applicable to partial winding-ups because the scheme as a whole does not cease to be contracted-out. Rather employments with the departing employer cease to be contracted-out by reference to the centralized scheme.

2. CIRCUMSTANCES GIVING RISE TO THE WINDING-UP

2.1 The decision to wind-up a pension scheme may arise from a number of different circumstances. The most common are as follows:

- (i) The Principal Employer exercises its option under the Trust Deed and Rules governing the scheme to discontinue contributions.
- (ii) The Principal Employer fails to contribute to the scheme or fails to meet other obligations specified in the Trust Deed and Rules.
- (iii) An Order is made or a resolution is passed to wind-up the Principal Employer.
- (iv) The Trustees, having taken actuarial advice, consider the scheme to be insolvent and resolve to terminate it.

The withdrawal of approval of a scheme by the Superannuation Funds Office or the cancellation by the Occupational Pensions Board of the contracted-out status of employments by reference to a scheme might also precipitate a winding-up. In cases (i) to (iii) the Trustees may have the power to continue the scheme.

Winding-ups at the Instigation of the Principal Employer

2.2. Winding-ups at the instigation of the Principal Employer may occur for a variety of reasons. The Company may decide that it is unable to continue providing occupational pensions or may wish to do so, for future service, on a reduced scale. The Company's fundamental attitude to pensions provision may have changed and accordingly it might be decided to terminate the defined benefit arrangement and to inaugurate a defined contribution arrangement, or vice-versa. A Group rationalization of pension arrangements may necessitate the termination of the autonomous schemes previously operated by Group subsidiaries.

2.3 In any of the above circumstances the instigator might be a company which has successfully taken over the Group or the Principal Employer (so becoming a party to the scheme's Trust Instrument).

Alternatives to Winding-up

2.4 Where the possibility of winding-up arises from the actual or apparent insolvency of the scheme it may be possible to avert the winding-up if the

Principal Employer is prepared to make a cash injection or to take other remedial action to correct the position.

2.5 Depending on the provisions of the Trust Deed and Rules the Trustees may have the power to postpone determination and to continue to operate the scheme as a closed arrangement either with further accrual of benefits (if the Principal Employer is prepared to maintain contributions for current members) or with no additional accrual of benefits.

2.6 However, there are severe practical difficulties in exercising the power of continuation if the Principal Employer is set upon terminating the scheme. The Principal Employer will often have the power of appointment and removal of Trustees. The Trustees may be under various pressures to comply with the wishes of the Principal Employer. Trustees who hold a managerial position in the Company may have been involved in the management decision to discontinue the scheme. Non-managerial member Trustees may be concerned about their continued employment in a declining company and a professional corporate Trustee will be aware that it is the Principal Employer who either directly or indirectly is paying his fee.

2.7 It is a fundamental principle that a Trustee should not put himself in a position where his personal interests may conflict with those of the trust. In such a position he must endeavour to differentiate between those considerations which can properly influence his decisions in relation to the trust and those which must be extraneous to such decisions. In such circumstances the Trustee's position is unenviable.

Implications for the Winding-up Process

2.8 The circumstances giving rise to the winding-up and in particular the motivation of the party instigating the winding-up are likely to have ramifications as regards both how the winding-up process evolves and for the quantum of discontinuance benefits eventually secured for the beneficiaries of the scheme either by transfer to another scheme or by the purchase of annuities.

2.9 In subsequent sections of this paper we consider how discrepancies can occur between the actual and expected discontinuance rights of beneficiaries. Suffice it to say, it is quite conceivable for two schemes in a financially identical position and with identical Trust Deeds and Rules to be wound-up with appreciably different apportionments of the assets between the different classes of beneficiaries (including in this context the Principal Employer who almost invariably has a beneficial interest in the trust assets on winding-up).

3. THE PARTIES INVOLVED

3.1 The principal parties involved in the determination of a pension scheme are the parties to the Trust Instrument; the Trustees, the Principal Employer and the participating employers. The role of the Trustees is of foremost importance because of the fiduciary capacity in which they act.

Parties with Direct Interests

3.2 The overriding concern of the Trustees must be to act in the interest of the beneficiaries. The different classes of beneficiary with a direct interest in the disposition of trust assets on winding-up are as follows:

- (i) Current pensioners.
- (ii) Active members of the scheme who have attained Normal Retirement Age.
- (iii) Deferred pensioners.
- (iv) Active members of the scheme.
- (v) Contingent widows, widowers and dependants of the beneficiaries in (i) to (iv).
- (vi) The Principal Employer and the participating employers.

Parties with Indirect Interests

3.3 The Principal Employer and the participating employers normally have a beneficial interest in the trust assets because they are settlors of the trust. As a result of this beneficial interest a number of parties do have or can have an indirect interest in the scheme particularly as regards the manner in which the assets are apportioned on dissolution. These parties are as follows:

- (i) The directors of the Principal Employer and the participating employers.
- (ii) Shareholders of the Principal Employer and the participating employers.
- (iii) The receiver.
- (iv) The liquidator.
- (v) Secured creditors (including employees both in pensionable and non-pensionable employment with unpaid wages).
- (vi) Unsecured creditors.
- (vii) Former employees in receipt of *ex-gratia* pensions.

3.4 It is, of course, possible for an individual Trustee to be a member of the scheme, a director of the Company, a shareholder of the Company and a creditor of the Company so having a number of competing direct and indirect interests. These conflicts of interest are discussed in later sections of the paper.

Professional Advisers

3.5 In order to wind-up the scheme with the appropriate standard of care the Trustees will take professional advice. This will include:

- (i) Legal advice from solicitors and perhaps counsel on the interpretation of the Trust Deed and Rules with particular regard under the winding-up rule to the application of surplus funds.
- (ii) Advice from the Actuary on the adequacy of the resources of the scheme, the method of securing the discontinuance benefits, including Guaranteed Minimum Pensions (GMPs), and the application of surplus funds between the different classes of beneficiaries.
- (iii) Investment advice in connection with the realization of trust assets.

3.6 A contracted-out scheme or a scheme with an audit requirement in its Trust Deed and Rules will also need audited accounts, so necessitating the advice of an accountant. In any event the Trustees would be unwise not to take the appropriate advice in drawing up the final accounts of the Scheme.

Statutory Bodies

3.7 There are three statutory bodies that have an interest in the winding-up of an occupational pension scheme; the Occupational Pensions Board (OPB), the Department of Health and Social Security (DHSS) and the Superannuation Funds Office (SFO), which is an office within the Inland Revenue.

Occupational Pensions Board (OPB)

3.8 The involvement of the OPB in the winding-up of a contracted-out scheme is described in detail in Appendix A. They have three principal concerns:

- (i) The formalization of the cessation of contracted-out status.
- (ii) The maintenance of financial supervision of the scheme so long as there remain any GMP rights under the scheme.
- (iii) The approval of arrangements for securing GMPs.

Superannuation Funds Office (SFO)

3.9 The Inland Revenue and in particular the SFO have an interest in the following aspects of a winding-up:

- (i) The collection of any income tax or tax on refunded contributions which is outstanding at the winding-up date.
- (ii) The type of policy which can be purchased to secure dissolution benefits.
- (iii) The amount of dissolution benefits and the policing of benefits where there is a possibility of Inland Revenue limits being exceeded.
- (iv) Tax payable on any repayments to the Principal Employer or the participating employers.
- (v) Ensuring that the Trustees act in accordance with the winding-up rule.

3.10 Tax arises on repayments to the employer under Part II Schedule 5 of the Finance Act 1970 where the money repaid is a receipt of the trade, profession or vocation. Where the employer is a partnership the repayment is treated as chargeable income under Case IV of Schedule D. When the employer has already ceased to trade the repayment is deemed to have been received on the last day of trading.

Department of Health and Social Security (DHSS)

3.11 The Contracted-Out Employments Group of the DHSS provides a calculation service to inform the Trustees of the GMP liabilities of the scheme on discontinuance. This service is described in Appendix C. The DHSS has an interest in outstanding State scheme premiums. They may also take Court action against an employer in respect of unpaid National Insurance contributions.

3.12 The OPB and the DHSS liaise to ensure that all GMP liabilities of a scheme are established and secured in an approvable manner.

4. THE INTERESTS OF THE PARTIES INVOLVED

The Trustees

4.1 The Trustees of the scheme will either be a collection of individuals, a corporate Trustee, or a combination of the two. Their concern will be to wind-up the pension scheme in accordance with the provisions of the Trust Instrument. In so doing they should exhibit the standard of conduct required by general trust law. At present the standard of care required of an unpaid trustee is that of an ordinary prudent man of business.⁽⁴⁾ However, the law imposes a higher standard on paid trustees.⁽⁵⁾

4.2 In exercising any discretionary powers the Trustees must act impartially and must not confer an advantage on any one beneficiary at the expense of another unless expressly authorized by the Trust Instrument.

4.3 To the extent that any of the provisions of the Trust Instrument are unclear the Trustees should seek legal advice. In particular we would consider it essential that legal advice is taken before any excess monies, after the basic dissolution benefits have been secured, are apportioned between the various beneficiaries. In the event of the Trustees' actions being contested, a factor in assessing their reasonableness may well be whether they sought legal advice. However, the Trustees will not necessarily escape responsibility if that advice proves erroneous in law. The Trustees will also seek actuarial guidance and we describe the role of the Actuary in subsequent sections of the paper.

The Employers

4.4 As already mentioned the Principal Employer and the participating employers almost invariably have a beneficial interest in the trust assets on determination. The prospect of a refund from the pension scheme is sometimes the prime motivation for precipitating the winding-up and in recent years the practice of asset-stripping of pension schemes (buying a company with a view to extracting money from its well-funded pension arrangements) has received much publicity. In such cases the interests of the Principal Employer and the participating employers may be antipathetic to those of the other beneficiaries of the scheme depending on the actions of the Company and the level of benefits granted to the members.

4.5 Where a scheme is wound-up because of a rationalization of Company (or Group) pension arrangements the Principal Employer is more likely to give balanced consideration to the expectations of scheme beneficiaries.

The Beneficiaries

4.6 The interest of an individual beneficiary in isolation is obviously to maximize the benefits payable to him from the scheme. However, there may be

other factors which temper this aim. Employees are often presented with the possibility of discontinued employment unless the Company is able to preserve its solvency by recovering monies from the pension scheme. It may be that a return of surplus assets from the scheme along with continued employment will give rise to higher pension expectations for the members in the longer term.

The Shareholders

4.7 There is little evidence to suggest that the U.K. investor regards the assets and liabilities of a pension scheme as part of the assets and liabilities of the Company or that the ongoing or discontinuance solvency of a pension scheme is fully discounted in the share price. The prospect of a refund from the pension scheme on winding-up is likely to fuel speculation in the shares of those companies with a potential interest in refunded monies. Whether any resultant increase in the share price can be sustained is likely to depend upon how successfully the Company utilizes the monies recovered. In turn this will depend upon the Company's current and projected tax position, its debt obligations, the anticipated cost of borrowing and future changes in the rate of corporation tax.

Receivers and Liquidators

4.8 The duties of a receiver are to realize the assets of the Company for the benefit of the secured creditor appointing him and, if he is appointed under a floating charge, for preferential creditors having priority to the floating charge holder. Any eventual surplus will be passed either to a liquidator (if appointed) for distribution to unsecured creditors or to the Company itself. The liquidator manages the formal process of terminating the legal existence of the Company and deals with the claims of unsecured creditors.

4.9 The powers and duties of both receivers and liquidators are ill-defined insofar as they relate to pension schemes.

4.10 Where the pension scheme is not discontinued a receiver may continue to pay the Company's contributions in respect of those employees whose services he wishes to retain. However, in our experience a receiver is unlikely to show any interest in a pension scheme which is being wound-up unless there is a real prospect of a return of assets. There is no legal obligation on a receiver to protect or pursue claims of Trustees or employees against the Redundancy Fund (see §6.7).

4.11 By the nature of his appointment a liquidator is likely to exhibit a higher standard of care and diligence in relation to the pension scheme. Whilst he too will be interested in the prospect of any return of assets from the scheme he is more likely to have regard to a claim against the Company for outstanding pension scheme contributions. To do otherwise might involve an action through the Courts alleging an improper distribution of the Company's assets.

Secured and Unsecured Creditors

4.12 Where the Company is insolvent both secured and unsecured creditors

will have an interest in a return of monies from the pension scheme as this increases the distributable assets of the Company.

4.13 A member of the pension scheme with unpaid wages is a preferential creditor of the Company in respect of those arrears. He might find that augmented dissolution benefits are less valuable than basis dissolution benefits together with the settlement of his unpaid wages claim financed by pension scheme money returned to the Company.

4.14 A bank who is a creditor of the Company and is responsible for the appointment of the receiver might also be the sole corporate trustee of the pension scheme, albeit through one of its subsidiaries.

Conflicts of Interest

4.15 It will be apparent from the above that the direct or indirect interests of the parties to the winding-up will not always coincide. As already mentioned an individual may find himself representing more than one party. Inevitably conflicts of interest arise and the outcome of the winding-up will depend upon how these conflicts are resolved. We consider the problems which may arise from such conflicts of interest in § 12.

4.16 Because of the potential conflicts of interest the Trustees and the Actuary advising the Trustees should tread warily. We cannot over-emphasize the necessity to take the appropriate legal advice before any action to distribute surplus assets is taken. In particular there may be circumstances where the Actuary should take his own independent legal advice.

5. THE WINDING-UP RULE

The Trustees and the Winding-up Rule

5.1 The overriding responsibility of the Trustees is to observe the terms of the Trust Instrument governing the pension scheme. Only to the extent that the Trust Instrument fails to deal specifically with a point does recourse have to be made to established principles of equity or the statute book. The dissolution provisions of the Trust Instrument are, therefore, of overwhelming importance to the winding-up process and we cannot emphasize too strongly that these provisions should be drafted in a comprehensive and unequivocal fashion.

5.2 It will normally be prudent for the Trustees to obtain legal advice. However, it can be a time-consuming exercise (as well as an unwelcome drain on trust assets) if the obscure wording of the dissolution provisions necessitates counsel's opinion at every stage. Gilley (1972) found that "dissolution provisions of trust deeds and rules usually leave much to be desired". Fortunately there has been some progress since then and there is now a degree of uniformity of drafting amongst those solicitors with pensions expertise.

5.3 The winding-up rule will normally cover the following points:

- (i) The cessation of the employers' liability to contribute.
- (ii) The notification of members of the determination of the trust.

- (iii) The realization of the trust assets and the application of the proceeds to secure specified dissolution benefits.
- (iv) The order of priority to be accorded to various classes of dissolution benefit (including for this purpose expenses of winding-up).
- (v) The manner in which the available monies are to be applied if they are insufficient to cover the dissolution benefits.
- (vi) The manner in which any monies remaining after basic dissolution benefits are secured can or must be applied to augment those benefits.
- (vii) The return to participating employers of any monies remaining after the securing of augmented dissolution benefits.
- (viii) The alternative approaches available for securing benefits and the conditions governing the implementation of those alternatives.

The Priority of Benefits in the Winding-up Rule

5.4 Subject to there being sufficient assets the benefits which will generally be provided on winding-up (before any augmentation) are:

- (i) Pensions in payment.
- (ii) Deferred pensions prospectively payable to former members.
- (iii) Benefits prospectively payable to members in service as at the winding-up date calculated as if they had left service immediately prior to that date (but without entitlement to a refund of contributions).
- (iv) Benefits contingently payable to widows, widowers and dependants.

These benefits will include any future increases specifically provided for in the Rules.

5.5 It should be realized, however, that different tranches of an individual's dissolution benefit may be accorded different priorities which will determine his or her entitlements in the event of an inadequacy of assets.

5.6 A contracted-out scheme must give priority in its winding-up rule to any liabilities of the scheme in respect of GMPs, Equivalent Pension Benefits (under the National Insurance Act 1965), pensions in payment and other benefits to which entitlement has arisen, and State scheme premiums. However, there are a number of further liabilities which may rank equally with or ahead of any of these items and a full description of the OPB's guidance on priority rules may be found in Appendix B.

5.7 In their 1982 Report⁽⁶⁾ entitled "Greater Security for the Rights and Expectations of Members of Occupational Pension Schemes" the OPB included a table summarizing the practice of thirty-five contracted-out schemes as regards the priority rankings in their winding-up rules. It would seem from this small sample that the majority of contracted-out schemes accord high priority to costs and expenses of winding-up and to pensions in payment and benefits contingently payable to pensioners' dependants. Priority rankings accorded to other categories of benefit are more varied. We would expect the winding-up rules of contracted-in schemes to exhibit similar features.

