

# corporate briefing



## Pensions Regulator's anti-avoidance powers extended

### Summary

The Government has proposed that the Pensions Regulator should be able to issue Contribution Notices where the effect of an action is materially detrimental to a pension scheme's ability to pay benefits, without having to demonstrate that this was intended.

The Government says this power would be targeted at controversial new business models but recognises that a wider range of transactions could fall within its scope.

### What powers does the regulator have now?

The Pensions Act 2004 empowers the Pensions Regulator to issue Contribution Notices and Financial Support Directions (FSDs) to prevent companies avoiding their pension debts. To date, it has issued two FSDs but no Contribution Notices. Companies or individuals can ask the regulator to issue a **clearance statement** confirming that it will not use these anti-avoidance powers in relation to a specific transaction unless it turns out that the applicant did not describe the transaction correctly. In 2007/08, the regulator received around 150 clearance applications.

### Figure 1 | The regulator's weapons

**Contribution Notices** require an employer, or an associated 'person', to make a payment into a pension scheme. This person can be either a company or an individual such as a company director. The maximum required payment is the full Section 75 deficit (the difference between a scheme's assets and the sum needed to secure its liabilities with an insurance company).

Currently, Contribution Notices can be issued where the regulator believes 'the main purpose or one of the main purposes' of an act (or failure to act) was to prevent the recovery of all or part of an employer's pension debt or to prevent that debt becoming due. The regulator can issue Contribution Notices up to six years after the event.

**FSDs** can be issued where an employer is a service company or where its resources are less than 50 per cent of the estimated Section 75 debt. The recipient of an FSD must put financial support for the scheme in place – for instance, by providing financial resources or ensuring that a wider group of companies stands behind the liabilities.

### How will these be strengthened?

The Department for Work and Pensions (DWP) proposed extending the regulator's powers in a consultation document published on 25 April 2008. If its proposals become law, the regulator's powers will be strengthened as follows.

#### Look at more than one event

The 2004 Act says Contribution Notices can be triggered by 'an act or a deliberate failure to act'. The Government says this phrase should be read to include a series of acts or omissions. The regulator will therefore be able to issue Contribution Notices in relation to a 'course of conduct' in which individual acts were 'connected in a relevant way and occurred within a reasonable timescale'.



### New Contribution Notice test – focus on the effect, not the intention

Existing legislation allows Contribution Notices to be issued where the regulator is of the opinion that the purpose of an act is to prevent a pension debt becoming due or to impede its recovery. The DWP says this could make it difficult for the regulator to intervene where the consequences for a pension scheme have simply not been considered.

Under a new alternative test, the regulator will be able to issue Contribution Notices where the effect of a course of conduct is materially detrimental to the scheme’s ability to pay members’ benefits. One possibility suggested by the DWP is that this could take the form of a ‘before and after’ test. Parties would look at how the likelihood of benefits being paid has changed, taking account of the scheme’s assets, liabilities and investment strategy, the employer’s resources, and the strength of the employer’s legal obligations to the scheme.

#### Removal of ‘good faith’ defence

Where the purpose of an act is to prevent all or part of a debt becoming due, existing legislation says a Contribution Notice should not be issued if the person acted in good faith. This provision would be removed.

#### New statutory defence

The Government suggests that, where a person can demonstrate that they could not reasonably have foreseen that their actions could be materially detrimental to the security of members’ benefits, a Contribution Notice could not be issued.

The burden of proof would be on the party concerned, raising the question of how someone can demonstrate what they could **not** reasonably have foreseen. The DWP says people should be able to show that they identified the relevant issues during due diligence and made appropriate provision. It does not favour the idea of making the regulator demonstrate what **should** have been foreseen.

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Figure 2 | How Contribution Notices can be triggered

	Old rules	New rules
<b>Subject of the test</b>	An act or failure to act	An act or failure to act, or a course of conduct
<b>Content of the test</b>	<p>A main purpose is</p> <ul style="list-style-type: none"> <li>to prevent the recovery of all or part of a Section 75 debt</li> <li><b>otherwise than in good faith</b>, to prevent all or part of a debt becoming due.</li> </ul>	<p><b>Test 1:</b> A main purpose is</p> <ul style="list-style-type: none"> <li>to prevent the recovery of all or part of a Section 75 debt</li> <li><b>except where this effect could not reasonably have been foreseen</b>, to prevent all or part of a debt becoming due</li> </ul> <p>OR</p> <p><b>Test 2:</b> The effect is materially detrimental to a scheme’s ability to pay benefits, except where this could not reasonably have been foreseen.</p>

#### Bulk transfers

Where the regulator would have issued a Contribution Notice before a bulk transfer which severs the link between the employer and the scheme the members are in, it will be able to do so afterwards. It will also be able to issue Contribution Notices where a bulk transfer is itself detrimental to the likelihood of members’ benefits being paid.

#### Test for issuing Financial Support Directions

Under existing legislation, the regulator can issue an FSD to a combination of entities in relation to a single scheme. First, however, it must identify a single entity whose resources are at least equal to the difference between the employer’s resources and 50 per cent of the Section 75 debt. A new alternative test will allow an FSD to be triggered

where a group of associated entities has sufficient resources between them. This is designed to ensure that the regulator cannot be thwarted by the transfer of resources within a group.

