ASSOCIATION OF
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Pensions Client Directorate
Department for Work and Pensions
1-11 John Adam Street
London
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Dear Sirs

Consultation on anti-avoidance amendments

I am writing on behalf of the Association of Consulting Actuaries, in response to your consultation on amendments to the anti-avoidance measures in the Pensions Act 2004. Thank you also for meeting with some of our representatives and inviting us to your seminar on 12th June. In regard to the seminar it was most useful to be part of the debate with the Minister of State for Pensions Reform who so generously gave of his time.

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and are subject to the code of professional conduct of the Faculty and the Institute of Actuaries. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of defined benefit pension schemes.

The ACA is the representative body for consulting actuaries, whilst the Faculty and Institute of Actuaries are the professional bodies.

Despite the Minister's reassurances we are concerned that some of the proposed changes could have very significant and unintended consequences which if you stick to your present course can only be avoided with clear and timely guidance from the Pensions Regulator.

The number of clearance applications has reduced significantly because employers and their advisers understand the Regulator's intentions and see the Regulator's limited powers. This could change under the proposed amendments and applications could increase significantly, imposing large additional costs, both in terms of time and money. Any corporate transaction involving the sale of a business from a stronger to a weaker employer could potentially be caught although we understand that this is not the intention. A full impact assessment is certainly required and the additional costs are likely to be significant.

The Minister made clear that wide powers have been proposed because of the difficultly in defining the problematic features of certain 'non-insured buy-outs', known and unknown, which the proposed legislation is aimed at preventing. However, the industry is being asked to accept that the Pensions Regulator would not use the proposed powers to their full potential on trust. Given this difficulty in accurately defining the precise target for the new powers, we have considerable concern over how our members would advise their clients on whether the Pensions Regulator would be likely to use its proposed powers in practice. We also note that the additional powers have not been subjected to the Parliamentary scrutiny accorded to the original powers.

One improvement would be to retain the short term restrictions outlined in paragraph 1.36 of the consultation document indefinitely. This would retain some consistency with the stated aims underlying the proposed new legislation. As a minimum, there should be an explicit statement that you intend there to be no change in the circumstances in which a Contribution Notice can be imposed, for transactions that are not of a non-insured buy-out type. It seemed clear from the Minister's remarks that you are not intending to widen the scope of Contribution Notices in this respect and yet your proposals could well have this effect, perhaps placing all 'type A events' within scope of a potential Contribution Notice. We do not recommend that you widen the powers in this way, as this would have a serious adverse effect of the ability of businesses to engage in normal business sales and purchases.

Our detailed comments on the specific issues raised can be found in Appendix A to this letter. In Appendix B we comment on the impact of the proposals and, as requested, how the proposals meet the stated aims. It is however difficult to comment fully until the draft regulations and the Regulator's draft guidance are available. We understand that the draft regulations may be available shortly. We ask that they be issued alongside the draft guidance so that we can see the package in its entirety. Only then will we be able to comment on whether your focus is indeed restricted to the non-insured buyout market.

We hope that you find our comments of assistance.

Yours sincerely

Charles Young
Chairman
Pension Scheme Committee of the Association of Consulting Actuaries

Appendix A – Detailed proposals

A1 The proposal that the resources of the whole group of associate or connected persons should be considered when assessing whether a Financial Support Direction can be issued.

In principle we support this proposal. It seems to us to be correcting an oversight in the drafting of section 44 of the Pensions Act 2004. However, this seems to be a tidying up amendment and is not related to concerns about non-insured buyouts.

It is clearly inappropriate for a group of companies to prevent a Financial Support Direction from being issued by distributing available assets throughout a group of connected or associated companies, so that no individual company meets the sufficient resource test.

A2 The issues that should be considered in drafting legislation to introduce this test, and in particular the proposal set out above.

In relation to paragraphs 2.22.-2.24 although we recognise there are difficulties in operating the existing 'intent test' for Contribution Notices in relation to debt avoidance, moving from this to an 'effect test' will introduce considerable difficulties which may have very significant and unintended consequences. The 'effect test' would need to be very tightly defined – allowing subjectivity may lead to the Pensions Regulator being inundated with requests for clearance and effectively performing part of the trustees' traditional role as a result.

One principle which must be firmly tied down is the time at which the test is to be carried out. There is a considerable danger that the effect of an action could be viewed very differently with the benefit of hindsight. We are pleased to note that this is included as the first principle outlined at paragraph 2.30.

Our key concern is your proposal at paragraph 2.26 to introduce an alternative "materially detrimental" test. This is much wider than debt avoidance and could undermine legitimate business activity as an unintended consequence of seeking to tackle the non-insured buyout market. In relation to this test assessments of employer covenant and how these should relate to funding and appropriate technical provisions are generally subjective, except in more extreme cases where the scheme is either very large or very small in relation to the employer's strength. Our view is that it would be very difficult to specify a sufficiently objective test. Without this, companies are likely to conclude that they would need to apply for clearance to be sure the proposed action would not lead to a subsequent Contribution Notice, imposing large additional costs, both in terms of time and money.