Securing Dissolution Benefits

5.8 The methods which will normally be described in the winding-up rule for securing dissolution benefits are the purchase of immediate and deferred annuities, or the transfer of rights to another occupational pension scheme. The rule will invariably permit a combination of these two approaches. This might occur, for example, where a transfer takes place to a contracted-in scheme which cannot accept GMP liabilities. Sometimes the winding-up rule also deals with the manner in which benefits are to be abated should State scheme premiums be paid to extinguish GMP liabilities. The mechanics of securing dissolution benefits are considered in detail in §7.

The Power of Augmentation

5.9 In our experience the power to augment benefits under the winding-up rule is usually vested in the Trustees. It is more often a discretionary power than a mandatory requirement. In some cases the power can only be exercised with the consent of the Principal Employer although this requirement may cease to apply on the appointment of a receiver or liquidator. Generally the Trustees have full discretion as to how they apply any augmentation, after consultation with the Actuary. The extent of any augmentation will be subject to the requirement that the augmented benefits should not exceed Inland Revenue limits.

Return of Assets to the Employer

5.10 The new code of approval introduced by the Finance Act 1970 made it a condition of approval that on winding-up any fortuitous surplus after maximum approvable benefits had been provided should be returned to the employer and be treated as a trading receipt in his hands.

5.11 Although there are still old superannuation funds which have no provision for payments to the employer in any circumstances, the majority of schemes nowadays provide for a return of surplus monies on winding-up. However, the ability to return monies in such circumstances is not usually contingent upon first providing maximum approvable benefits.

The Power of Amendment

5.12 An important aspect of the Trust Instrument is whether the power to amend its provisions (if such a power exists) continues once the scheme is in the process of winding-up. Where the power of amendment is not entrusted to the Trustees under the winding-up rule they have little option but to implement the winding-up provisions as drafted⁽⁷⁾ since “when a Trustee ventures to deviate from the letter of his trust, he does so under the obligation and at the peril of afterwards satisfying the Court that the deviation was necessary or beneficial”.⁽⁸⁾

5.13 Problems may arise where the power of amendment is vested in the Principal Employer or where the Trustees must obtain the consent of the Principal Employer to exercise the power. In either case the Trust Instrument

should make provision for the possible liquidation of the Principal Employer or the power of amendment may become unexercisable.

5.14 Any amendments to the rules of a contracted-out scheme after the cessation of contracted-out status, but where there is a continuing liability for GMPs, will require the consent of the OPB.

5.15 Notwithstanding the wording of the Trust Instrument there may be considerable practical difficulties in trying to amend its provisions once discontinuance is contemplated or in progress and in such circumstances a Trust Instrument which has been carefully drafted and does not need amendment is clearly an advantage.

Schemes Operating Under Interim Documentation

5.16 A scheme may be operating under interim documentation when it ceases to be contracted-out. When the scheme is to be wound-up and GMP liabilities are to be secured definitive documentation may be required to meet the preservation requirements. However, the interim contracting-out deed should be left extant to cover the period when employments were contracted-out by reference to the scheme.

6. THE SOLVENCY OF THE FUND

6.1 In the context of discontinuance, solvency is to be understood as the extent to which the assets of the scheme are sufficient to meet the liabilities prescribed in the winding-up rule. On completion of winding-up procedures the degree of solvency becomes a matter of fact rather than a matter of speculation. For convenience we shall refer to winding-ups as being 'insolvent' where the assets are insufficient to meet the dissolution benefits and 'solvent' where the dissolution benefits can be honoured and where there are excess monies for augmentation and/or a refund to the Principal Employer and the participating employers.

Insolvent Winding-ups

6.2 There are clearly degrees of insolvency and solvency. The most extreme degree of insolvency is where the assets are insufficient to meet the liabilities specified in the Actuarial Certificate. In the normal course of events such situations should not arise.

6.3 Insolvencies also occur where the assets are sufficient to secure the liabilities specified in the Actuarial Certificate but are nevertheless insufficient to secure the basic dissolution benefits.

6.4 In their 1982 Report the OPB noted that on the basis of figures supplied by the six largest life offices less than 4% of dissolutions amongst insured schemes between 1975 and 1982 disclosed assets insufficient to secure fully benefits on winding-up. In the majority of insolvent cases the deficiency arose because of benefits in respect of pre-scheme service which were not fully funded at the time

of winding-up. We would not expect any greater incidence of insolvencies amongst self-administered schemes. Indeed for a final-salary pension scheme funding for benefits related to pay levels close to retirement and with carefully worded winding-up provisions, the possibility of insolvency on winding-up (where benefits are generally related to pay levels then prevailing) should be fairly remote.

Protection of Members on Insolvency of the Employer

6.5 Insolvent winding-ups may themselves be the result of the actual or approaching insolvency of the employer. In such cases it is not uncommon for there to be arrears of contributions due to the scheme. Members of a pension scheme have a two-tier system of protection in the event of the employer's insolvency.

6.6 Under the terms of Section 58 and Schedule 3 of the Social Security Pensions Act 1975, members' contributions which have been deducted from earnings payable in the four months ending on the relevant date are granted priority over other debts of the company together with claims in respect of wages, National Insurance contributions, rates and taxes. In addition contracted-out schemes have a priority in respect of arrears of employer's contributions payable in the twelve months ending on the relevant date to the extent that such contributions are required to pay pensions in payment and to provide accrued GMPs. Priority is also accorded to any outstanding State scheme premiums (Contribution Equivalent Premiums (CEPs) or Limited Revaluation Premiums (LRPs)) that relate to the last twelve months of contracted-out service. Any residual liability for outstanding premiums is passed on to the scheme's Trustees.

6.7 To the extent that the Trustees are unable to recover certain unpaid contributions either due from the employer on his own behalf or on behalf of employees a claim may be lodged with the Secretary of State under Section 123 of the Employments Protection (Consolidation) Act 1978. In the event of the claim succeeding the Redundancy Fund will make good any member's contributions deducted from pay but not paid over to the scheme in the twelve months ending on the relevant date together with whichever is the least of:

- (i) The amount needed to meet the scheme's liabilities.
- (ii) The employer's contributions due but unpaid in the twelve months ending on the relevant date.
- (iii) The equivalent of 10% of the earnings of the scheme members over the same twelve months.

6.8 The employees' rights under the insolvency provisions are supplementary to any rights the employees may have as preferential creditors. However, to the extent that the employees' claims are paid from the Redundancy Fund the employees' rights will pass by subrogation to the Secretary of State. As a result a claim which in some circumstances should properly be made by the liquidator can lead to a reduction in the free assets under his control.

6.9 Despite the economic recession the number of claims on the Redundancy Fund has been relatively low. According to the OPB's 1982 Report between April 1976 and May 1982 some 80 schemes received payments in respect of 2,000–3,000 members.

Should Discontinuance Solvency be Guaranteed?

6.10 Under some Trust Deeds and Rules the Principal Employer guarantees the solvency of the scheme on winding-up. Such a guarantee is likely to be academic if the Principal Employer becomes insolvent and does not have significant assets. When the Principal Employer does not guarantee discontinuance solvency he may terminate the scheme knowing it to be insolvent irrespective of whether his business is continuing or not. With these problems in mind there has been some discussion as to whether or not the employer should be statutorily required to take steps to guarantee discontinuance solvency.

6.11 In their 1982 Report the OPB describe in some detail systems of pension credit insurance and termination insurance which operate to underwrite discontinuance solvency in other countries.

6.12 Pension credit insurance guarantees that if the employer becomes insolvent contractual pension obligations to his employees will be met to the extent that they are not already covered through insurance policies or segregated pension scheme assets.

6.13 A system of termination insurance operates in the U.S. and differs from pension credit insurance in that the insolvency of the employer is not a prerequisite for the insurance cover to operate. Under the U.S. system the Pension Benefits Guaranty Corporation (PBGC) guarantees to make good any shortfall on discontinuance between plan vested benefits and plan assets. There is obviously a problem of potential abuse under such a system where the insurable event (the winding-up of the scheme) is under the employer's control. To limit the scope for such abuse the PBGC has a prior charge on the employer's assets to the extent of 30% of his net worth up to the limit of the cost of meeting the unfunded liabilities. The cost of the termination insurance is met by a flat rate levy on employers. The levy operates irrespective of the level of funding of an employer's own pension scheme.

6.14 The OPB found that a system of compulsory credit insurance has some attractions but felt unable to recommend introduction of such a system because of "the lack of evidence that the loss of accrued pension entitlements is a widespread problem." They also found that "it seems to be widely accepted that, with the combination of moral obligation and industrial relations considerations, including pressure from trade unions, employers would seldom wind-up their schemes without the payment of accrued benefits, so long as they had the resources to meet any deficit".

The Reduction of Benefits in Insolvent Winding-ups

6.15 If the scheme remains insolvent after any recovery of unpaid contribu-

tions or any injection from the Redundancy Fund some beneficiaries will necessarily receive lower benefits than those prescribed in the winding-up rule. The normal approach will be to apply the available monies to secure dissolution benefits in descending order of priority until a class of benefit (or tranche of benefits ranking *pari passu*) is reached which cannot be fully secured. Within that class or tranche the monies should be apportioned for the benefits of members in a fair and equitable fashion, consistent with any provisions of the Trust Instrument. Whilst each case must be judged on its merits the apportionment will normally be made on the basis of the open market cost of securing the particular class or tranche of dissolution benefits.

6.16 In the event of the scheme proving so insolvent that all GMP liabilities cannot be met the DHSS has the power to deem as paid any outstanding premiums to buy members back into the State scheme.

Solvent Winding-ups

6.17 Amongst schemes which are solvent on winding-up there will be cases where the assets are not sufficient to augment members' entitlements to Inland Revenue limits and there will be cases where the assets are more than sufficient to provide maximum approvable benefits (or approximations thereto). Where there are excess monies after securing basic dissolution benefits the decisions regarding the manner and level of augmentation of members' entitlements are of crucial importance. We deal with these questions in later sections of the paper.

7. SECURING DISSOLUTION BENEFITS

7.1 In this section we consider the practicalities of securing the dissolution benefits of a contracted-out self-administered scheme that is approved by the Inland Revenue and is solvent on winding-up. The problems of establishing discontinuance benefits where the winding-up is insolvent are discussed in §6. However, once the benefits are established the same methods are available for securing those benefits.

Collation of Information

7.2 Having been informed of the decision to terminate the scheme, the Actuary should obtain full membership details for the scheme together with a list of the scheme's investments and net current assets. The Actuary will require details of the pensions currently in payment, deferred pensions prospectively payable and details of the active membership at the date of termination. In addition a list of membership movements since the date of the last actuarial valuation of the scheme will enable the Actuary to validate the membership at the dissolution date. The full data requirements of the Actuary are set out in Appendix D.

7.3 We would emphasize that the collection and collation of the membership details is fundamental to the whole process of determination. In our experience,

however, it can be an extremely time-consuming process, and fraught with practical difficulties. We would recommend that particular attention is paid to the reconciliation of the membership with the data used in the previous actuarial valuation and with details supplied by the DHSS. Where the Employer is in receivership or liquidation the collection of data may be hindered by the absence of any personnel with detailed knowledge of the pension scheme or its records. Where the Principal Employer is preoccupied with trying to save his business the level of co-operation may be very unsatisfactory.

7.4 Furthermore before the Actuary proceeds with the preparation of his report to the Trustees it is necessary to obtain copies of the Definitive Trust Deed and Rules and subsequent amendments, booklets and other announcements issued to members, and details of any Resolutions made by the Trustees affecting the Rules of the scheme.

Calculation of Dissolution Benefits

7.5 The benefits currently in payment to pensioners, widow(ers) and other dependants and those prospectively payable to former members will normally have been calculated already and will, therefore, be a matter of record. The benefits prospectively payable to active members at the winding-up date will often be related to the Short Service Benefits payable on the withdrawal of a member from the scheme. The calculations that will normally be required to determine the dissolution benefits for an individual member and his dependants relate to the following items:

- (i) Guaranteed Minimum Pensions at the date of termination and revalued to State Pension Age at either the fixed rate, or limited rate. (Where future revaluation is in line with Section 21 Orders the revalued GMP will be unknown).
- (ii) State scheme premiums including the Pensioner's Rights Premium (PRP), or the Accrued Rights Premium (ARP), and (where appropriate) the LRP.
- (iii) The 'accrued' or 'scale' deferred pension at the date of leaving. This will normally be based on Pensionable Service completed to and Final Pensionable Salary at the date of termination of scheme membership.
- (iv) Increments which must be added to the 'accrued' or 'scale' deferred pension between the date of leaving and Normal Retirement Age in accordance with increases guaranteed in the Trust Deed and Rules. (This calculation will only be possible when the increases are ascertainable in advance.)
- (v) The 'value for money' deferred pension based on the member's contribution paid to the scheme.
- (vi) Contingent widows', widowers' and dependants' pensions payable on death before or after retirement.
- (vii) The maximum benefits which may be paid without prejudicing the Inland Revenue's approval of the scheme.

7.6 Where the winding-up occurs during 1985 the Actuary must have regard to the 'anti-franking' legislation contained in the Health and Social Security Act 1984 which places a statutory minimum on benefits payable from State Pension Age. Where the winding-up occurs after 1 January 1986 the Actuary will also be required to ensure that the increases granted during the period of deferment are at least as great as those determined in accordance with the provisions of the Social Security Act 1985.

7.7 A scheme which increases Short Service Benefits during the deferred period at a rate of not less than 3% per annum compound or by reference to the cost of living is not required by the preservation requirements of the Social Security Act 1973 to apply a 'value for money' test. However, we would consider it good actuarial practice always to apply such a test unless it is obviously redundant. We would also consider it appropriate to extend such a test to transfer payments received by the scheme in respect of a member where this is possible under the provisions of the Trust Deed and Rules.

7.8 If dissolution benefits are to be bought-out with an insurance company it is not necessary to quantify the 'value for money' entitlement. The 'value for money' criterion to be applied is that the benefits eventually secured for an individual should cost at least as much as his own accumulated contributions based on the annuity rates of the insurance company involved.

7.9 Although the DHSS provide the comprehensive calculation service described in Appendix C the Actuary will usually have to carry out the calculations of State scheme premiums and GMPs himself if dissolution benefits are to be established within a reasonable time scale.

7.10 As soon as the Actuary has completed the calculation of the dissolution benefits he will be able to estimate the likely cost of securing them on the open market. Having made an appropriate allowance for expenses, professional fees, and any outstanding State scheme premiums he can compare the potential liabilities with the market value of the assets. This will give him the first indication of whether or not the scheme is solvent.

Methods of Securing the Benefits

7.11 Pensions in payment and deferred pensions prospectively payable can be secured, at least in theory, by any one or more of the following methods:

- (i) The purchase of non-profit annuity contracts.
- (ii) The purchase of with-profit annuity contracts.
- (iii) The purchase of unit-linked annuity contracts.
- (iv) The purchase of index-linked annuity contracts.
- (v) By transfer to another approved scheme.

In addition deferred pension rights can be secured by:

- (vi) The purchase of a Section 32 Buy-Out policy.
- (vii) The purchase of a Personal Pensions policy (should those be prescribed as suitable in Regulations laid under the Social Security Act 1985).

7.12 The options actually available to the Trustees will depend upon the wording of the Trust Instrument (unless its provisions are specifically overridden by legislation). The Trustees will also be constrained by the availability of suitable contracts. Index-linked contracts, particularly deferred annuity policies, are not widely available and would normally only be considered where the scheme guaranteed index-linked benefits.

7.13 We believe that when a scheme is discontinued the Trustees should take every possible precaution to ensure that basic discontinuance benefits are honoured, subject to the adequacy of the resources of the scheme. Accordingly if the Trustees do not intend to augment basic dissolution benefits these benefits should be secured by the purchase of non-profit immediate and deferred annuity policies. Any decision to effect participating policies should only be taken in conjunction with a decision to augment basic dissolution benefits. Such augmentation is covered in the following section.

7.14 The policies used to secure dissolution benefits must have a number of features to satisfy the supervising authorities. The constraints imposed by the OPB are summarized in §A.13. As far as possible the policies should enable beneficiaries to exercise any options that would have been available had the scheme not been discontinued. Options which might be provided are:

- (i) Commutation of pension for a tax-free lump sum (within limits advised by the Actuary at the time benefits are bought-out).
- (ii) Early or late retirement on a reduced or increased pension.
- (iii) Surrender of personal pension to provide additional widow(er)s' and/or dependants' pensions.

The options would either be exercisable on terms guaranteed in the Trust Deed and Rules or on terms advised by the insurance company in the light of financial conditions prevailing at the exercise date.

