

Corporate Pensions Bulletin

Returns of Capital

April 2006

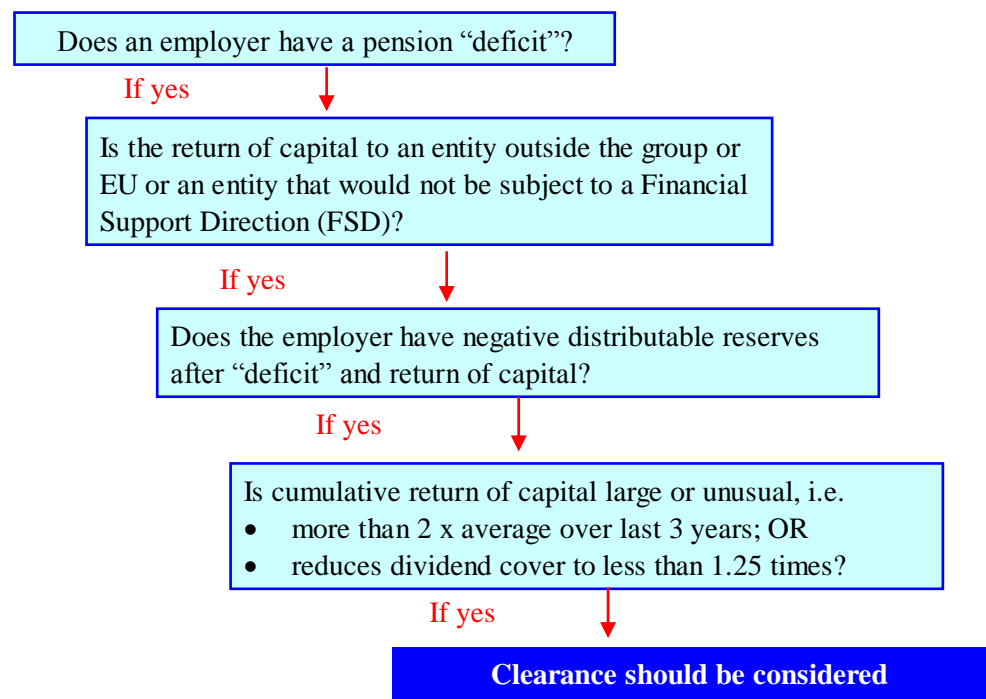
An important area where the new UK regulatory regime for pensions impacts everyday corporate activity is returns of capital out of a business. Circumstances vary, but companies with large pensions deficits planning to make large or unusual payments to shareholders or overseas parents (particularly if outside the EU) are likely to be most affected.

Companies with a UK defined benefit scheme paying out capital to stakeholders that rank below unsecured creditors in the event of insolvency (e.g. dividend payments and share buybacks) are reducing the assets potentially available to fund a pension deficit. In the normal course of events, this is unlikely to be a problem, but where the payments are unusually large and the scheme is not so well funded, it may give the scheme trustees and the new Pensions Regulator cause for concern.

In certain circumstances, the Pensions Regulator can direct the parties involved (potentially including those based outside of the UK) to provide additional cash and/or financial support to the scheme up to the full annuity buy-out cost of the liabilities. In any event, pension scheme trustees are now expected to have greater interest in current and future plans for returning cash to shareholders as part of their ongoing monitoring of the employer's covenant to the scheme.

Applying for clearance

Advance clearance can be obtained from the Pensions Regulator to provide companies with certainty that intended actions (such as a share buy-back programme) will not subsequently be viewed by the Regulator as being a deliberate attempt to avoid pension liabilities. The Regulator's guidance sets out in what circumstances, advance clearance might be appropriate:



What happens in practice?

The Regulator has been receiving around 15 to 30 formal clearance applications per month since it began operating – although not all in respect of capital returns. It seems to be taking a case by case approach, and generally appears to be more amenable to the repayment of capital to parent companies than to external shareholders (as one might expect).

Obtaining clearance will largely depend on the impact of the proposed transaction on the company's covenant to the pension scheme and how well funded it is. The Regulator will look for evidence of mitigation of the risks to the scheme. Although clearance has only been refused in two cases to date, there are many situations where the company has been required to accelerate deficit funding or provide other forms of additional security, such as parent company guarantees or a charge over company assets. A typical requirement has been to look for most or the entire current FRS17/IAS19 deficit to be met within 5 years.

A balance of risks?

There is little doubt that obtaining clearance often comes at a price – normally in the form of additional funding requirements. In our experience, when considering whether to apply for clearance, companies are now weighing up this “price of clearance” against the commercial risk of the Regulator subsequently taking action.

To date the Regulator has not exercised any of its moral hazard powers and it is not fully clear what *in the Regulator's opinion* would constitute an action with the main purpose of avoiding pension liabilities. The risk of the Regulator taking action can therefore be very hard to assess. One way is to have an initial discussion with the Regulator on a “no names” basis to explore the issues. We have undertaken this on behalf of many clients.

Trustees and funding

Even where there is no specific event or a clearance application is not deemed necessary, scheme trustees will be expected to scrutinise more closely the company's plans for future returns of capital as part of the first valuation under the new scheme specific framework and as part of their ongoing monitoring duties.

Conclusion

These changes to the UK regulatory regime have come at a time when levels of UK corporate profitability are up and levels of business investment are low. As a result there may be more announcements of share buybacks and extra-ordinary dividends over the coming months. In addition, overseas tax legislation can give incentives for UK subsidiaries to repatriate monies overseas, leaving the residual UK business with a smaller asset base. The Jobs Creation Act in the US last year was a prime example of this.

Boards, FDs and Treasurers need to plan for and consider the potential intervention of the Pensions Regulator and scheme trustees in this type of corporate activity. Please contact Steven Dicker on 0161 839 1600 or Andrew Reid on 020 7222 8033 if you would like to discuss any aspect of this in more detail.

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