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Protecting defined benefit pension schemes – a stronger Pensions Regulator

This document sets out the response by the Pension Schemes Committee of the Association of Consulting Actuaries to the consultation of the above name issued by the Department for Work and Pensions on 26 June 2018.

Submission was made electronically via the DWP's website on 21 August 2018.

Notifiable Events Framework

1. We have set out a number of proposed changes to the existing Notifiable Events Framework.

a. Do these proposals strike the right balance between improved regulations on business and protecting pensions?

b. Alternatively, are there any other significant business events which you think should be captured?

We have a concern that the proposed changes might result in a significant increase in the number of events notified to the Pensions Regulator that will in turn lead to a need to ensure it is adequately resourced in terms of numbers of people and capability to respond swiftly and appropriately where necessary.

It will also be essential for the Notifiable Events Framework to be clearly defined, particularly given the significant penalties suggested for failing to comply. For example, what is a "material proportion" of the business?

It is not clear how the "funding responsibility for at least 20% of the scheme's liabilities" condition will be defined. The most obvious way is by reference to each employer's prospective share of section 75 debt liabilities, but this will often have limited correlation with each employer's ability to pay ongoing funding contributions and who pays the funding contribution in practice. Therefore, although such a filter might be reasonable in principle, it would need to be very carefully defined to reflect who pays the contributions in practice (or might be called upon to pay such contributions in future). In practice, there will be cases where the majority of funding contributions are paid by an employer that has only limited exposure to section 75 liabilities.

This '20% of funding responsibilities' filter also seems to be applied inconsistently. If employers with a limited share of funding responsibilities are to be excluded from a requirement to notify the Pensions Regulator of a sale of a material part of the business, we believe a similar exclusion should apply to the other proposed new notifiable events – if anything, a sale is likely to be a relatively significant event. It seems counter-intuitive, for example, for an employer below the 20% threshold not to have to notify the Pensions Regulator of a sale but to have to notify the Regulator of changes to their board of directors.

There are areas in which the proposed events would need careful consideration, to avoid creating a burden on business. For example, in the context of granting security on a debt, relatively routine events such as rolling over existing debts or securitising invoices should not presumably trigger a notifiable event. The Framework should make this clear.

It may be helpful for some of the details to be provided in the Regulator's 'directions' rather than in legislation, as this will give further flexibility to make amendments. However, it will be important for the Regulator to consult fully on the proposed details of these directions and for the legislation to set appropriate boundaries for the Regulator.

There appears to be a potential overlap between the proposed "significant restructuring" notifiable event and the current 'relinquishing control' event in some circumstances. It might be worth seeing whether the two notifiable events could be combined.

In terms of further significant events that might be considered, large dividends or other distributions to shareholders which are not funded out of trading profits (eg through borrowings) would seem to be worth some further thought. Similarly, although the proposed Framework focuses on the sale of a business, it may be what is done with the cash following a sale that is of more relevance to the security of the pension scheme.

Assuming no retrospection is envisaged for the new powers, it would be helpful if the Government sets out when each of these new powers will come into effect. Without this there would be legitimate concern in relation to corporate planning and for trustees who might need to be prepared.

2. Have we captured the right criteria for a significant change in the make-up of a board of directors?

We note that the Notifiable Events Framework originally included a very similar requirement relating to changes in 'key employer posts' but that this was removed in 2009 under the Pensions Regulator (Miscellaneous Amendment) Regulations 2009. We suggest you review the reasoning behind removing this requirement as this may well still be relevant.

3. We are proposing to bring forward or specify more clearly the timing of reporting notification of certain events (as described above), for instance to the point at

which Heads of Terms are agreed for some transactions. Is this appropriate or is there a better time/ event to pin the reporting notification to?

This is another area in which a clear definition will be essential, to avoid creating potential loopholes which might delay the requirement to notify. It is not clear to us that the 'Heads of Terms' are sufficiently well defined to be used as a trigger for notification requirements.