7.15 Where the policies provide benefits which are so far as possible equivalent to the basic dissolution benefits the members' consents to the purchase are not required. However, if the policy provides for unit-linking or participating in profits on the basis of a lower guaranteed benefit or if it provides a different range of benefits members' consents must be obtained. Further, although the consent of contingent beneficiaries is not a statutory requirement the Trustees would be well-advised in such circumstances to obtain a legal opinion as to whether or not this should be sought. These constraints clearly reinforce the argument for securing basic dissolution benefits on non-profit terms.

Arrangements for Securing Guaranteed Minimum Pensions (GMPs)

7.16 As we have already mentioned the OPB must approve the arrangements for securing GMPs. There are three options available and different options may be adopted for each individual member. The options are:

- (a) To reinstate the member's entitlement to the additional component of the State scheme benefit by the payment of State scheme premiums.
- (b) To purchase an annuity policy to provide the GMP.
- (c) To transfer the GMP liability to another contracted-out scheme.

7.17 The financial advantage of paying State scheme premiums can be assessed by comparing, on an individual basis, the amount of the ARP or PRP and the cost of securing the GMP on the basis of competitive non-profit annuity rates. The relative costs will depend upon the member's age and sex and the relationship between the Market Level Indicator and the financial assumptions implicit in non-profit annuity rates. However, an insurance company's expense loadings are likely to vary depending on whether the whole benefit is to be secured or only benefits in excess of the GMP and this complicates the comparison.

7.18 In practice the decision to pay State scheme premiums should be taken either in respect of the whole membership or in respect of large homogeneous sub-groups of the membership (for example, pensioners or certain age bands of deferred annuitants). The decision will be constrained by the following considerations:

- (i) Whether the Trust Deed and Rules provides for the abatement of benefits when State scheme premiums are paid.
- (ii) Whether a sufficient number of the competitive offices are prepared to quote for the provision of the abated benefits only.
- (iii) Whether the saving in the cost of securing the benefits outweighs the additional expense of determining the abated benefits and the increased administrative complexity.
- (iv) Whether the arrangements can be satisfactorily presented to the membership. (For example, explaining why, following the payment of a PRP a current pension is reduced by the amount of the GMP.)

Benefits in Excess of the GMP

7.19 The only difference between the benefits in excess of the GMP and the GMP itself is that there is no option to pay State scheme premiums. As we have already mentioned we consider that the Trustees should determine the cost of securing these benefits on the open market by the purchase of non-profit immediate and deferred annuities. These costs may then be used to design the augmentation package (see §8) or to calculate transfer payments to other arrangements (see paragraph 7.25).

Obtaining Quotations

7.20 We would recommend that quotations are obtained from at least five insurance companies who are competitive in this market. The membership and benefit data should be presented to the insurance company in distinct sub-groups. This will facilitate the comparison of quotations, the design of the

augmentation package and the obtaining of further quotations. A minimum sub-division would be pensioners, deferred pensioners and active members.

7.21 The insurance companies should be asked to provide the cost of securing dissolution benefits on an individual basis. This will enable the Actuary to check that the 'value for money' criteria is satisfied. It will also assist in the calculation of any individual transfer payments in respect of basic dissolution benefits.

7.22 It is not necessary to secure all the dissolution benefits with the same insurance company. However, any spreading of the business is only feasible in respect of distinct classes of beneficiary. It is also important to note that some insurance companies will produce their quotation by cash flow projection techniques based on the assumption that all the benefits will be secured with their office. In the event that a sub-group of the benefits is secured with another office they will wish to revise their quotation for the remaining business. Thus, in order to compare the cost of securing the benefits of a sub-group of the membership it is necessary to obtain quotations for the sub-group in isolation.

7.23 Cost should not be the only determinant by which the insurance company is selected. The Trustees should also satisfy themselves as to the quality of the administrative services that can be offered. If the policies being purchased are participating policies the Trustees should have close regard to the past and likely future performance of comparable policies of that office.

7.24 The Trustees should satisfy themselves as to the financial security of the office(s) selected notwithstanding that the effects of the default of an office will be mitigated by the Policyholders Protection Act 1975.

Transfer Payments

7.25 As an alternative to the purchase of annuities dissolution benefits can be secured by individual or bulk transfer payments. We would suggest that the cost of securing the alternative benefits on competitive non-profit rates provides a useful basis for determining the transfer values that might be paid. Where transfers are made excluding the GMP liability the transfer value should be reduced either by the cost of securing the GMP on the non-profit rates or by the ARP/PRP whichever is appropriate.

8. THE AUGMENTATION OF DISSOLUTION BENEFITS

8.1 The Trustees have been informed, by the Actuary, that there are sufficient assets to secure the GMPs, the remaining contractual benefits and to meet all professional and administrative charges. They must now perform the onerous duty of equitably apportioning the surplus funds in accordance with the provisions of the Trust Instrument and general trust law. The constraints placed upon Trustees when they exercise discretionary powers are described in detail in § 12.

8.2 There are three situations that will normally arise. These are as follows:

- (i) The Trustees do not have any power, discretionary or otherwise, to apply

surplus assets in favour of the members. The balance of the funds is automatically returned to the Principal Employer and the participating employers.

- (ii) The Trustees have a discretionary power, normally after seeking the advice of the Actuary, to augment benefits payable to the members. In these circumstances the Trustees will be responsible for determining the amount of the surplus funds that is applied to each category of membership and the residual monies that are returned to the Principal Employer and the participating employers.
- (iii) The Trustees are under a mandatory trust, where there are sufficient assets, to augment the members' benefits up to such limits as may be consistent with the approval of the scheme under Chapter II Part II of the Finance Act 1970. Only after these limits are met for each individual are any surplus assets returned to the Principal Employer and the participating employers. In the event that there are not sufficient assets to provide maximum approvable benefits the Trustees cannot return any monies to the employers and they would normally have a discretionary power to determine the augmented benefits payable to the various classes of beneficiary.

8.3 For the purpose of this Section we have considered the general case outlined in (ii) where the Trustees have discretion as to the application of excess assets. The position in (i) does not require further discussion. The principles set out in the following paragraphs will be equally applicable to case (iii) if the Trustees are required to exercise discretionary powers.

The Role of the Actuary

8.4 Although the Trustees will invariably take legal advice on the application of the excess funds it is here, in our opinion, that the Actuary has most to offer. In particular he must advise the Trustees on the equitable distribution of excess assets acting impartially between the different classes of beneficiaries including for this purpose the Principal Employer. It is worth stressing that unless the Trust Instrument so provides the Trustees are not bound to implement the Actuary's recommendations. Indeed there will certainly be instances when they do not. However, if their actions are contested they may have to demonstrate why they did not act upon expert advice.

8.5 In finding for the defence in *re George Newnes Pension Fund*⁽⁹⁾ the Judge stated that "the function of an actuary in advising . . . on the determination of the scheme is to achieve the greatest practicable degree of fairness between various persons interested under the scheme consistent with the rules". In performing this function there is an obvious parallel to be drawn with the Appointed Actuary distributing surplus in a life or pension fund of a proprietary office by way of bonus declarations to the with-profit policyholders and transfer to shareholders funds. Unfortunately the Actuary advising on a discontinuance does not have the opportunity to adjust his apportionment at future reviews.

8.6 The Actuary will have regard to the legal advice given to the Trustees. However, it will often be prudent for him to obtain independent legal advice. Indeed Buckley J. saw it as evidence of the 'careful consideration' displayed by the Actuary to the George Newnes Pension Fund that he 'discussed the appropriate basis of calculation with counsel'.

8.7 The Actuary need not assume for the purpose of calculating dissolution benefits that the scheme would continue. In the same case the Judge held that "once the scheme was terminated, the Trust Fund became the source not of normal benefits but of dissolution benefits". However, we consider that the pension expectations of the members and the prospective benefits that might have been provided from the scheme if it had continued serve as a useful guideline for the Actuary in his determination of the benefits awarded to the beneficiaries. In this context we would suggest that it is wholly appropriate that the expectations of the Principal Employer should also be considered to the extent that they are consistent with the information provided to members.

Factors to be Considered

8.8 In formulating his advice the Actuary should have regard to the following:

- (i) The provisions of the Trust Instrument.
- (ii) The circumstances of the winding-up.
- (iii) The attitude of the Trustees.
- (iv) The attitude of the Principal Employer.
- (v) The expectations of the beneficiaries.
- (vi) The minimization of anomalies.

8.9 The circumstances of the winding-up will influence the method adopted by the Actuary for the apportionment of the fund between the differing classes of beneficiaries. Where the scheme is being discontinued for the purposes of Group rationalization and the members are offered membership of another scheme within the Group it may be wholly appropriate to make a transfer based on past service reserves. Provided the two schemes concerned have equivalent benefit structures and the same level of funding determined by similar methods and on comparable actuarial assumptions this will leave the pension expectations of the active and former members unaltered. We would, however, agree with the opener of the discussion on Gilley's paper that this situation is best dealt with by a reconstruction rule leaving winding-up rules to deal specifically with situations where the main reason for the termination is the employers' reluctance or inability to maintain contributions to the scheme.

8.10 It is self-evident that the Trustees' attitude to the allocation of surplus monies is all important. Normally, the Trustees will rely heavily on the advice of the Actuary. However, where the Trustees are financially sophisticated they may have strong views on particular aspects of the winding-up exercise. To the extent that it is reasonable, the Actuary should accord with their wishes and instructions.

8.11 The Actuary will rarely be able to carry out his deliberations immune from the options of the Principal Employer, not least because some of the Trustees may be directors of the Company or management appointees. Normally the Trustees will be the client, and, to comply with the code of professional conduct, the Actuary's advice must be unaffected by interests other than those of his client. The Actuary should emphasize to management Trustees that he is advising them in their capacity as Trustees and not as representatives of the Principal Employer. Where the Trustees and the Principal Employer have conflicting attitudes they should seek separate actuarial advice.

8.12 If the Principal Employer indicates that he wishes all the assets of the scheme to be applied in favour of the members the Actuary should have little difficulty in reflecting this attitude in his recommendations to the Trustees.

8.13 The discussion on Gilley's paper revealed some divergence of opinion as to whether the Principal Employer has a legitimate interest in part of the surplus funds. We consider that in one particular circumstance he does. Gilley rightly draws attention to the situation where the assets of the scheme are more than sufficient to meet the interests of the pensioners and former members and to provide benefits at least as valuable as the past service reserves held in respect of current members.

8.14 In the majority of final-salary schemes the benefits payable to members and their contributions are defined in the Rules. The employers meet the balance of the cost of providing the benefits, as required from time to time. Thus any past service surplus could either be used to offset the cost of future service benefits so reducing the level of the employers' future contributions or to improve the benefits provided from the scheme. Alternatively a combination of the two approaches might be used. Notwithstanding the uncertainty surrounding how this surplus would have been applied had the scheme continued we would contend that the interests of the Principal Employer and the participating employers cannot be totally dismissed.

8.15 It is apparent from the above that we disagree with the closing speaker in the discussion on Gilley's paper who stated that the attitude of the Employer was irrelevant and, by implication, should be ignored.

8.16 The final aspect that the Actuary should bear in mind is the need to minimize anomalies. A particular example is the level of benefits that may be payable to a member who retires either one day before the winding-up date or one day after.

Particular Types of Augmentation

8.17 Before we discuss the general approach to augmentation it will be useful to consider the methods by which pension benefits can be increased. For this purpose we have distinguished between those augmentations that increase the liabilities broadly in proportion to the cost of the basic dissolution benefits and those that have a non-proportional effect.

8.18 The main proportional augmentations that the Trustees may consider are:

- (i) Post-retirement increases on the whole benefit.
- (ii) A percentage uplift of the basic benefits.
- (iii) An increase in the existing post-retirement widow(er) benefit or the introduction of such for all Pensionable Service.
- (iv) The adoption of a more favourable definition of Final Pensionable Salary (for example Final Salary rather than an average over three years).
- (v) The introduction of dependent children's benefits.

8.19 The main non-proportional augmentations that the Trustees may consider are:

- (i) Post-retirement increases on part of the benefit (for example that part in excess of the GMP).
- (ii) The provision of increases on the basic benefits in the period up to Normal Retirement Age.
- (iii) Improvement of the accrual rate for a particular period of Pensionable Service.
- (iv) An increase in or the introduction of a death in deferment widow(er) benefit.
- (v) Extension of the post-retirement widow(er) benefit to a particular period of Pensionable Service (for example, to pre-78 service).
- (vi) An increase of all pensions by a flat amount.
- (vii) The introduction of a repayment of the member's own contributions on death before retirement.
- (viii) The introduction of a minimum pension benefit.

8.20 In addition unless the terms offered by the Trustees for early retirement or commutation of pension are set on a 'cost-neutral' basis then this will effectively be a non-proportional augmentation. For this purpose we consider 'cost-neutral' terms to be those available in the market at the exercise date.

8.21 In discussing the proposed scheme of augmentation with the Trustees it is easier for the Actuary to estimate the cost of the proportional types of benefit improvement. It will be obvious that the insurance company will also prefer to quote for a proportional augmentation rather than the non-proportional types on grounds of simplicity and administrative convenience. This is in no manner a recommendation to ignore non-proportional augmentations. Indeed, as we will see later, one of the non-proportional improvements goes furthest to meeting the expectations of the members.

Matters of Fact and Matters of Speculation

8.22 Before we proceed to discuss the method of apportionment it is important to distinguish between those parameters entering into the calculations which are matters of fact and those which are matters of speculation.

8.23 On the dissolution of a final-salary scheme the following items will generally be known facts:

- (i) The realizable value of the assets.
- (ii) The non-profit immediate and deferred annuity rates available in the open market.
- (iii) The Pensionable Service rendered by active members to the date of determination.
- (iv) The Final Pensionable Salary of active members as at the date of determination.
- (v) The basic dissolution benefits of active members determined from (iii) and (iv) above, subject to the statutory minima.
- (vi) Benefits in payment and prospectively payable to former members and benefits contingently payable to dependants.
- (vii) The age and sex of each beneficiary.

8.24 The following items will inevitably be matters of speculation:

- (i) The future mortality, morbidity and demographic experience of the beneficiaries.
- (ii) Future price inflation.
- (iii) Future levels of general salary inflation.
- (iv) The level of discretionary pension increases both before and after retirement that might have been accorded had the scheme continued.
- (v) The salary increases an active member would have enjoyed as a result of increasing experience and promotion had the scheme continued.
- (vi) The likelihood that a member might have withdrawn from the scheme prior to attaining Normal Retirement Age if the scheme had continued.
- (vii) The Pensionable Service an active member would have rendered had the scheme continued.

8.25 The Actuary should in our opinion give greater weight to the known facts than to parameters of an indeterminate and subjective nature.

8.26 We have already mentioned that the Actuary should have regard to members' expectations when designing an augmentation package. Being based upon a mixture of known facts and speculation these expectations are necessarily subjective and ill-defined. However, it is generally accepted that the active members of a final-salary scheme would expect, in the normal course of events, to receive a benefit in respect of service already completed which is related to salary levels close to the date of retirement. We would suggest that it is appropriate for the benefits payable from the scheme on dissolution to reflect these expectations to some extent by adopting an allowance for increases in the deferred period.

The General Approach to Augmentation

8.27 In order to produce an augmentation package which reflects the members' expectations the Trustees and the Actuary will have to adopt two crucial financial assumptions which can considerably affect the results of the apportionment. These assumptions are:

- (i) The prospective rate of general salary inflation.
- (ii) The prospective rate of price inflation.

8.28 These assumptions should be made having due regard to the investment returns implicit in the non-profit annuity rates available in the market as these are a matter of fact. This may imply the use of falling rates of inflation. However, it must always be remembered that the reinvestment rates assumed by an office may be conservative as it will be aiming to write the business on profitable rates.

8.29 Based upon his own view of future inflation, and the view of the Trustees, the Actuary should consider what level of increases should be applied to the basic dissolution benefits in the period up to and after Normal Retirement Age.

8.30 It could be argued that in determining the ideal level of pre-retirement increases it would be appropriate to make an allowance for promotional increases over and above general salary inflation and for the withdrawals which would have occurred had the scheme continued. In our view these assumptions are too subjective and particular to individuals to warrant material consideration.

8.31 The level of pre-retirement increases cannot be determined without regard to the rate of increases to be applied to pensions in payment. However, it is pre-retirement increases which go furthest to realizing members' expectations because to some extent they re-establish the 'salary-related' nature of the benefits that would have been paid if the scheme had continued.