Fears have been raised that this proposal could see private equity portfolio companies having to support each other’s pension liabilities. The DWP says it is only changing the test for imposing an FSD, not the range of entities to whom the FSD could eventually extend. The chairman of the Pensions Regulator has previously said that an FSD is unlikely to be imposed on an otherwise unrelated company if it simply has the same investors as the employer and does not derive any benefit from the association. Existing legislation requires the regulator to consider the relationship that an entity has with the employer before imposing an FSD and there is no proposal that this will change.

## How and when will these powers be introduced?

The consultation period runs until 20 June, and the DWP has appealed for feedback that can help it 'get the details right'. The Government intends to take powers allowing it to implement these proposals through regulations. It has an opportunity to do this by amending the Pensions Bill currently before Parliament.

To prevent deals being rushed through before the rules change, these new powers would be backdated to 14 April 2008. To provide reassurance for those engaged in transactions before the legislation is enacted later this year, the regulator has said it will only deploy the new tests for issuing Contribution Notices and FSDs in relation to these events if they have at least one of the features listed in Figure 3.

The possibility of basing a Contribution Notice on a course of conduct rather than a single act would be backdated further, to 27 April 2004. Where clearance has already been granted for a particular transaction, this transaction could not form part of a course of conduct unless the facts were not as reported.

## The scope of these powers

The consultation paper says the 'particular focus' of these new powers will be new business models which sever the link between the employer and the pension scheme in order to run schemes for profit without providing the capital reserves that an insurance company would have to put in place. Pensions Minister Mike O'Brien has warned of 'a perverse situation that enables profits to be privatised but losses to fall on members or the PPF'.

Although this may be the Government's principal concern, the DWP 'recognises that a wide range of transactions could potentially fall within the scope of the new test it proposes as a basis for issuing Contribution Notices'. This is illustrated by the regulator's guidance on clearance applications, which gives examples of transactions for which the regulator would expect clearance statements to be sought if they materially weaken the employer covenant and if there is a 'relevant' deficit. The list, which the regulator has indicated will still apply once it has these new powers, includes:

- return of capital, for example, through a dividend payment, share buyback or de-merger
- granting or extending a fixed or floating charge over the employer's assets
- sale and leaseback transactions
- business and asset sales
- granting or extending inter-company loans.

The Government does not expect the new powers to provoke a significant increase in clearance applications, and the Minister has insisted that 'the overwhelming majority of pension schemes and corporate transactions will be unaffected'.

There is therefore a wide gap between the potential scope of these powers and the way in which the authorities are suggesting they will be used. To help bridge this gap, the Government proposes to add the reasonableness of the person's actions and the value of benefits they received from the employer or scheme to the list of factors which the regulator must take into account when deciding if it is 'reasonable' to issue a Contribution Notice. Other safeguards are provided by the regulator's Determinations Panel and the Pensions Regulator Tribunal.

The DWP will also consider issuing guidance on what could be covered by the new powers. It suggests publishing a 'non-exhaustive list' of transactions which can pose risks to scheme members. This could be based on the features of transactions taking place before the legislation is enacted which will attract the regulator's attention, as set out in Figure 3.

## Figure 3 | Features of transactions which might prompt the regulator's attention

- moving the employer or pension scheme to another jurisdiction
- splitting the operating company from the pension scheme without appropriate mitigation
- splitting the assets from the operating company without appropriate mitigation
- transferring scheme assets and liabilities to another scheme that lacks adequate support
- running a scheme for profit without adequate account being taken of member interests
- business models in which risk is predominantly borne by scheme members, but high investment returns would benefit investors.



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However, such guidance 'would not preclude the regulator acting with regards to other transactions which take place on or after...the date that the final legislation comes into force'

#### **Watson Wyatt comment**

The Government does not want every dividend payment to be rubber-stamped, but proposes to address specific concerns by giving the regulator quite open-ended powers. Some PPF leypayers might welcome this approach for fear that narrower powers could be circumvented, leaving them to pick up the bill. Companies should think about how the regulator might use these new powers when planning corporate transactions and considering applying for clearance or negotiating mitigation with trustees. Trustees should be aware that the regulator expects them to be consulted in advance of any clearance application.

The DWP says 'stakeholders have recognised that the regulator has exercised its powers in a risk-based way since its inception, only using its powers as a last resort'. However, it also thinks that some of the existing powers could be circumvented because of difficulties in proving what was intended.

Accordingly, the regulator's conduct during a period when it had more limited powers might not be a completely reliable guide to how it will act once these powers have been extended. Also, Contribution Notices can be issued up to six years after the event in question, and the way the regulator uses its powers could change significantly during this time. Those who could find themselves liable for a pension shortfall, and who could no longer base a defence on the innocence of their intentions, may choose to consider how the regulator could conceivably behave in future as well as how it behaves now.

#### **Further information**

For further information, or if you would like to provide feedback on these proposals to inform Watson Wyatt's consultation response, please contact:

**James Riley**  
+44 (0) 20 7227 2369  
[james.riley@watsonwyatt.com](mailto:james.riley@watsonwyatt.com)

**Steven Dicker**  
+44 (0) 7808 176397  
[steven.dicker@watsonwyatt.com](mailto:steven.dicker@watsonwyatt.com)

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