We are also not sure whether the accelerated reporting could conflict with the requirements of the EU Market Abuse Regulation which listed companies need to comply with.

4. What is the likely impact (either direct or indirect) on business of sponsoring employers being required to report earlier? How could the framework be modified to ensure that any adverse impact is mitigated?

The ultimate impact of more onerous reporting requirements will be to make it more expensive for businesses to transact.

5. Are there any additional changes that could further improve the design of the framework for sponsoring employers, trustees and the Regulator?

We suggest an additional filter based on the level of funding of the scheme should be applied to some of the new notifiable events – perhaps under the Pensions Regulator's 'directions'. We note that there is an existing filter based on a scheme being fully funded at its most recent section 179 valuation for PPF levy purposes. Although this does not reflect the scheme's technical provisions it is a reasonable proxy in many cases and avoids potential problems associated with linking the filter more directly to technical provisions.

One circumstance in which this PPF-based funding filter would not seem appropriate is where the employer covenant is very weak (or will be very weak as a result of the notifiable event) and technical provisions would be expected to be set on a particularly prudent basis (e.g. close to buy-out). One option to address this might be to dis-apply the level of funding filter to the most significant notifiable events, which could result in a significant deterioration in covenant – such as the sale of a business.

A number of difficulties have arisen in applying the current Notifiable Events Framework, including interpreting whether an event is notifiable and understanding the logic for the notification. In our response to your 2015 consultation entitled "Better Workplace Pensions: Reducing regulatory burdens, minor regulation changes, and response to consultation on the investment regulations" we gave the following examples:

- Large transfers – The legislation is not clear whether the requirement relates only to the transfer of an individual member or whether it also extends to bulk transfers. We also suggest that the current reporting threshold of the lower of 5% of the scheme assets and £1.5m is too low in the current climate;

- Granting large benefits – How the "cost" is determined for the purpose of ascertaining whether the threshold for reporting has been reached is not clear. Is it the cost within the scheme of providing the benefits, a cost on a section 143 valuation basis or the cost on a

buyout basis? Also, however the cost is measured, the current reporting threshold of the lower of 5% of the scheme assets and £1.5m is arguably too low in the current climate. It is also debatable whether or not large scheme benefits simply falling due for payment (without requiring any type of "decision" by trustees) under the scheme rules are notifiable because the wording of this notifiable event is ambiguous;

- Decision not to achieve full debt recovery – Given the plethora of mechanisms that have been available since 6 April 2008 to meet a section 75 debt in addition to the liability share, it is not clear whether invoking any of these alternatives is regarded by the Pensions Regulator as not achieving a full debt recovery and so is potentially a trustee notifiable event as well as being an employer notifiable event.

We ask that these issues are addressed as part of the current proposals to modify the Notifiable Events Framework. It would be helpful to know, for example, if the Regulator has in practice found these notifiable events, for example the granting of 'large' benefits, a useful marker in identifying risk; if not, could some of them be dropped?

Declaration of intent

6. We have set out a number of proposed transactions which would trigger a Declaration of Intent.

a. Do these proposals strike the right balance between improved regulations on business and protecting pensions?

b. Alternatively, are there any other significant business transactions which you think should be captured?

This is another area in which clarity will be key. Although we have tried to answer the questions, not enough information has been provided to give a fully considered response. In particular, depending on how they use the declaration, the effect could be that trustees have new powers to influence the success of a sale or purchase, which could affect various other stakeholders' prospects in ways that haven't been, but need to be, considered before such a change is implemented.

The proposals take it as read that the trustees should always be consulted, although agreement is not required. An alternative approach might be to allow the employer to assess whether there is a potential detriment to the pension scheme as a result of the proposed arrangement and only to require consultation with the trustees over the declaration of intent where there is a potential detriment.

The proposed notifiable events that lead on to a declaration of intent look reasonable.