8.32 In determining the appropriate level of post-retirement increases over and above any guaranteed increases already provided, the Actuary should consider the past practice of the Trustees and the Principal Employer in granting discretionary increases. Any intentions that were expressed during the currency of the scheme (for example, attempting to match a proportion of the increase in the Retail Price Index) should also be taken into account.

8.33 After the Actuary has considered the range of pre- and post-retirement increases that he considers are just and equitable he will put forward proposals of other methods of augmenting benefits. We would emphasize that such deviations from the letter of the Trust should only be considered in view of the Company's and Trustees' intentions and the members' expectations. In our opinion these types of augmentation should be accorded a lower priority than the pre- and post-retirement increases.

8.34 Once the Actuary has decided upon the optimum range of pre- and post-retirement increases he should obtain quotations for the cost of providing various augmentations based upon permutations of these rates. He will also obtain a costing of any other forms of augmentation being considered. The costs should be calculated on non-profit annuity rates. This ensures that the financial effect of the augmentations is assessed reflecting the view of the market as to the yields available from invested assets and the future mortality experience of the beneficiaries.

8.35 We have already mentioned that the Principal Employer could be

considered to have an interest in the excess of assets over the total past service liabilities. We consider that a guideline to the proportion of the realizable assets that may be returned to the Principal Employer is $(1 - R) \times MV$ where:

- (i) R is the ratio of the present value of all benefits in respect of past service to the value placed on the assets of the scheme, both amounts being assessed on the on-going valuation basis.
- (ii) MV is the current market value of the assets.

If R is greater than unity then there may be no scope for a return of assets to the Principal Employer.

8.36 We would stress that this computation can only be taken as a rough guideline. In particular it may be inappropriate to use the valuation basis if the pace of funding has been reduced significantly prior to the dissolution because of the impending insolvency of the Principal Employer. By implication the results of this calculation establish the amount of monies that might be applied for the benefit of members.

8.37 The Actuary will make his final recommendations in view of the calculations completed and quotations received and after discussion and consultation with the Trustees on the merits of the various options. These discussions will centre on the question of the extent to which the various possible schemes of augmentation satisfy the criteria of fairness and equity.

The Chicken and the Egg

8.38 If the reader has studied the theoretical apportionment of assets described in §28 of Gilley's paper he will have noticed that the method we are recommending involves a fundamental difference of approach. Gilley's method proceeds as follows:

- (i) The Actuary determines a dissolution valuation basis which is his 'best estimate' of future events but consistent with known factors.
- (ii) Having established the interests of pensioners (and deferred pensioners) these residual assets are apportioned between active members in relation to past service reserves, but subject to (iii).
- (iii) If there is a past service surplus on the dissolution basis this is apportioned in relation to future service reserves.
- (iv) The members' asset shares are applied to purchase augmented benefits or transferred to other arrangements.

8.39 The basic rationale of Gilley's method is that there is a known amount of money to be applied for the benefit of members. Equitable shares are determined and the augmentation granted to a member depends upon what his share will purchase on the open market or in the new arrangement to which he has transferred.

8.40 The approach we have described proceeds from a known position; namely, the apportionment of the assets required to secure basic dissolution

benefits for each member and former member. This apportionment is then adjusted by designing a scheme of augmentation which keeps clearly in view the comparative treatment of individual members. The process is iterative in that the scheme of augmentation is constantly adjusted until it exhausts the monies available for augmentation. The final apportionment depends upon the interaction of the augmentation package with the cost of securing the basic dissolution benefits.

8.41 We consider that a weakness of Gilley's approach is that if the dissolution valuation basis is inconsistent with the assumptions implicit in non-profit annuity rates the asset shares attributed to members might actually purchase benefits which appear inequitable when comparisons are made between individuals. Accordingly we would maintain that although an apportionment may be unavoidable on a partial winding-up it is unnecessary on a full winding-up. If individual shares are required in order to determine transfer payments these should be based upon the cost of providing the augmented dissolution benefits in the open market.

8.42 We do not consider that there is any particular merit in apportioning any past service surplus in the manner suggested by Gilley because such an approach involves the additional speculative parameter of the amount of future service a member might have rendered had the scheme continued. In practice due to the widely differing views as to the extent of the Principal Employer's interest the apportionment of the past service surplus may well be decided on an *ad hoc* basis. For example, the Trustees may decide to apportion these monies in proportion to the employer/employee contribution rates. The additional amounts available for augmentation could be applied to increasing members' augmented benefits in a proportional manner.

Practical Considerations

8.43 In determining the level of augmented benefits we would recommend that all increases in the period up to Normal Retirement Age are applied to the accrued pension at the date of leaving before the application of any statutory minima. A member's basic dissolution benefits would only be augmented as a result of pre-retirement increases at such time as those increases were sufficient to increase the accrued pension above the statutory minima.

8.44 The method outlined in previous paragraphs assumes that all benefits are purchased on non-profit annuity rates. However, as we have mentioned in § 7, the Trustees may consider the purchase of with-profit or index-linked annuities as part of the augmentation exercise, allowing the bonuses to mitigate the effects of future inflation. The main attraction of this approach is that it removes a subjective decision from their deliberations. However, as policy proceeds will not be ascertainable at the date of purchase it will be more difficult for beneficiaries to quantify the 'generosity' of the augmentation package. Further, at least some of the purchase monies may have to be applied on non-profit rates to guarantee the basic dissolution benefits.

8.45 In determining the appropriate level of increases to be granted in the deferred period the Trustees may wish to discriminate on the basis of the date of cessation of Pensionable Service. In particular they may wish to distinguish between prior early leavers who left of their own volition and former members who were made redundant as part of an exercise just before the winding-up. If they do propose to discriminate in this way the Trustees should take legal advice.

8.46 The level of increases in deferment accorded to prior early leavers should be consistent with past policy. If there has been no history of granting such increases to do so as part of the augmentation exercise might inflate the benefits paid to this category of beneficiary above those they might have expected had the scheme continued. On the other hand, discretionary increases might have been awarded in the future. If the Trustees do decide to grant such increases as part of the augmentation package we would suggest that they are credited from the winding-up date and not the date of leaving.

8.47 Instances can occur where there are no active members at the winding-up date because the Trustees and/or the Principal Employer have deliberately postponed the determination of the scheme until all employees have been made redundant. The argument for special treatment of the members made redundant is strengthened in such cases. We consider this situation further in § 10.

8.48 One further possibility which may arise is that where special pension terms are agreed with the Trustees as part of the redundancy terms they will then be obliged to reflect these terms in the dissolution exercise.

An Hypothetical Example

8.49 To illustrate the points made in this Section we describe in the following paragraphs the winding-up of an hypothetical scheme and in particular the method of augmentation adopted by the Trustees. Full details of the hypothetical scheme may be found in Appendix E.

8.50 The scheme is contracted-out and approved by the Inland Revenue. Benefits are calculated as one-sixtieth of Final Pensionable Salary for each year of Pensionable Service. There is a 50% contingent widow's pension payable on death after retirement. On death before attaining Normal Retirement Age a widow's benefit is provided of one half of the member's pension accrued in respect of Pensionable Service completed after 5 April 1978. All benefits are subject to the relevant statutory minima. The practice of 'franking' has been applied in determining benefits.

8.51 An actuarial valuation of the scheme was completed as at 5 April 1983. In completing his calculations the Actuary adopted a valuation rate of interest of 9% per annum together with an allowance for general salary inflation of $7\frac{1}{2}\%$ per annum. An allowance was also made for age-related salary increases in respect of promotion and experience gained.

8.52 Increases on pensions in payment to the extent that they exceed the GMP have been made by the Trustees on a discretionary basis at the rate of 3% per annum compound or one half of the increase in the RPI if lower. No increases

have been granted on deferred pensions in the period up to Normal Retirement Age. An allowance was made in the valuation basis for pensions in payment to be increased at a rate of 3% per annum on that part of the pension that exceeds the GMP.

8.53 The Principal Employer went into receivership on 1 January 1984 and subsequently into liquidation. Redundancies from the Company commenced on 1 January 1983 and large scale redundancies were made throughout the ensuing period. The Trustees determined to wind-up the scheme on 1 September 1984 after all the employees had terminated their service with the Company.

8.54 Initially the Trustees and the Actuary decided to divide the beneficiaries into the following categories:

- (i) Pensioners.
- (ii) Members who left on or before 31 December 1982 (referred to as prior early leavers).
- (iii) Members who left during 1983.
- (iv) Members who left on or after 1 January 1984.
- (v) Contingent widows/widowers in respect of the above.

8.55 In view of the established practice of granting pension increases the Trustees wished to incorporate an allowance for post-retirement increases of at least 3% per annum on pensions in excess of the GMP. The Actuary agreed with this suggestion, and he also indicated to the Trustees that an allowance for increases in the period up to Normal Retirement Age may be appropriate. He demonstrated that the adoption of such increases would have a significant effect on the balance of the augmentation package.

8.56 The Trustees decided that had the scheme continued it would have been unlikely that prior early leavers would have been awarded any discretionary increases in the deferred period. Accordingly they determined not to provide any such increases as part of the augmentation exercise. However, they felt that those members who could be considered to have left the Company involuntarily should be compensated to some extent for the effects of inflation in the period up to Normal Retirement Age. In formulating their decisions the Trustees had regard to redundancy terms that had been available to the former employees of the Company. The policy of the Company had been to offer terms that were somewhat in excess of the statutory minimum although the Trustees considered that they were not sufficient to compensate fully for the loss of pension benefits. On the appointment of the receiver the redundancy terms were reduced to the statutory minimum. The Trustees, therefore, proposed to grant increases in deferment on the dissolution benefits of all members who left on or after 1 January 1983. The increases were to apply from 1 September 1984 and not the date of leaving.

8.57 The Trustees were conscious that those members who were made redundant prior to the appointment of the receiver obtained better redundancy terms. However, they felt unable to redress the balance through the augmen-

tation package except to the extent of applying increases only from the date of termination of the scheme rather than the date of leaving. The Actuary also pointed out that there would be some anomalies between voluntary leavers in late 1982 and voluntary leavers in early 1983. The Trustees argued that many of the voluntary withdrawals in 1983 resulted because redundancy was seen as the only alternative and that the anomalies should be tolerated in pursuit of a broadly equitable approach.

8.58 The Trustees and the Actuary discussed the likely level of price inflation in the longer term. They considered that it was likely to fall in the range of 4% to 6% per annum and decided to try and provide increases in the deferred period at the rate of 6% per annum subject to the sufficiency of the resources.

8.59 In addition it had been the intention of the Trustees and the Company to extend the widow's pension payable on death before retirement to include Pensionable Service completed prior to 6 April 1978. The Trustees decided to implement this improvement in respect of those members who left on or after 1 January 1983 if sufficient assets were available.

8.60 As a result of their deliberations the Trustees and the Actuary decided to cost the following augmentations:

- (i) Increases on that part of pensions in payment in excess of the GMP at the rate of 3% per annum.
- (ii) Increases on the deferred pensions from the winding-up date to Normal Retirement Age at a rate of 6% per annum for those members who left on or after 1 January 1983.
- (iii) The introduction of a widow's benefit for pre-1978 service for those members who left on or after 1 January 1983.

8.61 All costings were made on competitive non-profit annuity rates. Increases on deferred pensions were applied to the scale deferred pension and then subjected to the 'value for money' test and a minimum of the revalued GMP.

8.62 The Actuary completed an actuarial valuation of the assets and the liabilities of the scheme on a continuing basis as at the dissolution date. For the purpose of these calculations the Actuary considered those employees who were members of the Scheme as at 1 January 1983 to be active members. The valuation disclosed a past service surplus of some 11% of the value placed on the liabilities. This excess of assets over liabilities in respect of past service had arisen mainly due to the returns achieved on the invested assets being significantly greater than those anticipated.

8.63 In view of the results of the above costings and the findings of the actuarial valuation the Trustees and the Actuary considered that there were sufficient assets available to make further augmentations. It was agreed, in principle, that the best course of action was to increase the allowance made for post-retirement increases which benefited the whole membership. The Actuary suggested that a provision for increases of two-thirds of the increase in the Retail Price Index on that part of the pension in excess of the GMP would be

appropriate. He further suggested that 4% per annum compound would be consistent with the top end of his 'best estimate' of future price inflation. The Trustees accepted this recommendation.

8.64 As there still remained some assets unexpended one of the Trustees suggested that consideration might be given to increasing the benefits of prior early leavers. As one can see from Appendix E the value of past service liabilities at the date of winding-up was some 90% of the value of the assets assessed on a continuing basis. It was, therefore, proposed that prior early leavers should receive an across-the-board increase of 10% in their entitlement. It was felt that the Principal Employer had a legitimate interest in that part of the surplus funds in excess of the total past service liability and accordingly that the residual monies could be reasonably refunded.

8.65 The final recommendations of the Actuary as accepted by the Trustees and the cost of implementing these recommendations were as follows:

	(£000's)
<i>Expenses of winding-up.</i>	45
<i>Basic dissolution benefits.</i>	2,770
<i>6% per annum compound increases during the deferred period on the deferred pensions of members leaving on or after 1 January, 1983.</i>	950
<i>The introduction of pre-1978 widows' benefits.</i>	25
<i>An allowance for post-retirement increases of 4% per annum on that part of a pension in excess of the GMP.</i>	995
<i>A 10% increase in the deferred pensions of prior early leavers.</i>	35
<i>Balance of funds repaid to the Employer.</i>	370
	<hr/>
<i>Total (£000's)</i>	5,190
	<hr/>

All costs are compounded on the previous improvements. This apportionment of the assets is shown diagrammatically in Figure 1 of Appendix E.

8.66 We have tried to demonstrate the practical difficulties which the Actuary and the Trustees will encounter in designing an augmentation package and how these may be resolved. However, as Gilley observed in relation to determining a dissolution valuation basis there is "considerable . . . scope for honest difference of opinion."

9. FINALIZATION OF THE WINDING-UP PROCESS

OPB Approval

9.1 The scheme continues to have a potential liability for State scheme premiums until they are either paid or alternative arrangements for securing GMPs are implemented and approved by the OPB under Section 44 of the Social Security Pensions Act 1975.

9.2 Where GMPs are secured by the purchase of immediate and deferred

annuity policies OPB approval will not be forthcoming until they have received form OP32 from the life office concerned and have checked that the GMPs listed on that form coincide with those established by the DHSS.

Trustees' Indemnity Policies

9.3 The liability of Trustees is joint and several. If a breach of trust occurs, each Trustee is equally liable and the aggrieved beneficiary may sue any one or more of them. Whilst the Trustee who is sued has a right of contribution against his co-Trustees, he may be unable to pursue his claim for contribution if the co-Trustees have negligible assets or have disappeared. Accordingly Trustees, particularly individual Trustees, will want to protect themselves against actions arising from the manner in which they have wound up the scheme.

9.4 Particular risks faced by the Trustees in connection with the winding-up are:

- (i) That a beneficiary has been wrongly omitted from the arrangements made to secure dissolution benefits.
- (ii) That a beneficiary or a contingent beneficiary has been granted incorrect dissolution benefits.
- (iii) That the manner in which benefits have been augmented is contested.
- (iv) That the apportionment of residual assets between the Principal Employer and the participating employers is contested.

9.5 The Trustees may be able to obtain an indemnity policy to cover some or all of these risks. The premium can usually be paid from trust assets. The level of cover provided by the policy will not normally be more than the amount by which the assets of the scheme exceed the cost of securing basic dissolution benefits.

9.6 The availability and scope of such a policy will be dependent upon the standard of care exhibited by the Trustees during the winding-up process. The insurer offering the policy will be particularly interested in the extent of consultation with and dissemination of information to the members about the discontinuance. He will also wish to know what steps have been taken to ensure that all actual and potential beneficiaries have been identified and provided for.

9.7 The insurer providing the immediate and deferred annuity policies in connexion with the winding-up may offer a suitable indemnity policy particularly if it is a very large scheme which is involved.

9.8 Where no indemnity policy can be obtained the Trustees can seek an indemnity from the Principal Employer. This is likely to be of little value if the Principal Employer is in receivership, liquidation or other financial difficulties.

9.9 The Trustees might consider an indemnity policy unnecessary if they have taken the appropriate professional advice throughout the winding-up process. In the event of a successful action against the Trustees they may have recourse to their advisers who may subsequently claim from their professional indemnity policies.

Refund of Residual Assets

9.10 After securing basic and augmented dissolution benefits, obtaining OPB approval, effecting a Trustees' Indemnity Policy (if required) and meeting expenses of winding-up the Trustees will normally be required to repay the residual assets to the Principal Employer and the participating employers.

9.11 The Trust Instrument will generally direct that the monies refunded should be apportioned between the employers in a just and equitable manner based upon the advice of the Actuary. Only those employers who are still in existence at the time of the refund will be able to receive a repayment.

9.12 Where the employers concerned have participated in the scheme from its inception the share of an individual company may be determined by reference to:

- (i) The open market cost of providing the augmented dissolution benefits of current and former employees.
- (ii) The past service reserve in respect of current and former employees.
- (iii) The total service reserve in respect of current and former employees.
- (iv) Asset shares.

9.13 The first method tends to penalize an employer with a young workforce if the deferred benefits bought-out do not attract increases in deferment. If such increases are part of the benefit scale, or if they have been provided as part of the augmentation exercise, the inequity will be reduced or eliminated.

9.14 The past service reserves involved in the second method should be assessed on a set of actuarial assumptions at the date of dissolution which is consistent with the funding intentions had the scheme continued. The assumptions will include an allowance for future salary increases in respect of employees in service at the winding-up date. Anomalies may occur where the pace of funding has been changed before the winding-up because of the potential insolvency of the Principal Employer. If the deferred pensions of prior early leavers do not escalate in deferment this method will tend to penalize an employer who has implemented a redundancy programme just before the winding-up. This might be eliminated by performing the calculations at a date prior to the redundancy programme.

9.15 The total service reserves will be calculated on the same actuarial basis as that described above. Where there is an excess of assets over the past service reserves this method will tend to favour those employers with a high proportion of active members. Conversely this method penalizes an employer with a young workforce for whom the cost of accruing future service benefits is lower.

9.16 Asset shares are determined by accumulating the net cash flows generated by the employer in line with the actual investment performance of the scheme's assets between the date of inception and the date of dissolution. The net cash flows are determined from the contribution income (from employer and employees) and the benefit outgo. Benefit outgo includes pension and commutation payments, contribution refunds, transfer payments and lump sum death benefits.

9.17 The ratio of individual asset shares to the total asset shares can be applied to the total amount available for repayment. Alternatively for each individual employer the amount available for refund can be calculated as the excess of his asset share over the open market cost of securing the augmented dissolution benefits for his current and former employees. If there are participating employers who cannot receive a repayment the remaining monies can be allocated in the same proportion.

9.18 This method has the merit of allocating turnover profits to the correct sources. However, there are considerable practical difficulties of calculation if the scheme is large and/or has been operating for any length of time.

9.19 Where one or more of the participating employers adhered to the scheme after the date of inception the shares of residual assets determined by one of the above methods may need some adjustment. Particular instances warranting such adjustments are:

- (i) Where employees of the adhering company were granted pre-adherence service credits which are not fully funded at discontinuance.
- (ii) Where a bulk transfer payment received in respect of employees of the adhering company was more than sufficient to provide the benefits granted in respect of pre-adherence service and/or the transfer payment was specifically earmarked for the benefit of transferring members.

If the net cash flows in the asset share calculation includes transfer payments received these points are automatically dealt with.

9.20 Some further adjustments may be required to the actual amounts paid if repayment is made to the various companies in instalments (see § 10.22).

9.21 In practice the Actuary should consider all of these methods before deciding upon the final apportionment. However, as we have mentioned in Section 8, the Actuary should give greater weight to matters of fact than to matters of speculation and this implies the use of methods (i) and (iv).

9.22 If there is no company in existence when the residual assets are available for repayment, or if the Trust Deed and Rules provide that monies cannot be refunded in any circumstances and there is no further scope for augmentation of benefits, any amounts remaining may have to be held upon trust for the Crown as *bona vacantia*.

Documentation

9.23 To formalize the termination of the trust the Trustees should execute a short Deed. Once executed they will no longer be covered by any indemnity clauses which might have been contained in the Trust Instrument so increasing the need for separate indemnity arrangements.

9.24 The Trustees should prepare a closing set of accounts showing the final disposition of trust assets.

9.25 There may be beneficiaries, particularly prior early leavers, who cannot be traced when the trust ceases to exist. Where immediate and deferred annuities

have been purchased and individual policies are issued the Trustees may find themselves holding the documents of untraced beneficiaries. In such circumstances they should approach the life office providing the policies to hold the documents and, at State Pensionable Age, to instigate enquiries through the tracing service offered by the DHSS.

SFO Policing

9.26 Where the increases granted on basic dissolution benefits are such that Inland Revenue limits might be exceeded it will be necessary to police the policies. Such policing will normally be carried out for the SFO by the life office providing the benefits.

10. SOME PRACTICAL CONSIDERATIONS

Notification of Members

10.1 We consider that irrespective of the provisions of the Trust Instrument it is good practice to keep members as fully informed as possible both before and during the winding-up. It is particularly important to communicate with current employees of the Company concerning the discontinuance because as a rule their benefits do not have a high priority in the winding-up provisions. The position regarding refunds of members' own contributions should be made quite clear at an early stage in the winding-up process (see § 10.5).

10.2 If the recommended procedures are followed to surrender the scheme's Contracting-Out Certificate on cessation of contracted-out status there will inevitably be some notification and, perhaps, consultation with recognized trade unions. However, as the OPB will eventually exercise their powers to cancel the Certificate whether or not the employer follows the procedures some employers decline to carry out the notifications.

10.3 Regrettably the Occupational Pensions Advisory Service (OPAS) has found that many of the complaints they receive in connexion with the termination of pension schemes concern the lack of information to beneficiaries.⁽¹⁰⁾

The Timing of the Winding-up and Contribution Refunds

10.4 Depending upon the events precipitating the winding-up the Principal Employer and/or the Trustees may have some latitude in choosing a winding-up date. When the Company is implementing a redundancy programme there are advantages in selecting a winding-up date that falls after the completion of that programme. This ensures that those made redundant have the fullest possible range of options.

10.5 A refund of members' own contributions is not allowed as an alternative to Short Service Benefits on winding-up, whether in respect of qualifying service before or after 6 April 1975, unless the member's service terminated before the winding-up date. This restriction can cause difficulties where some employees are

made redundant just prior to the winding-up date and some are made redundant shortly afterwards.

10.6 In our experience when members of a pension scheme are informed of its discontinuance they are naturally concerned about the security of their entitlements. Further they often regard the availability of a refund of contributions as the most tangible evidence of that security. When such an option is offered it should be made quite clear to members that by exercising the option they are giving up their share in any monies available for the augmentation of their basic dissolution benefits.

10.7 The flexibility available in determining the winding-up date is open to abuse. If all employees have been made redundant prior to the winding-up date and the contribution refund option is widely taken up the cost of what might be regarded as a 'reasonable' scheme of augmentation can be greatly reduced. This obviously increases the scope for a return of assets to the Principal Employer and the participating employees. This will be particularly true where under the Trust Deed and Rules a member who leaves before the winding-up date and does not satisfy the qualifying conditions is entitled only to a refund of contributions (if any).

Changes in Member Status During the Winding-up

10.8 The process of collating membership data, quantifying dissolution benefits, establishing GMP liabilities, proposing approvable arrangements for securing GMP liabilities and eventually implementing those proposals can take several months (perhaps even years). Augmentation of dissolution benefits necessarily increases the time span. Throughout this period changes occur in member status through leaving, redundancy, death, incapacity and attainment of Normal Retirement Age.

10.9 Inevitably members want to know their entitlements on these changes of status. Where there is any doubt as to the solvency of the winding-up extreme caution should be exercised in dealing with such cases. It should be realized that the degree of solvency may be substantially reduced where members are permitted to exercise options which accord them more valuable benefits than those to which they were previously entitled. A common example might be a large number of requests from redundant employees for early retirement on generous terms specified in the Trust Deed and Rules. The Trustees and the Principal Employer (who may have to consent to such retirements) should consider very carefully whether to concede such requests where there is a possibility that either the winding-up could become insolvent as a result or there could be an inequitable dissolution of surplus funds.

10.10 Even where the solvency of the winding-up is beyond doubt legal advice should be sought to determine to what extent options which increase the value of a member's benefit package are exercisable once the winding-up is in progress.

10.11 We consider that where the winding-up is solvent there is no objection to allowing members to exercise options in a 'cost-neutral' manner. If the Trust

Deed and Rules provide for the Actuary to determine option terms the following may be catered for:

- (i) Early retirement.
- (ii) Deferred retirement.
- (iii) Commutation of pension for a tax-free lump sum.
- (iv) Surrender of personal pension to increase widow's/dependant's pensions.
- (v) Transfers to other approved arrangements.

The 'cost-neutral' terms will be those available in the open market at the exercise date.

10.12 The option terms should only make an allowance for any guaranteed pre- and post-retirement pension increases. Where it is subsequently decided to grant increases at some higher level or to augment the dissolution benefit the members' entitlements should be adjusted to reflect the fact that the option was exercised assuming different conditions. For example, where a member has taken a transfer payment to a new employer an additional payment should be made representing the improvement in the value of the benefits foregone.

10.13 The Trust Deed and Rules will often give the Trustees a discretionary power to permit a member to commute his entire pension entitlements (excluding the GMP) on the grounds of serious ill-health. Provided the Trustees seek the necessary legal and medical advice they may continue to exercise this discretionary power until such time as dissolution benefits have been secured.

Commutation on the Grounds of Triviality

10.14 Commutation of the whole Short Service Benefit is permitted by the Inland Revenue when a scheme is wound-up provided the aggregate amount of benefit currently or prospectively payable to the member under all schemes relating to employment with the same employer does not exceed £104 per annum. The member's consent is not required. The GMP can also be commuted where the member is over State Pension Age or where the GMP is subject to fixed or limited rate revaluation.

10.15 Similar conditions apply to benefits payable to a widow and/or dependants. Commutation may take place at the same time that the member's pension is being commuted.

10.16 The Trustees will only carry out such commutation if it is permitted under the Trust Deed and Rules. Where commutation terms are guaranteed the comments in §§ 10.9 and 10.10 are pertinent. Where commutation terms are not guaranteed we suggest that lump sums are determined as the open market cost of providing the alternative trivial benefit but perhaps excluding any *per capita* expense loadings. Commutation on grounds of triviality may then produce a financial saving as well as an administrative saving.

10.17 The commutation should not take place until augmented dissolution benefits have been determined.

Selective Augmentation

10.18 Unless there are specific provisions in the Trust Instrument the Trustees cannot discriminate between individuals within the same beneficiary class. Provisions permitting selective augmentation are unusual.

10.19 However, there will be cases where the Principal Employer wishes to protect the pensions expectations of key personnel. In practice this can usually be achieved by establishing limited pension arrangements financed by assets returned from the scheme. Selective improvement of pensions in payment can be achieved by purchasing Hancock annuities. These too can be purchased using monies repaid.

Applications to the Courts

10.20 Circumstances may occur during the winding-up where an application to the Courts is necessary. The Court may be asked to adjudicate where:

- (i) The Trustees are unclear as to the construction of the provisions of the Trust Instrument.
- (ii) The Trustees cannot agree upon a course of action and the Trust Instrument does not provide for them to reach majority decisions.
- (iii) The Trustees are unable to establish some or all of the dissolution benefits because proper records were not kept, have been lost, or are in doubt because of fraudulent practices.
- (iv) The Trustees are unable to proceed because the receiver or liquidator cannot or will not act in the capacity of Principal Employer.
- (v) The Trustees require advance approval for a proposed scheme of augmentation.

10.21 The actions taken by the Trustees will obviously be more difficult (if not impossible) to contest where an application has been made to the Court as part of the winding-up process.

Return of Assets to the Employer in Instalments

10.22 It may become apparent early on in the winding-up process that there are residual assets that will eventually be returned to the Principal Employer and the participating employers. There is usually no objection to repayments being made in instalments before the winding-up is fully completed subject to the following provisos:

- (i) The repayments should be conservatively assessed by the Actuary to ensure that sufficient monies remain in the fund to secure any basic or augmented dissolution benefits not yet secured, to pay any outstanding State scheme premiums and to meet all outstanding costs and expenses.
- (ii) The Trustees should seek legal advice before authorizing a repayment.
- (iii) The repayments should be reported to the Superannuation Funds Office.

10.23 The Actuary should bear in mind that until all GMPs have been secured

in a manner approved by the OPB he should at all times be able to confirm the adequacy of resources to meet these liabilities and any other liabilities given equal or higher priority in the winding-up rule.

10.24 Monies repaid are treated as trading receipts and as such the timing and amount of repayments will be subject to tax-planning considerations. Any Schedule D relief which the employer can claim, such as losses carried forward, can be offset against the repayments. For an ailing employer who has accumulated substantial tax losses there will often be no tax immediately due on repayments which will simply reduce the losses available to carry forward. If unused relief is seen as a loan to the Revenue the employer will wish to accelerate the repayments.

10.25 Where the employer is paying tax but the rate of corporation tax is changing, and the changes are predictable, he will wish to time repayments so that they attract the lowest possible rate of tax.

Investment Strategy

10.26 Because the winding-up will take some time to evolve there is no immediate need to liquidate the scheme's investment portfolio. Indeed where the assets of the scheme are substantial the portfolio may never be fully liquidated because the insurance company or receiving scheme assuming liability for the dissolution benefits will usually be prepared to accept investments rather than cash.

10.27 If the scheme is or may be insolvent a low risk investment strategy is required to minimize the chance of a deterioration in the level of cover for benefits in the lowest priority classes. If the scheme is clearly solvent the Trustees (or the investment managers acting on their behalf) can reasonably adopt a higher risk strategy with part of the portfolio seeking the maximum return consistent with the desired level of security. Such a policy could increase the scope for benefit augmentation and/or return of assets to the employer. It must be remembered that on the dissolution of a scheme the investment horizon changes from the long term to the short term. Typically the Trustees of a continuing scheme will be considering the investment of existing assets and contribution income over periods of 20 to 50 years. On the dissolution the relevant term may be a matter of months.

10.28 In broad terms the investment aims stated above could be achieved by constructing a portfolio (or sub-portfolio) to match the basic dissolution liabilities in the following manner:

- (i) State scheme premiums and fixed monetary amounts due to creditors matched by cash and short-term deposits.
- (ii) Expenses of winding-up matched by short-term deposits and/or short-dated index-linked gilts.
- (iii) The potential cost of immediate and deferred annuity policies to provide basic dissolution benefits matched by a range of gilts of appropriate terms.

(iv) A contingency reserve of cash, short-term deposits and short-dated gilts.

In essence this amounts to the construction of a dedicated bond portfolio.⁽¹¹⁾ Any other investments could be of the higher risk/higher return type provided they have a marketability consistent with the short-term investment horizon. The higher the degree of solvency the greater scope there might be to depart from the strictly immunized position. However, there will be costs involved in rearranging the portfolio and these may restrict the extent of any restructuring.

10.29 Because of the time taken to sell property it should be established as soon as possible whether any direct property holdings of the scheme will be acceptable to the insurance company or the receiving scheme.

11. THE EXPLOITATION OF PENSION SCHEME ASSETS

The American Scene

11.1 It is generally recognized that American management is inclined to view pension scheme assets as a tool of corporate finance to a far greater extent than their U.K. counterparts. We are not concerned here with the many reasons behind these divergent attitudes. However, it is perhaps apposite to consider some of the strategies used in the U.S. to recover money from their pension plans to finance projects other than the provision of pensions. Besides voluntary terminations the two commonest devices are termination/replacements and spinoff/terminations.

11.2 Termination/replacements involve the winding-up of the existing (usually defined benefit) scheme, the recovery of assets, and the establishment of a new scheme. The new scheme might be fundamentally different (for example, some sort of defined contribution plan) or it might provide identical but less well-funded guaranteed retirement benefits. Either way a primary motive behind the changes might be the prospect of the reversion of assets.

11.3 Spinoff/terminations involve splitting the existing scheme into two separate schemes. One scheme covers only past leavers and pensioners but holding most, if not all, of the excess assets, the other covers current employees. The existing scheme is effectively maintained for active members, albeit with a lower level of funding, but the pensioners' scheme is wound-up and the excess assets are recovered.

The Economic Background

11.4 The U.S. predilection for manipulating pension scheme assets has been exacerbated by economic factors which have also manifested themselves in the U.K. These factors are:

- (i) High investment returns relative to salary inflation.
- (ii) Depletion of workforces during the economic recession.
- (iii) High borrowing costs during periods of modest inflation.
- (iv) Stagnant corporate profitability.

11.5 The first two factors have tended to produce significant improvements in the level of funding of occupational pension schemes. This has occurred at a time when companies, hungry for cash to stimulate profit growth, are faced with historically high real rates of interest. The prospect of a cash injection from the pension scheme is inevitably enticing. Further, the possible extent of such an injection is increased by high interest rates which reduce the cost of securing annuities in the open market.