You note that it is 'currently envisaged' that the declaration of intent will be subject to the same risk-based criteria (such as level of funding test) applied to notifiable events. As we noted in answer to Question 5 above, the existing filter relates to the scheme being fully funded on a section 179 valuation basis. This might not be appropriate where the covenant is very weak (or will become very weak as a result of the event in question).

7. Is there any further information which could be included in a Declaration of Intent to improve understanding of the proposals to strengthen the position of the pension scheme?

It is not immediately clear to us how the various parties involved in the sale will feed in to the declaration and the extent to which they would be bound by its content.

In particular, the key party in a sale would seem to be the potential purchaser and the key issue is what their intentions are for the scheme. However, we understand that it is the selling entity that is expected to prepare the declaration and agree it (or otherwise) with the trustees. It is not at all clear what obligation this document will place on the potential new owners of the business who will need to support the scheme in future.

Even if the potential purchasers agree a declaration of intent with the trustees, it is not clear to us what action could be taken by the trustees should the purchasers change their stance once the sale is completed. Further clarity on this issue would be helpful.

It would be helpful to have more information on the potential implications of the company failing to agree the declaration with the trustees (other than this being stated in the declaration itself). We presume, as a minimum, that the Regulator would want to be informed where this is the case.

8. At which point in the transaction process should sponsoring employers a) engage with trustees and b) issue a Declaration of Intent to them?

Ideally, discussions would start at an early stage to maximise the chance of an acceptable agreement being reached with the trustees. However, this may not always be possible, particularly in relation to listed companies where price sensitive information may mean it is difficult to engage with trustees until a potential deal is announced to the market.

Thought will also need to be given to how the process would be expected to work in real life situations. Deals can take many forms. For example, there may be an auction process with many possible bidders, or decisions might be taken several layers up the corporate hierarchy, perhaps overseas, with the direct scheme sponsor having no input into the sale negotiations. Some deals can occur over a very short period of time. It will be essential for a full consultation to be carried out on the detailed proposals to ensure they will work in practice.

9. What would be the impact (both direct and indirect) of our proposals on businesses, for example on transactions or administration costs of notification?

As noted above, the ultimate impact of more onerous reporting requirements will be to make it more expensive for businesses to transact.

Employers may also have concerns over confidential information being passed to trustee boards in advance of a sale being completed (especially in the context of listed companies). Legislation to enforce confidentiality or to allow the employer to deal with a sub-committee of trustees may help to reduce the risks in this area.

10. What more could we do to increase trustees' involvement in negotiations to ensure there is due consideration of the potential transactional risks to pension schemes?

Ultimately this will come down to the strength of the trustees' hand in negotiations – and the regulatory powers that realistically might be used if trustees' concerns are not addressed.

If trustees/the Regulator are in a powerful position, sponsors will need to engage with them, whether there is an explicit requirement to involve them or not. If the trustees have very limited leverage and the Pensions Regulator's powers are difficult to use in practice, a requirement to involve trustees in negotiations is likely to have limited impact.

There is also a question over how closely trustees should be involved in negotiations of this nature. The trustees' role is to ensure the pension scheme is treated fairly.

Voluntary Clearance

11. Are these the right areas for the Pensions Regulator to focus on in relation to improvements to their existing guidance? Should anything else be considered?

They seem reasonable. Clearly the guidance will need to be updated to reflect the new requirements, once these are finalised.

Improved Regulator powers

12. What are the likely effects and impacts on business and trustees of the introduction of this proposed new system of penalties?

As you note, the majority of schemes and employers carry out their duties and responsibilities fully, and would thus be unlikely to be impacted by these changes.

Additional powers which can be used against employers may be helpful to trustees where they are failing to get the necessary engagement from sponsors.

It may be that further potential risks to trustees (in particular the new criminal offence around notifiable events) could further discourage non-professionals from acting as trustees. A number of schemes struggle to find Member Nominated Trustees for example and this could exacerbate this trend. We suggest that the circumstances in which these penalties might be applied are clearly set out to minimise this risk.