The Scene in the United Kingdom

11.6 In the U.K. the employer's access to the pension scheme assets of a continuing scheme is very limited. Where a scheme has accumulated an excessive surplus a refund may be permitted in exceptional circumstances but only after full discussion with the SFO as to how the surplus has arisen and what other remedial steps must be and might be taken. It is certainly true to say that where the scheme continues the interests of beneficiaries are well protected.

11.7 The SFO does not have jurisdiction over the decision to wind-up a pension scheme. Because it is a condition of approval that a fortuitous surplus arising on winding-up should be repaid to the employer there may be a temptation to discontinue a flourishing scheme and to replace it with an identical scheme supported by a reduced level of assets. This is clearly the termination/replacement approach. However, the Revenue has gone so far as to state that even if the new scheme conforms with previous Revenue requirements it must not be assumed that the Revenue will exercise its discretion under Section 20 of the Finance Act 1970 to grant approval. If it appears that the winding-up was undertaken primarily to enable the employer to recover pension scheme assets, the new scheme will not be approved. The Revenue is also prepared to refuse mandatory approval under Section 19 of the Finance Act 1970 to a scheme set up ostensibly to comply with the 'prescribed conditions' on the grounds that it was not set up with the 'sole purpose' of providing relevant benefits.⁽¹²⁾

11.8 At present the Inland Revenue's attitude to a return of pension scheme assets from a continuing scheme or via a termination/replacement approach is rather ambivalent and we would reiterate the many requests for a clarification of their practice.

11.9 It follows from the above that other than to take a contributions holiday in an existing scheme the best way for an employer to gain access to pension scheme assets in the U.K. is to:

- (i) Wind-up the scheme without replacement.
- (ii) Wind-up the scheme and provide continued pension provision through another scheme of the employer which is already subject to Revenue approval.
- (iii) Wind-up the scheme and provide future service benefits through Section 226 policies or through personal pension policies (after the enactment of proposed legislation).

Any of these actions might be taken by the Principal Employer, particularly during times of financial hardship. In our view it is a cause for greater concern that those actions can be taken by a predatory company which has taken over the Principal Employer.

11.10 It will make little difference to the aggrieved beneficiaries whether the predator company captures pension scheme assets as part of an asset-stripping exercise planned before the takeover or because of a fortuitous discovery during rationalization following the takeover. However, the scope for deliberate asset-stripping may be increased if the Government press ahead with their proposals for a pension scheme Register so increasing the availability of information to the potential purchaser.

11.11 The Government's proposals to introduce Personal Pensions may encourage employers to terminate their existing schemes and recover any fortuitous surplus which may emerge.

Defensive Measures

11.12 Faced with the possibility of a takeover bid the Principal Employer might consider a number of defensive measures to limit the extent to which a successful purchaser could extract pension scheme assets. Such measures might include:

- (i) Amendments to the Trust Instrument removing any powers the Principal Employer may have to appoint or dismiss Trustees.
- (ii) The appointment of a corporate Trustee or individual Trustees quite independent of the Company together with (i).
- (iii) Amendments to the winding-up rule requiring augmentation of dissolution benefits to the maximum approvable before any refund of assets can be made to the Principal Employer and the participating employees.
- (iv) Where there is no power of amendment in the Trust Instrument improvements in the scale of benefits or the provision of guaranteed pre- and post-retirement pension increases.
- (v) A reduction in the level of funding of the scheme.
- (vi) Allowing the pension scheme to invest in the ordinary shares of the Company to the extent necessary to frustrate a bid.
- (vii) Wind-up the scheme before a takeover occurs.
- (viii) Amendments to the Trust Instrument which have the effect of closing the scheme to new entrants should a takeover succeed.

11.13 It will be clear that most of these measures involve fundamental changes either in the terms on which the Principal Employer provides pension benefits or in the extent of that provision. As a result they might be considered more unacceptable than the risk of a takeover.

11.14 Self-investment may be restricted in a contracted-out scheme if the Actuary considers that it undermines his Actuarial Certificate. More importantly it may place the Trustees in an invidious position should a bid materialize. If they do not sell the shares at what is clearly an attractive price they may be failing in

their “paramount duty . . . to provide the greatest financial benefits for the present and future beneficiaries”.⁽¹³⁾

11.15 The Principal Employer may be unable to take some of these defensive measures once an offer has been announced. In a recently reported case⁽¹⁴⁾ it seems that in applying Rule 21 of the City Code on Takeovers and Mergers the Takeover Panel regard the assets of the pension scheme as assets of the Principal Employer. Whilst the Panel cannot inhibit decisions which are wholly within the powers of the Trustees, the Takeover Code may have some impact where positive action is required on the part of the Principal Employer and where such actions may indirectly affect its finances.

12. CONFLICTS OF INTEREST

12.1 In the previous section we considered how a Principal Employer (or its successor) might gain access to pension scheme assets in the U.K. This may involve the winding-up of the scheme. Once a winding-up is in progress the share of the assets available to any class of beneficiary (including the Principal Employer) will depend upon how the Trustees exercise their discretionary powers of augmentation.

12.2 Where the Trust Deed and Rules prescribe exactly the winding-up process and give the Trustees no powers to exercise their discretion in the disposition of the assets the conflicting interests of the various beneficiaries cannot influence the outcome of the dissolution (unless the Trustees act in breach of trust). However, Trust Deeds and Rules are usually drafted to be flexible and invariably include discretionary powers.

Exercising Discretionary Powers

12.3 We have already mentioned that in exercising discretionary powers the Trustees must exhibit the requisite standard of care and act in an impartial manner consistent with the provisions of the Trust Instrument. The Court will only interfere with the exercise of the Trustees’ discretion if they misconstrue the terms of their trust or base their decision on manifestly improper reasons. The Trustees need not give reasons for decisions and if they do not the scrutiny of the Court will be “confined to the question of the honesty, integrity and fairness with which the deliberation has been conducted, and will not be extended to the accuracy of the conclusion arrived at”.⁽³⁾ On the other hand if the Trustees do state their reasons for a decision, then the Court will consider whether they acted correctly.⁽¹⁵⁾ However, we fail to see how, in practice, the Court could adjudicate upon the honesty, integrity and fairness of the deliberations without having regard to the result of those deliberations and, by implication, the reasoning behind the result.

12.4 In some instances the Trust Instrument may be so worded that in the eyes of the Court the discretion is reposed in an expert, for example, the Actuary. In such cases “the burden rests on any party who criticizes the decision of the expert

to show that the expert has acted fraudulently or with some improper motive or that he has been guilty of a mistake of a substantial character or has materially misdirected himself'.⁽⁹⁾

12.5 In exercising their discretion the Trustees should only consider members' interests as present or future pensioners of the scheme and not their interests as employees. A pension scheme involves individuals having beneficial interests in property which are restricted to a certain purpose: the payment of pensions. Accordingly beneficiaries' pension rights should not be traded-off against other types of benefit, even if the Trustees genuinely believe that their general welfare is thereby increased. In practice the Trustees may have regard to the wider aspect because if the overall result is perceived to be equitable they may consider that there is little likelihood of an action.

Influencing the Exercise of Discretion

12.6 It is widely recognized that aggrieved beneficiaries face considerable financial and procedural impediments to the mounting of an effective challenge to the Trustees' exercise of discretion. Both the OPB (in their 1982 Report) and the Wilson Committee⁽¹⁶⁾ have referred to the need for an effective and inexpensive system of redress. Despite the establishment of the OPAS and the Personal Insurance Arbitration Service the obstacles are still formidable.

12.7 In view of the potential gains to be made, and the unlikelihood of action through the Courts by dissatisfied parties, it is possible that the Principal Employer and/or other beneficiaries will attempt to manipulate the Trustees' exercise of discretionary power. If the Company is the sole Trustee overt manipulation may not be needed.

12.8 Where the Trustees are individual employees of the Company they may have to face the following pressures:

- (i) Doubts about the security of their own employment and that of scheme members.
- (ii) The refusal of the Principal Employer to consent to the proposed exercise of discretionary powers where such consent is required by the Trust Instrument.
- (iii) Actual or threatened dismissal from their position as Trustees where the powers of appointment and removal are vested in the Principal Employer.
- (iv) Restricted access to legal advice.
- (v) Psychological pressure from fellow employees either exerted individually or collectively as a result of representations by staff associations and/or trade unions.
- (vi) Moral pressure to favour pensioners whose standard of living has been progressively eroded or to favour members made redundant on poor terms as against those remaining in employment.
- (vii) Self-interest, where the Trustees are themselves beneficiaries of the scheme.

- (viii) Self-interest, where the Trustees are shareholders or creditors of the Company.

The Trustees may not be conscious that some of these pressures are being exerted. Even where they are aware of them, they may not appreciate that they should not be allowed to influence the proper exercise of their discretionary powers. This will be particularly true if some or all of the Trustees are not fully conversant with the terms of their trust and the onerous nature of their fiduciary responsibilities.

12.9 An independent corporate Trustee will obviously be immune from many of these pressures. However, the Principal Employer may still have the power to remove the corporate Trustee and substitute 'user-friendly' Trustees.

Is There a Problem?

12.10 It would be ridiculous to claim that all pension scheme wind-ups involve a hard-nosed manipulating Principal Employer and a set of ineffectual Trustees either unaware of their fiduciary duties or reluctant or unable to perform them. We fully appreciate that in many cases the Principal Employer will be sensitive to his legal and moral obligations and will be concerned that the other beneficiaries of the scheme should be treated in a fair and equitable manner. Many Trustees will carry out their duties and exercise their discretionary powers with diligence and integrity and independently of external pressures.

12.11 However, we hope that we have demonstrated that as things stand at present there is scope for abuse and that in some circumstances pension scheme members can suffer an unwarranted reduction in their pension expectations when a scheme is wound-up.

12.12 There will be those who deny the existence of the problem just as there were those who denied the existence of the 'early leaver problem'. Before we discuss some possible solutions it might be as well to address some of the counter-arguments.

12.13 The first counter-argument states that there is no problem because the Trust Instrument and the Explanatory Booklet both refer to the possibility of discontinuance. In addition the Trust Instrument sets out a member's pension rights in such circumstances. Further the member should have no pension expectation over and above his defined pension rights.

12.14 In seeking to refute this line of argument we would advance the following points:

- (i) Pension rights on discontinuance are uncertain as beneficiaries cannot predict the solvency of the fund.
- (ii) Discontinuance of a pension scheme involves the involuntary cessation of pensionable service for current members.
- (iii) Expectations are determined in relation to possible future events and are revised in the light of emerging experience. However, we consider it is

unacceptable for expectations in respect of past service benefits to be reduced by the pre-meditated actions of another party.

12.15 The second counter-argument claims that the conflicts of interest faced by an individual Trustee help ensure an equitable distribution of the assets. By facing the conflicts he is likely to produce a more reasoned solution than if he had a single viewpoint. This argument has some attractions but is based upon a number of questionable premises, namely:

- (i) That a Trustee can rationalize the conflicting interests and determine which of these should not influence the proper exercise of his fiduciary duties.
- (ii) That having reached a reasoned solution a Trustee and his co-Trustees are free to implement that solution.

12.16 The third counter-argument suggests that the recent abolition of the practice known as 'franking' and the statutory requirement, introduced by the Social Security Act 1985, to inflate part of a deferred pension will automatically reduce the problem in the future. Although this is true the effects of this legislation will only be gradual and will have minimal impact upon the dissolution entitlements of members in the event of schemes being wound-up ahead of the introduction of the Government's legislation on Personal Pensions.

13. POSSIBLE SOLUTIONS

13.1 Some possible measures which might be considered to reduce the scope for abuse of the winding-up provisions of a pension scheme are as follows:

- (i) Legislation to prohibit the practice of having the Company as sole Trustee.
- (ii) Legislation to prevent the power of removal of Trustees being vested in the Principal Employer.
- (iii) Legislation to give recognized trade unions and/or staff associations the right of appointment to 50% of the Trustee posts.
- (iv) Legislation requiring the disclosure of information to members, particularly as regards the intentions of the Trustees.
- (v) Legislation to outlaw indemnity clauses in Trust Deeds and Rules.
- (vi) Legislation to prohibit any refund of assets to the Principal Employer and the participating employers until benefits have been augmented to the maximum approvable limits.
- (vii) Legislation to establish a minimum requirement for augmentation on winding-up consistent with the funding intentions of the scheme when it was a going concern.
- (viii) Legislation requiring all schemes of augmentation under the winding-up rule to be sanctioned by the Courts.

- (ix) Legislation providing for the appointment of a completely independent Liquidator Trustee to supervise the winding-up.
- (x) Legislation requiring that any discretionary powers of augmentation in the winding-up rule are reposed absolutely in the Actuary.

Measures Covering Trusteeship

13.2 We consider that the first measure is clearly desirable. The second measure is unsatisfactory in that whilst the scheme continued there may be Trustees who cease to have any connexion with the Company and are thus reluctant to fulfil their duty. If they will not voluntarily resign it is far easier to remove them than to take Court action to force them to accept their fiduciary responsibilities.

13.3 Proposals along the lines of (iii) have been suggested in the past and dropped as being too contentious. Trustees will always be susceptible to external pressures during the winding-up irrespective of their affiliations and we consider that legislation along these lines would not reduce the problem, *per se*.

13.4 The fourth proposal could be accomplished by extending the scope of the regulations to be made by the Secretary of State under the Social Security Act 1985. Such a requirement clearly addresses itself to the main problem highlighted by OPAS.

13.5 Increasing the accountability of the Trustees by ceasing to allow the Principal Employer to accord them a degree of indemnity might be expected to improve the consideration given to any exercise of discretionary power. However, there would inevitably be an increased reluctance on the part of individuals to accept a position as Trustee.

Measures Covering the Quantum of Dissolution Benefits

13.6 At one time the Inland Revenue required that no provision could be made for a return of assets to the employer and that no amendment could authorize such a payment. The new code requirement for the return of a fortuitous surplus after maximum approvable benefits had been provided on winding-up arose because the Revenue considered a safeguard against the provision of excessive benefits to be preferable to the full and final alienation of past contributions. Legislation along the lines of (vi) would seem to be consistent with the genesis of the acceptability of payments to employers.

13.7 However, we would consider such legislation as placing an unduly stringent constraint on the Trustees. Private sector schemes rarely target for maximum approvable benefits and it seems inconsistent that they should have to provide them in one eventuality.

13.8 Ideas along the lines of (vii) have been voiced elsewhere⁽¹⁷⁾ and they have some intrinsic appeal. However, there would be substantial problems of definition if an attempt were to be made to enshrine them in legislation. We doubt if such legislation could be drafted without the introduction of some statutory minimum funding requirements. There is no consensus on the desirability of such

standards. Once introduced there could be a tendency to fund for the statutory minimum.

13.9 Legislation along the lines of (viii) could have a number of undesirable effects. Augmentation might be discouraged. Winding-ups involving augmentation would take a considerably longer time to finalize and probably at a greater cost. At present the judiciary has very little accumulated expertise in adjudicating upon the equitable apportionment of pension scheme assets.

A Liquidator Trustee

13.10 A requirement to appoint an independent Liquidator Trustee on discontinuance could have several advantages including:

- (i) Ensuring that any discretionary powers under the winding-up rule are exercised in full cognisance of all material facts and in a reasoned and balanced manner.
- (ii) Ensuring that the winding-up progresses in a smooth organized manner as a result of the accumulated experience of the Liquidator Trustee.
- (iii) Ensuring that schemes are not unnecessarily terminated by the Principal Employer in anticipation of being able to manipulate the Trustees' disposition of assets under the winding-up provisions.

13.11 Guidelines would have to be drawn up setting out the necessary qualifications of a Liquidator Trustee. His duties would have to be given some legal basis or it should be apparent that he is required to act in accordance with general trust law.

13.12 The Principal Employer and/or the Trustees should have the right to appoint the Liquidator Trustee but any right of removal should only be exercisable in exceptional circumstances. The Liquidator Trustee should act in partnership with the incumbent Trustees but would have the right of veto.

13.13 The Liquidator Trustee would be required by law to effect indemnity cover to protect himself against successful actions brought by aggrieved beneficiaries.

13.14 There would be statutory disclosure requirements by which the Liquidator Trustee would have to abide during the winding-up process.

13.15 The Liquidator Trustee would be remunerated from trust assets and his fee would be a prior charge on those assets irrespective of the wording of the winding-up rule.

13.16 We consider that an Actuary would be ideally qualified to act as a Liquidator Trustee. To a large extent this would be similar in effect to the tenth proposal. However, the Actuary would be acting in conjunction with the Trustees rather than in isolation. There are obviously some similarities with an accountant acting in the capacity of receiver or liquidator of a Company.

General Measures

13.17 The applicability of general trust law to pension schemes has come under considerable scrutiny in recent times from organizations as various as the

OPB, the TUC, the Wilson Committee, the Gower Committee and the Law Reform Committee. The OPB's 1982 Report expressed the opinion that "the time has come for the Government to initiate a wide-ranging review of the relevant law, with particular regard to the desirability and feasibility of taking pension schemes out of trust law completely and putting them on a new statutory basis". The Wilson Committee envisaged a Pension Scheme Act to "formulate the duties and obligations of employing companies, scheme Trustees and their advisers". We agree that there is a need for clarification but we doubt whether such a clarification will necessarily make the task of individual Trustees any easier on scheme discontinuance.

13.18 As already mentioned both the OPB and the Wilson Committee recognize the need for more efficient methods of redress of individual members and beneficiaries. At present there are few legal precedents on pension scheme dissolutions but if a satisfactory system of redress could be introduced a body of case law might begin to emerge. Whilst this would certainly improve matters it would be a gradual process and, in our view, other shorter term measures are still needed.

Conclusion

13.19 We consider that the statutory requirement to appoint a Liquidator Trustee would significantly reduce the scope for abuse which currently exists. We do not believe that such a requirement would discourage employers from establishing pension schemes. It would certainly make them think twice before discontinuing them. We believe an Actuary is ideally qualified to act as a Liquidator Trustee.

14. NON-STANDARD CASES

Contracted-In Schemes

14.1 The winding-up of a contracted-in final-salary pension scheme will usually be appreciably less complex than the winding-up of a contracted-out scheme. As there are no GMP liabilities the OPB and the DHSS will have no involvement in the exercise. As a result, procedural details are significantly reduced.

14.2 Whereas the entire dissolution liabilities of a contracted-out scheme can only be transferred to another contracted-out scheme those of a contracted-in scheme may be transferred to either a contracted-out or a contracted-in scheme.

14.3 A corollary of the involvement of the OPB and DHSS in the winding-up of a contracted-out scheme is that the Administrator is provided with an independent check that all members who were contracted-out by reference to the scheme, and for whom the scheme retains a liability, are catered for during the winding-up process. The Administrator of a contracted-in scheme does not benefit from such confirmation.

Defined Contribution Schemes

14.4 The winding-up rule of most defined contribution schemes provides that on dissolution each member's accumulated account is applied exclusively to secure benefits for him and his dependants. To the extent that his account is more than sufficient to secure the maximum benefits approvable by the Inland Revenue then any surplus assets are available for a refund to the employer. Where a scheme is set up in this way the problems of whether to augment members' dissolution benefits and if so how to augment them do not arise. However, some unitized schemes determine the member's account by reference to the average market value of the units over a certain period of time. In these cases the employer effectively has an account in the scheme which may be either in credit or deficit. Problems may, therefore, arise on the treatment of any such surpluses or deficiencies.

14.5 If the defined contribution scheme is a small self-administered scheme for controlling directors the pensioner trustee will have to inform the Inland Revenue of the intention to wind-up the scheme. The role of the pensioner trustee is not purely nominal. He will have to exhibit, as a paid Trustee, a higher standard of care than his co-Trustees in handling the winding-up.

Insured Schemes

14.6 The principles involved in the winding-up of an insured scheme are similar to those for a self-administered scheme. However, although there may be a contract between the Trustees and the office the Actuary should consider the use of any 'open market' option and the application of available monies to secure benefits with an office with more favourable annuity rates.

15. CONCLUSIONS

15.1 The winding-up of a pension scheme will almost inevitably stimulate acrimonious debate and it is hardly surprising that both the OPB and OPAS have received representations from dissatisfied beneficiaries. We believe that at least some of this dissatisfaction arises because beneficiaries have been accorded dissolution benefit rights which fall short of their reasonable expectations. We would further maintain that in many schemes there remains the potential for abuse of the winding-up provisions and as a result cases will continue to occur where there is a perceived disparity between rights and expectations.

15.2 We appreciate the difficulty of trying to define expectation and we are conscious that there will be those who seek to play down the problems we describe on the basis that our idea of expectation is misconceived. However, it is crucially important to realize that pension schemes are established for beneficiaries and it is their expectations (misconceived or otherwise), and the extent to which these are met, that dictate the public's perception of the adequacy of these schemes.

15.3 The Profession cannot take refuge in a learned discussion on the semantic

niceties of the problem but should seek to advertise the dangers inherent in the current system. If no action is taken we run the risk of being caught in the verbal crossfire of what might conveniently be called 'the smash-and-grab debate'.

16. ACKNOWLEDGEMENTS

16.1 We should like to thank Peter Felton and David Johnson for their helpful comments on earlier drafts on this paper. We are especially grateful to Shirley Sterry for her efforts in producing a typescript which (we hope) makes sense where previously we did not. Any errors and inaccuracies which remain are entirely our responsibility.

16.2 We would emphasize that the opinions expressed in this paper are our personal views and are not necessarily those of the partnership or the individual partners with whom we are associated.

17. POSTSCRIPT

17.1 The Social Security Act 1985 has removed the 'value for money' requirement subject to the necessary amendments being made to a Scheme's Trust Deed and Rules. However, our comments in § 7.7 still apply.

17.2 In his Budget Statement on 18 March 1986 the Chancellor of the Exchequer proposed changes in the tax treatment of actuarial surpluses in occupational pension schemes approved under Finance Act 1970. Enabling powers to give effect to these proposals are contained in clause 42 and Schedule 11 to the Finance Bill 1986. One of the reasons cited by the Chancellor in announcing his proposals was the ambivalence of past Revenue practice (see § 11.8).

17.3 The proposals will also apply to monies recovered as part of a winding-up exercise. When a Scheme is wound-up after 18 March 1986 and is not replaced by another scheme any monies recovered will be subject to an 40% tax charge deducted at source. The tax is 'free standing' and is unaffected by the company's (or sole trader's or partnership's) general tax position. Therefore, some of the tax-planning considerations described in §§ 10.22 to 10.25 will no longer apply.

17.4 It seems likely that different rules will apply to refunds from discontinued schemes which are to be replaced by a new scheme.

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APPENDIX A

THE INVOLVEMENT OF THE OCCUPATIONAL PENSIONS BOARD
IN THE WINDING-UP PROCESS

A.1 The Occupational Pensions Board (OPB) has a threefold involvement when a contracted-out pension scheme ceases to be contracted-out and is wound-up. Firstly, the OPB will be involved with the formalization of the cessation of contracted-out status and the cancellation of the Contracting-Out Certificate. Secondly, pursuant to Section 49 of the Social Security Pensions Act 1975, the OPB is required to maintain financial supervision of the scheme so long as any GMP rights remain under the scheme. Thirdly, pursuant to Section 44 of the Social Security Pensions Act 1975, the OPB is empowered to approve arrangements put forward by the Trustees for securing GMPs and when such approval has been granted the OPB will inform the Department of Health and Social Security accordingly.

Surrender or Cancellation of the Contracting-Out Certificate

A.2 When a scheme is discontinued by a positive act of the employer the OPB expect the employer to submit an Election (to Surrender the Contracting-Out Certificate) having first given Notices of Intention to those employees and recognized trade unions concerned. The necessary consultations should be undertaken and a period of notice of less than three months is only possible subject to the consents of recognized trade unions and the OPB. The Election should be dated after the expiry of the notice period and should be made with effect from the end of the last day that it is desired that employments by reference to the scheme should be contracted-out.

A.3 The OPB will use their powers to cancel a Contracting-Out Certificate if it no longer serves any useful purpose in circumstances where the employer's surrender action has not or cannot be taken (for example, because of the insolvency of the employer). The OPB will cancel the Certificate from the end of the last day that members could qualify for requisite benefits by reference to the scheme. It is, therefore, necessary to establish both the fact that the scheme has been discontinued and the date of discontinuance.

A.4 It is the practitioner or life office who should inform the OPB if they are aware that a scheme is to be or has been discontinued but surrender action has not been taken.

Continued Financial Supervision

A.5 As soon as they are aware that a scheme has ceased to be contracted-out, the OPB will write to the Trustees to ask what arrangements, if any, they intend to submit for approval. The Trustees should reply within one month or the OPB will assume that the Trustees intend to pay State scheme premiums and will advise the DHSS that no arrangements have been put forward for approval. As it is most unlikely that the Trustees will be in a position to put forward proposals

within this time-scale they should reply to the OPB explaining the need for more time.

A.6 If the proposed arrangements have not been implemented within six months of the cessation of contracted-out status active supervision by the OPB will recommence. Until such time as approved arrangements have been implemented, or State scheme premiums have been paid the GMP rights will be regarded by the OPB as preserved in the scheme as an interim arrangement. For a self-administered scheme the OPB will require a renewed Certificate A or a statement from the actuary stating that in his opinion the resources are sufficient to cover in full the liabilities which must be given equal or greater priority because the legislation expressly permits their inclusion. The OPB will also require the Administrator to complete Form OP21 (INT) incorporating statements relating to audited accounts, concentration of investment and self-investment. If for any reason the form cannot be completed the OPB should be advised accordingly.

A.7 OPB Announcement No. 1 (December 1982) introduced a further time limit. For schemes winding-up after the issue of the Announcement a two year time limit is imposed from the date of cessation of contracted-out status for approval to be granted to arrangements for securing GMPs. At the end of that period an extension can only be obtained by renewal of Certificate A. The two year time limit was phased-in for winding-ups commencing prior to the issue of the Announcement.

A.8 The OPB can certify that arrangements are not subject to approval if replies are not forthcoming from the Trustees and/or the Administrator, if the requirements for interim financial supervision are not met, or if the two year time limit has expired and it is not possible to approve continued preservation of GMP rights within the scheme. Certificates of non-approval will not normally be withdrawn and they establish a liability for State scheme premiums.

Approval of Arrangements for Securing GMP Rights

A.9 On cessation of contracted-out status the scheme's GMP liabilities consist of accrued rights to GMPs held by pensioners, members who have deferred retirement, prior early leavers and current earners and contingent rights to widows' GMPs. These rights must be secured in a manner which can be approved by the OPB or State scheme premiums must be paid to extinguish the liability by reinstating members' State Earnings-Related Pension entitlements.

A.10 There is no requirement for the rights of all members to be secured by the same approved arrangements and State scheme premiums could be paid for some members but not all. It is for the Trustees to decide what arrangements (if any) are to be submitted for OPB approval in respect of each member with GMP rights. The OPB will look at the scheme as a whole and before they give approval to arrangements for securing the GMPs of one group of members (e.g. pensioners) they will need to know that the resources of the scheme will still be adequate to meet the remaining GMP liabilities.

A.11 For a scheme which is being wound-up there are two approvable

arrangements for securing GMPs: by transfer to another contracted-out scheme or by the purchase of annuities.

A.12 Provided that the documentation of the scheme provides for transfers out and that the receiving scheme has suitable transfer in provisions the OPB will normally approve arrangements for GMP rights to be transferred to another contracted-out scheme in accordance with the following conditions:

- (i) The member's consent is required except where accrued rights are to be transferred to another contracted-out scheme which relates to employment with the same employer or where accrued rights of all members of the scheme, or those of a specified group of members (of whom the member is one) are being transferred.
- (ii) A transfer without the member's consent must be conditional on the Trustees or Administrators of the transferring scheme being satisfied, before the transfer is effected, that the rights to be given in the receiving scheme are at least equal in value to the rights transferred, subject always to the guaranteed minimum.
- (iii) If the GMP rights being transferred are in respect of a member whose contracted-out employment was terminated by the scheme's ceasing to be contracted-out, those rights should normally be revalued by the method used by the transferring scheme for revaluing the GMPs of its early leavers. However, if the employer wishes to treat the member's service as not having terminated and to revalue his GMP rights in accordance with orders made under Section 21 of the Social Security Pensions Act 1975, the OPB are prepared to approve the transfer arrangement on that basis. (This could be the case where a scheme ceases to be contracted-out as the result of a takeover, merger or group re-organization and a bulk transfer is being arranged.)
- (iv) If the member is treated as not having terminated contracted-out employment (despite the cancellation or surrender of the certificate) because he is entering contracted-out employment by reference to another scheme of the same employer to which his accrued rights to GMP are being transferred, the receiving scheme must continue to revalue the GMP rights in line with Section 21 Orders.
- (v) Where it is desired to include in the transfer arrangement the GMP rights of prior early leavers or pensioners—or of the widows of former members—the OPB are prepared to use their powers under Section 44 to approve the arrangement. Where the GMP rights being transferred are those of members whose contracted-out employment terminated before the scheme ceases to be contracted-out, the revaluation method applied to the GMP at the time of termination should normally be continued by the receiving scheme.

A.13 The OPB will normally approve arrangements for the purpose of annuities in accordance with the following conditions:

- (i) GMP rights may be secured by immediate or deferred annuities bought for, or assigned or transferred to, each member or pensioner concerned. The contract may be an individual one for the beneficiary or a group annuity contract under which named persons have rights to their GMPs enforceable against the insurance company.
- (ii) The amount of each annuity must be at least equal to the amount of GMP in payment or the GMP accrued for the member concerned at the termination of his contracted-out employment and prospectively due to him at pensionable age, subject to revaluation in accordance with the rules of the scheme. Where the scheme has adopted the limited revaluation method the premiums (LRPs) due in respect of members who left service before the scheme ceased to be contracted-out will have been paid or be payable, by the employer. However, the liability for LRPs which arises on the scheme ceasing to be contracted-out falls on the Trustees and must be met out of scheme resources.
- (iii) For a widow, the amount of the annuity must be at least equal to half the GMP to which the member was entitled (or was prospectively entitled) at the time of his death. For each male member or pensioner the annuity must provide contingent widow's benefits, whether or not he is married.
- (iv) At least to the level of the GMP the annuity must be non-commutable (except on the grounds of triviality) and non-assignable.
- (v) The insurance company writing the annuity must be one to which Part II of the Insurance Companies Act 1982 applies and which is authorized by or under Section 3 or 4 of that Act to carry on ordinary long-term insurance business as defined in that Act. The insurance company will be asked to certify to the OPB (on Form OP32) that the appropriate annuities are being provided.

Payment of State Scheme Premiums

A.14 State scheme premiums become payable either at the election of the Trustees or in the circumstances described in paragraph A.8. Accrued rights premiums (ARPs) are payable in respect of employees who have not yet reached State Pension Age, pensioner's rights premiums (PRPs) are payable in respect of those who have, irrespective of whether the GMP is actually in payment or not.

A.15 If State scheme premiums are going to be paid PRPs should be paid at the earliest opportunity. This will give maximum protection to scheme pensioners by limiting the extent of any temporary diminution in their benefits whilst the revised State pension is established and becomes payable.

References

A.16 A more comprehensive summary of the legislation governing the cessation of contracted-out status can be found in the following Memoranda issued by the Joint Office of the Inland Revenue Superannuation Funds Office and the Occupational Pensions Board:

- (i) Memorandum Number 74, September 1982, and subsequent amendments.
- (ii) Memorandum Number 77, December 1982, and subsequent amendments.
- (iii) Memorandum Number 78, December 1982, and subsequent amendments.

A further useful guide is to be found in leaflet OP96 issued by the OPB to Trustees of occupational pension schemes which cease to be contracted-out.

A.17 Memoranda 74, 77 and 78 have all been amended following the issue in May 1986 of the Joint Offices Amending Memorandum No. 6. The vast majority of the amendments incorporate the provisions of the Social Security Act 1985 but do not appear in this Appendix.

APPENDIX B

OPB GUIDANCE ON BENEFITS TO BE ACCORDED PRIORITY IN THE WINDING-UP RULE OF A CONTRACTED-OUT SCHEME

B.1 Subject to the conditions contained in subsequent paragraphs the following liabilities should be treated as priority liabilities on winding-up if any employment becomes contracted-out employment by reference to the scheme:

- (i) administrative expenses;
- (ii) benefits attributable to service before this rule comes into effect;
- (iii) benefits resulting from transfer credits;
- (iv) benefits to which members who have attained normal pension age before the scheme is wound-up will become entitled on retirement;
- (v) benefits to which the (widow or) (widower or) (dependants) of any member who has attained normal pension age before the scheme is wound-up will become entitled on the death of the member;
- (vi) benefits to which any dependant of a member who died before the scheme is wound-up will become entitled on the death of (the widow or) (the widower or) (any other dependants) of the member;
- (vii) benefits to which (the widow or) (the widower or) (any dependant) of any member who has retired before normal pension age become entitled on the death of the member;
- (viii) GMPs and accrued rights to GMPs;
- (ix) any such benefits as are excluded by Section 33(5) of the Social Security Pensions Act 1975 from earners' GMPs;
- (x) pensions and other benefits in respect of which entitlement to payment has already arisen; and
- (xi) State scheme premiums.