13. Are there other behaviours that should attract sanctions? If so, what are they?

The proposals already include the "wilful or reckless" clause which would appear to be extremely widely drawn, and thus would appear to cover a wide range of behaviours. There does not appear to be a limb on the "wilful or reckless" cause which requires there to be a detriment to a scheme following such behaviour. We would prefer to see less broad wording to encourage understanding of the behaviours you are seeking to ensure are avoided.

14. We have proposed a new civil penalty (up to a maximum £1m) for example to take action for non-compliance with providing a declaration of intent. Will this deter wrongdoing? If not, what would be a suitable deterrent?

Yes, we believe this would act as a deterrent. Recent experience around increased fines for data protection breaches suggests that higher potential fines do increase the prominence of the issue to corporates. For larger companies a maximum penalty linked to turnover might be more appropriate than a fixed cap.

15. We have proposed a new criminal offence for wilful or reckless behaviour in relation to a pension scheme, and for failures to comply with Contribution Notices and the Notifiable Events Framework. Do you agree with these proposals? Will this deter wrongdoing? If not, what would be a suitable deterrent?

We agree that this may be appropriate for sponsoring employers and for the first two categories – "wilful or reckless behaviour" and "failure to comply with a Contribution Notice". We have some concern that trustees could face criminal penalties for failures to comply with the Notifiable Events Framework, which could be relatively minor breaches. We would like to see clear guidelines for the level of non-compliance which could lead to criminal sanction.

We also request clarification as to whether these offences could be applied retrospectively – we would have concerns about fairness if this was to be the case.

16. If yes, should the maximum penalty for these offences be:

a. Unlimited fines?

b. Custodial sentence and/or fine for the worst offenders – do you have views on the appropriate maximum term?

Unlimited fines may be appropriate, with custodial sentences for the worst offenders, particularly in relation to failure to comply with contribution notices. We regard sentences consistent with those for other corporate crimes, such as serious fraud, as being appropriate.

We observe that prosecutions and associated penalties should be proportionate, to avoid the risk of the penalties being seen to be so severe that securing convictions becomes unnecessarily difficult.

17. What more can we do to support the Pensions Regulator in enforcing legal requirements in an effective and proportionate way?

Ensure that the responsibilities of all parties and the Regulator's powers are well communicated to trustees and sponsors.

Ensure that the Regulator is sufficiently well resourced and focuses these resources on the most appropriate cases.

Contribution Notices

18. We have set out a number of proposed changes to the way Contribution Notices function.

a) Do these proposals strike the right balance between improved regulations on business and protecting pensions?

b) Alternatively, what else could we do to improve the way Contribution Notices work?

We did have some difficulty in commenting on the proposed changes to Contribution Notices and Financial Support Directions as the consultation document contains just short sentences, with no discussion of the rationale for each point and no proposed legislation. However, in the light of attending one of your stakeholder meetings we are now in a better position to comment. We look forward to further opportunities to engage with the proposals as they develop ahead of the legislation being laid before Parliament.

In relation to the Contribution Notice proposals, of those not covered in specific questions we comment as follows:

1. **Amending the "reasonableness" test so that there is a stronger focus on the loss or risk caused to a scheme by the "act" when assessing the amount to be demanded. Balancing this, scope will be given for the employer's justification for the "act" as a determining factor.**

   We understand that you are thinking of creating a new test of "reasonableness" for the purpose of determining what is to be demanded and this will be separate from the current non-exhaustive list of matters whose focus seems to be more about passing a reasonableness test as to the target.

   We can see the attraction of this proposal to the Regulator, as once liability had in principle been conceded by the target, it could reduce the scope for subsequent legal argument as to quantum (that most notably arose in the Bonas case) due to the current legislation being completely silent on the matter. We suspect that the attraction to corporates (and particularly individual directors) of such a test is more muted as their first concern will be whether they are potentially in scope for a Contribution Notice. The wording of the new test will also have to be thought about quite carefully in order that it does not restrict the amount that should be demanded.

2. **Creating an additional limb to the "material detriment" test, assessed by reference to the weakening of the employer.**

   We understand and share your concern that the current test, with its focus on detriment to the likelihood of benefits being received, can be difficult to evidence that it has been met, given that the detriment may not play out for many years into the future.

Your proposal for an additional limb, which we understand is to stand separate from the current test and so act as an alternative gateway to the raising of a Contribution Notice, is potentially easier to evidence that it has been met than the current test. Having said this, the precise wording of the test will be important as covenant can be difficult to quantify.

A more significant concern is that a test along the lines of "detrimentally affected in a material way the covenant of the employer towards the scheme" could bring many more situations into scope than at present, a number of which are unlikely to be appropriate for regulatory action. The obvious example is that the Regulator views payment of dividends as covenant reducing, which it is, in an immediate quantitative sense, but companies need to attract investors and one way to do that is to provide them with annual returns, so on a qualitative basis, paying dividends can be covenant enhancing. We have a concern that a pure covenant test, measured at a point in time, could enable intervention which with hindsight would prove not to be appropriate.

19. What would be the most appropriate way of protecting the value of the Contribution Notice through uprating? What are the likely impacts of this?

Having settled on a sum within the Contribution Notice there is an attraction to provide for a specific mechanism for adjustment for the passage of time, rather than having the very open power to increase as per the current legislation, with all the potential for legal challenge. Referencing it to some notional asset allocation, that is investible, has merit, especially if the target is then able to make provision for it in a way that removes any further risk from the target.

Having said this, the purpose of a Contribution Notice is to put the scheme back into the position it would have been had the "act" not happened. Even if it is possible to objectively quantify what the payment should be at the time of the "act", the longer the time between the act and payment the less likely the amount will deliver this, whatever mechanism is used – and in some circumstances the payment could constitute a windfall.

20. What could be the impacts of changing the date at which the cap was calculated to a date closer to the final determination?

The impact could be very significant, where the amount in the Contribution Notice is tied to a specific proportion of the cap, because of the time that elapses between the "act" and the date of the final determination. The cap in most cases is the section 75 debt, so changing the date seems to imply that an updated section 75 calculation may be necessary which could be very different to that as at the date of the "act". Whilst we appreciate the logic from a public policy point of view (the employer makes good some or all of the shortfall – the precise amount depending on what is reasonable in the circumstances), it does create an uncertain liability for the target.

We assume that the separate delay mechanism would operate only from the date at which the Contribution Notice is finally calculated.

Financial Support Directions

21. What could be the likely impacts on business of a more streamlined Financial Support Direction regime?

Before answering this question we want to make clear that we also had difficulties with the much more significant changes to the Financial Support Direction legislation, but attending one of your stakeholder meetings was useful. Please do keep us informed and involved as you develop your proposals.

Of those not covered in specific questions we comment as follows:

1. **Allowing FSDs to be issued to a broader range of individuals, where they are associated with or connected to the sponsoring employer.**

   This seems to be filling a regulatory gap. So long as the individuals are, in effect, part of the corporate entity whose veil is being pierced it seems appropriate to provide for such an extension.

2. **Amending the reasonableness test to make clear that the actions of a target in creating or increasing risk are a relevant (but not necessary) factor.**

   This proposal seems to fly in the face of the FSD regime which has nothing to do with blame, but is rather about piercing the corporate veil so that the strong support the pension responsibilities of the weak. We think that the current non-exhaustive list in relation to the imposition of an FSD should remain focussed on connections to the sponsoring employer.