B.2 Any or all of the items (i) to (vii) may be omitted from the priority class. Item (ix) may be omitted if there is no liability for equivalent pension benefits for

the purposes of Part II of the National Insurance Act 1965 and the previous corresponding enactments or if (ii) is included.

B.3 Any of the liabilities (i) to (xi), or such of them as are included, may take equal precedence as long as they are accorded priority over the other liabilities of the scheme. Alternatively, they may be arranged in whatever order of priority is considered appropriate and the winding-up rule should be drafted accordingly.

B.4 Items (v) to (vii) may be adjusted so as to exclude any of the benefits indicated by brackets.

B.5 Benefits secured on a money purchase basis by members' additional voluntary contributions may be given priority over all or any of items (i) to (xi) provided this is reflected in the winding-up rule.

B.6 Items (viii) to (xi), which must be included in the winding-up rule, are specifically referred to in the Actuarial Certificate which the actuary must provide on a triennial basis. The Certificate states that in the actuary's opinion and in the normal course of events, the assets of the scheme will be sufficient at all times over the next five years to meet in full the specified liabilities, administrative expenses of winding-up and any other liabilities granted higher priority than items (viii) (xi) in the winding-up rule.

APPENDIX C

SERVICES PROVIDED BY THE DEPARTMENT OF HEALTH AND SOCIAL SECURITY

C.1 The Contracted-Out Employments Group (COE Group) of the DHSS operate a comprehensive calculation service to provide the Trustees of a scheme which has ceased to be contracted-out with details of their liability for GMP rights of past leavers (including pensioners) and current earners. In addition the COE Group will establish whether there are any outstanding premiums (CEPs or LRP) in respect of prior early leavers.

C.2 On being notified by the OPB that a scheme has ceased to be contracted-out the COE Group will arrange for a search of DHSS records and will send the Scheme Administrator two schedules: the first will contain two GMP figures and corresponding State scheme premiums (ARPs and PRPs) for past leavers and pensioners and the second will be a list of current members. The Scheme Administrator should add to the list of current members' details of contracted-out rate contributions paid during the last two tax years together with particulars of any recent new entrants to the scheme who were still in contracted-out employment at the winding-up date but who were omitted from the DHSS list. On receipt of this amended list of current members the COE Group will produce the four-way calculations.

C.3 The two GMPs provided will be a GMP based on revaluation in accordance with orders made under Section 21 of the Social Security Pensions Act 1975 (or a mixture of Section 21 Orders and 5% or 8½% where appropriate for prior early leavers) and a GMP calculated by substituting 12% per annum as

the rate of revaluation in the five-year period ending with the year in which the scheme ceased to be contracted-out ('the relevant period'). Where an employee's contracted-out service terminated during the relevant period the 12% rate is substituted for any Section 21 Order or fixed or limited rate revaluation that would have otherwise applied in the relevant period. Where an employee's contracted-out service terminated prior to the relevant period and where the scheme revalues early leavers' GMPs in accordance with Section 21 Orders the 12% rate is substituted for any Section 21 Order made in the relevant period. The 12% rate of revaluation will not be substituted where the scheme revalues early leavers' GMPs either at the limited (5%) rate or the fixed ($8\frac{1}{2}$ %) rate. Two ARP or PRP figures are provided for each individual based on the two GMP amounts.

C.4 If the scheme uses the limited rate of revaluation and if the Trustees wish to consider paying LRPs and putting forward proposals for securing the residual GMPs, the Administrator should specifically request LRP calculations as the COE Group will not provide these automatically.

APPENDIX D

INFORMATION REQUIRED BY THE ACTUARY IN RELATION TO THE ASSESSMENT OF DISCONTINUANCE SOLVENCY

D.1 In order that the Actuary may prepare a report to the Trustees on the winding-up of the scheme he will require certain information on the assets and liabilities of the scheme. A summary of the details usually needed is contained in the following paragraphs. The precise requirements will obviously differ from scheme to scheme. It is of paramount importance that the Actuary ensures he has a copy of the Definitive Trust Deed and Rules and any subsequent amendments.

Liabilities

D.2 In respect of each active member of the scheme as at the date of determination:

- (i) Name or other identification.
- (ii) Date of birth.
- (iii) Sex.
- (iv) Date of commencement of Pensionable Service (including any additional service granted in respect of transfer values received).
- (v) Final Pensionable Salary.
- (vi) Accumulated member's contributions at the date of determination.
- (vii) Accrued Guaranteed Minimum Pension at the date of cessation of contracted-out employment. Alternatively, a note of the 2nd Tier National Insurance contributions paid in each tax year of contracted-out employment.
- (viii) Details of any additional paid-up pensions indicating whether these are:
 - (a) an asset of the scheme

- (b) a liability of the scheme, or
 - (c) neither an asset nor a liability of the scheme but an amount on which the Trustees will pay post-retirement pension increases.
- (ix) Details of any AVCs paid and the basis on which these are to secure additional benefits.

D.3 In respect of all members who have left the scheme since the date of the last valuation:

- (i) Name or other identification.
- (ii) Date of birth.
- (iii) Sex.
- (iv) Date of commencement of Pensionable Service (including any additional service granted in respect of transfer values received).
- (v) Date of leaving.
- (vi) Accrued GMP at the date of leaving.
- (vii) GMP at State Pension Age (if known).
- (viii) Cause of leaving, whether due to death, withdrawal, early retirement, late retirement, normal retirement, ill-health retirement.
- (ix) Final Pensionable Salary.
- (x) Accumulated member's contributions at date of leaving.
- (xi) Details of any AVCs paid.
- (xii) Withdrawal options quoted and which of the options has been selected.

D.4 In respect of each deferred pensioner who is a liability of the scheme at the date of determination:

- (i) Name or other identification.
- (ii) Date of birth.
- (iii) Sex.
- (iv) Date of withdrawal.
- (v) Amount of deferred pension payable at Normal Retirement Age.
- (vi) GMP at the date of withdrawal.
- (vii) GMP at State Pension Age (if known).
- (viii) Benefits payable on death in deferment.
- (ix) Benefits payable on death after retirement.

D.5 In respect of each current pensioner (including widow, widower and dependent child) who is a liability of the scheme:

- (i) Name or other identification.
- (ii) Date of birth.
- (iii) Sex.
- (iv) Status (widow, widower or child).
- (v) Date of commencement of pension.
- (vi) Annual amount of pension in payment.
- (vii) GMP or widow's GMP included in the amount in (vi).
- (viii) Benefits contingently payable on the death of the pensioner.

Assets

D.6 Copies of the scheme's accounts for the period from the date of the previous actuarial valuation to the date of determination. Where audited accounts are not available draft accounts will be sufficient initially.

D.7 A schedule of the scheme's investments at the date of determination showing in respect of each investment held:

- (a) The book value of the holding.
- (b) The market value of the holding.
- (c) The nominal amount of the holding (where appropriate).

Additional Information Required by An Insurer

D.8 If dissolution benefits are secured with an insurance company further data will have to be collated. In the following paragraphs we describe the typical requirements.

D.9 In respect of pensioners and (where appropriate) their spouse:

- (i) Full names.
- (ii) Home address.
- (iii) National Insurance Number.
- (iv) Confirmation from the Trustees that birth and marriage certificates have been inspected.
- (v) Payment details for the pension (bank account number, sorting code, etc.).
- (vi) DHSS confirmation of GMP liability.

D.10 In respect of each future pensioner:

- (i) Full names.
- (ii) Home address.
- (iii) National Insurance Number.
- (iv) Confirmation from the Trustees that birth certificates and (for female members) marriage certificates have been inspected.
- (v) DHSS confirmation of GMP liability.
- (vi) Maximum tax free cash sum that can be taken at Normal Retirement Age.

D.11 The insurance company will also wish to have a copy of the full up-to-date documentation of the scheme to satisfy themselves as to the definitions of 'Widow', 'Child', etc.

APPENDIX E

AN HYPOTHETICAL EXAMPLE

E.1 In this Appendix we describe the benefits and financial standing of an hypothetical scheme which has been used for illustration purposes in Section 8 of the paper. The scheme is contracted-out of the additional component of the State

scheme and is approved by the Revenue under Chapter II of the Finance Act 1970 as amended.

The benefits structure of the Scheme is as follows:

- (i) Normal Retirement Age is 65 for males and 60 for females.
- (ii) Final Pensionable Salary is defined as the member's basic earnings in the tax year prior to retirement or earlier withdrawal less the Lower Earnings Limit.
- (iii) A pension is payable from Normal Retirement Age of one-sixtieth of Final Pensionable Salary for each year of Pensionable Service completed.
- (iv) On the permanent incapacity of a member an ill-health pension is payable calculated as in (iii) above but based on the Pensionable Service that could have been completed to Normal Retirement Age.
- (v) On the death of a pensioner a widow's pension is payable of one-half of the pension in payment adjusted for any commutation of pension on retirement.
- (vi) On the death of a member whilst in the service of the Company a widow's pension is payable calculated as one-half of the member's pension based on the Pensionable Service that could have been completed to Normal Retirement Age but after 5 April 1978.
- (vii) On death before Normal Retirement Age whilst in the service of the Company a lump sum of two times salary, together with the amount of the member's contributions, is payable at the discretion of the Trustees.
- (viii) Early and late retirements are permitted at the discretion of the Trustees and on terms advised by the Actuary.
- (ix) A part of a member's pension may be commuted on retirement for a lump sum on terms advised by the Actuary subject to Inland Revenue limits.
- (x) On the withdrawal of a member who has completed more than 5 years' service a deferred pension becomes payable from Normal Retirement Age. The current and past practice of the Trustees has been to revalue the GMP at the limited rate and to pay an LRP. On death before attaining Normal Retirement Age a widow's benefit is payable of one-half of the member's pension accrued in respect of Pensionable Service completed after 5 April 1978.
- (xi) On the withdrawal of a member who has completed less than 5 years' qualifying service a refund of the member's contributions less deductions for the Certified Amount and tax is made.
- (xii) The practice of 'franking' is applied in determining benefits.

E.2 The actuarial valuation of the Scheme as at 5 April 1983 was completed on the following financial and demographic assumptions:

- (i) A valuation rate of interest of 9% per annum.
- (ii) An allowance for earnings inflation of $7\frac{1}{2}$ % per annum.

- (iii) An allowance for increases in the Lower Earnings Limit at the rate of $7\frac{1}{2}\%$ per annum.
- (iv) An age-related allowance for salary increases in respect of promotion and experience gained.
- (v) A specific allowance for future increases to pensions in the course of payment on that part of the pension that exceeds the GMP at a rate of 3% per annum.
- (vi) Assumptions regarding future in-service mortality of members, their widows, rates of future withdrawal from service, rates of future ill-health retirement, proportions married and the age of members' widows based on the experience of similarly constituted pension schemes.
- (vii) The PA(90) table unadjusted for post-retirement mortality.
- (viii) The benefit valued on withdrawal was a return of the member's contributions plus the employer's share of the CEP.
- (ix) The assets of the scheme were valued by discounting at the valuation rate of interest the notional income which would have been obtained had the investments been realized at the valuation date and reinvested in the shares underlying the Financial Times Actuaries All-Share Index. The notional income was assumed to increase at the rate of 4% per annum.

The aggregate method of funding was adopted with no allowance for future new entrants.

E.3 All the members of the scheme were male. At the date of the dissolution, 1 September 1984, there were the following members and former members of the scheme:

PENSIONERS

<i>No.</i>	<i>Pensions in payment (£ p.a.)</i>	<i>Contingent widows' pensions (£ p.a.)</i>
120	133,770	76,950

DEFERRED PENSIONERS (PRE-83 LEAVERS)

<i>No.</i>	<i>Deferred pensions (£ p.a.)</i>	<i>Contingent widows' pensions payable on death in deferment (£ p.a.)</i>
130	130,280	34,000

Members who left after 1.1.83

<i>No.</i>	<i>Scale deferred pensions (£ p.a.)</i>	<i>Basic dissolution deferred annuity (£ p.a.)</i>	<i>Contingent widows' pensions payable on death in deferment (£ p.a.)</i>
410	396,000	425,000	55,000

E.4 The market value of the investments at the date of termination amounted to £5,190,000. The discounted income value of these investments adopting the actuarial assumptions described above at the date of termination was £5,105,000 being some £85,000 less than the market value.

E.5 The results of the calculations are summarized in the form of the actuarial balance sheets below:

	<i>On-going valuation basis (£ 000's)</i>	<i>Basic dissolution benefits (£ 000's)</i>	<i>Final augmented benefits (£ 000's)</i>
<i>Expenses of winding-up</i>	—	45	45
<i>Capitalized value of pensions in payment and contingent wi- dows' pensions</i>	1,415	1,000	1,300
<i>Capitalized value of de- ferred pensions and contingent widows' pensions payable in respect of leavers prior to 1.1.83</i>	370	285	375
<i>Capitalized value of de- ferred pensions and contingent widows' pensions payable in respect of leavers after 31.12.82</i>	2,810	1,485	3,100
<i>Total liabilities (£ 000's)</i>	4,595	2,815	4,820
<i>Less: Fund taken at</i>	5,105	5,190	5,190
<i>Excess of assets over liabilities</i>	510	2,375	370

E.6 Figure 1 illustrates the eventual apportionment of the assets. Figure 2 demonstrates how the value of the basic dissolution benefits of members who left after 1 January 1983 is increased by the provision of pre- and post-retirement increases.

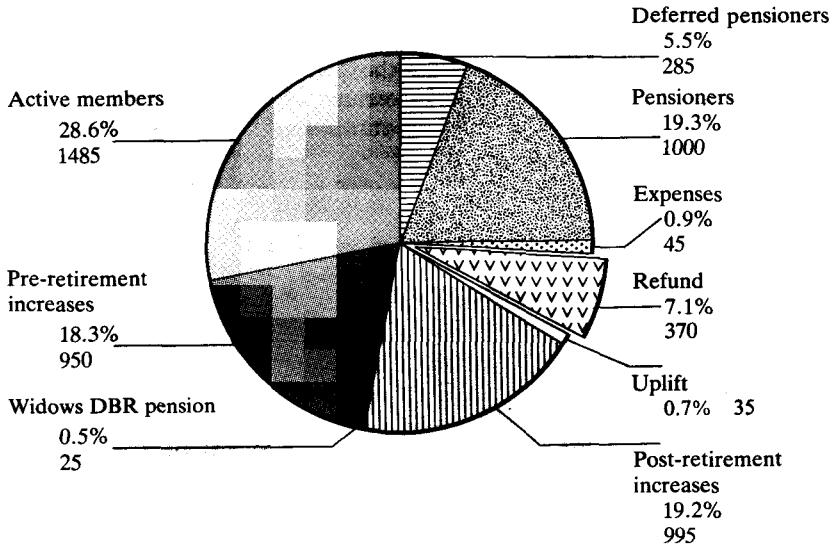


Figure 1. Hypothetical example. Apportionment of fund.

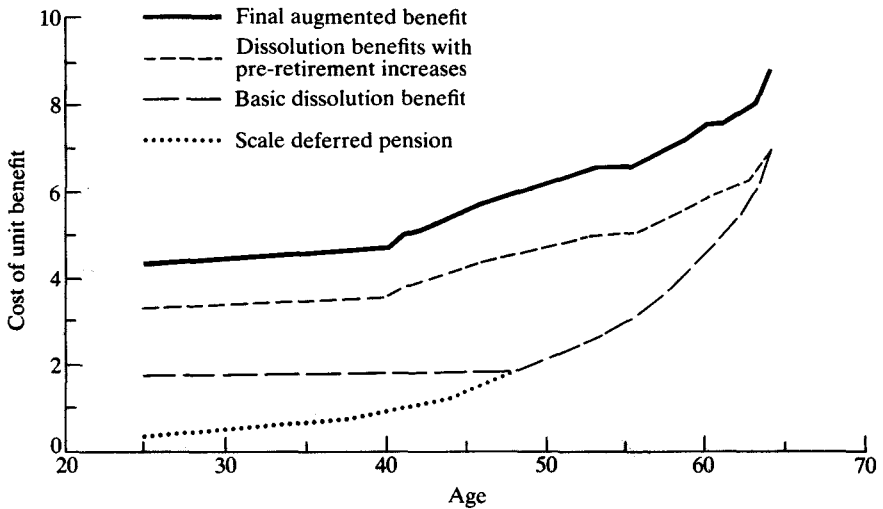


Figure 2. Hypothetical example. Augmentation of benefits of active member.