3. **Providing the Regulator with a power to impose a CN on any person associated or connected with the recipient of the FSD.**

   Currently the Contribution Notice can only be imposed on the recipient of the FSD. This seems to be another case of filling a regulatory gap, being an important new power to enable the Regulator to widen the net and presumably chase the money that was with the original target, but was deliberately moved on. It will presumably have to come with its own safeguards, such as whether it is reasonable to change the target.

4. **Providing the Regulator with a power to issue a FSD after a scheme has entered the PPF and enabling it to enforce it in the form of a cash payment.**

   We understand that this is intended to enable a failed scheme to not have to remain in PPF assessment, whilst FSD processes are brought to a conclusion. Whilst we understand that schemes should not be held in assessment for what is in essence an artificial reason, it will surely be important for schemes to be held back from PPF entry if the recovery under the FSD could result in the scheme being more than 100% funded on the PPF entry basis.

On the question being posed, the proposed creation of a single-stage process, under which the FSD would create a specific and enforceable obligation on the target is a complete change from the current system under which the target can put forward (within a certain timescale) its proposals for delivering financial support. We understand the rationale for the proposal – to

streamline regulatory action and in particular to obviate the potential need for two visits to the Determinations Panel – but the danger with a single-stage process (which we understand is to replace the current multiple-stage process) is that it becomes too prescriptive. If there is to be this change it will need appropriate safeguards, so that there remains scope for the target to agree to deliver financial support to the scheme ahead of the single-stage FSD powers being used. One possible safeguard is for the Warning Notice to set out precisely what the Regulator wants the target to do. We understand that the current practice in FSD Warning Notices is for the Regulator not to set out what sort of financial support it wants to target to put in place.

22. How could we best amend the 'insufficiently resourced' test to make it simpler and clearer?

We understand that due to impreciseness of the legislation there can be difficulties in determining whether the first leg of the test is met – ie establishing the value of the employer's resources to compare again the estimated section 75 debt to see whether the "less than 50%" test is met. The 'rich uncle' second leg is normally a formality. But rather than seek to resolve the 'poor parent' issue it may be better to replace the insufficiently resourced test with a completely different measure, such as providing that the corporate veil can be pierced in relation to any scheme that is funded below a certain percentage of its technical provisions. It may then also be possible to drop the service company gateway. A technical provisions approach could act as a spur to better scheme funding and lessen the need to seek a lookback period greater than two years. Any such proposal would need separate consultation before being finalised.

23. We propose to tighten up the forms of financial support the target is required to make to the scheme to include cash payments or statutory guarantees.

a. What would the impact of this approach be on business?

b. Are there other forms of support we should take into consideration?

This is understandable if the point is accepted that there needs to be a single-stage prescriptive system.

24. What would be the impact on business of a longer 'lookback' period?

The longer the Regulator can look back when testing whether either the "insufficiently resourced" or "service company" criterion has been met, the greater the uncertainty that will be passed to corporates. It is not clear why an extension beyond two years is needed, or how much is required. Whilst we can understand the need for a six year look back from the Warning Notice to the "act" when it comes to the blame-based Contribution Notices, if the proposition is for a similar look back for FSDs the effect could be to create a significant brake on corporate activity from the viewpoint of acquirers of corporate entities with DB funding responsibilities.

Conclusion

25. The proposals in this consultation are suggested as ways in which the Pension Regulator's powers could be increased or improved in order to clamp down on

corporate wrongdoing and ensure improved compliance with all legal responsibilities by sponsoring employers.

a. **Do these proposals strike the right balance between improved regulations on business and protecting pensions?**

b. **Alternatively, do you think there are other areas where the Pensions Regulator's powers could be increased or improved to achieve our intended outcomes?**

It is difficult for us to give a view on whether the proposals strike the right balance when the consultation document contains little detail on both the rationale for each proposal and the proposal itself. Whilst we are supportive of the general direction of the proposals, our concern at this stage is one of unintended consequences, particularly as it is not clear whether there will be further consultation once each of the proposals is fully worked up.

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