We note that there is a potential conflict between the final two principles set out in paragraph 2.30: providing clarity for employers on the implications of the powers could restrict the Regulator's flexibility to act.

Paragraph 2.28 recognises that a wide range of transactions could potentially fall within the scope of the new test. Although this paragraph provides some reassurance that Contribution Notices will only be issued in limited circumstances, using the Regulator's risk based approach, it rather misses the point. Unless the test can be made objective, companies will be unsure whether these transactions will be subject to a future Contribution Notice unless they apply for and obtain clearance. A large volume of additional clearance applications will involve both additional administrative burden, for the Regulator, the employers and the trustees, and the potential for mitigation to be required in a large number of cases. We understand that this is not the intention underlying the proposals.

A3 Whether a non-exhaustive statutory checklist of factors to consider in any detriment test would be useful for parties who could be subject to the issue of a Contribution Notice under the new test.

Anything other than an exhaustive list will inevitably introduce subjectivity to the test and the consequences outlined above which flow from this. A non-exhaustive list is preferable to having no list but any subjectivity could lead to large numbers of clearance applications.

It would also be helpful to have some guidance on materiality. For example, a move from a very strong employer (0.01% probability of insolvency p.a.) to a merely strong employer (0.1% p.a.) is a tenfold increase in the likelihood of insolvency. Is this material? These are the sort of issues which are likely to require clearance to resolve with certainty, if detailed guidance is not provided.

A4 The additional 'reasonableness factors' it proposes to prescribe should be taken into account when considering the issue of a Contribution Notice.

The proposed additional factors are appropriate.

A5 The value of setting out such a non-exhaustive list, where to set out this list and on the proposed characteristics.

Anything other than an exhaustive list will inevitably introduce subjectivity to the test and the consequences outlined above which flow from this. A non-exhaustive list is preferable to having no list but any subjectivity could lead to large numbers of clearance applications.

At this stage we are not sure how the guidance on material detriment could differ from the Regulator's clearance guidance which discusses this concept in relation to type A events.

A6 other provisions that could be included in legislation or elsewhere to ensure that the new test to issue Contribution Notices is effectively targeted on risks to scheme members' benefits.

The Minister made clear that wide powers have been proposed because of the difficultly in defining the problematic features of certain 'non-insured buy-outs', known and unknown, which the proposed legislation is aimed at preventing. However, the industry is being asked to accept that the Pensions Regulator would not use the proposed powers to their full potential on trust. Given this difficulty in accurately defining the precise target for the new powers, we have considerable concern over how our members would advise their clients on whether the Pensions Regulator would be likely to use its proposed powers in practice. We also note that the additional powers have not been subjected to the Parliamentary scrutiny accorded to the original powers.

One improvement would be to retain the short term restrictions outlined in paragraph 1.36 of the consultation document indefinitely. This would still leave considerable subjectivity but it would at least retain some consistency with the stated aims underlying the proposed new legislation. As a minimum, there should be an explicit statement that you intend there to be no change in the circumstances in which a Contribution Notice can be imposed, for transactions that are not of a non-insured buy-out type. It seemed clear from the Minister's remarks that you are not intending to widen the scope of Contribution Notices in this respect and yet your proposals could well have this effect, perhaps placing all 'type A events' within scope of a potential Contribution Notice. We do not recommend that you widen the powers in this way, as this would have a serious adverse effect of the ability of businesses to engage in normal business sales and purchases.

The document does not adequately explain why such extensive powers are thought necessary; given that the Pensions Regulator already has the power to replace trustees where necessary. We understand that the existing regulatory powers to appoint trustees are not considered sufficient and that there is a concern that these could lead to the Pensions Regulator taking an active role in the administration of a large number of schemes, by appointing trustees, if these powers were relied upon to regulate the issues of concern. We would caution that a large increase in the number of Clearance applications might also lead to the Pensions Regulator taking an active role in a large number of schemes.

A7 The proposed removal of the words 'otherwise than in good faith' from s.38(5)(a)(ii) of the Pensions Act 2004.

This proposed change is closely linked to the move from intent to effect discussed above. We recognise the difficulties involved in proving intent or that the parties did not act in good faith. However, this is an important legislative protection for the vast majority of employers, who do act in good faith. Without it, employers would need to apply for clearance to ensure they would not be subject to a future Contribution Notice as a result of their actions (or failure to act).

A8 The proposed statutory defence for parties who could be subject to the issue of a Contribution Notice.

This is a key part of the process. If employers and trustees can satisfy themselves that they will be able to successfully use the statutory defence in the majority of transactions then the anticipated large increase in Clearance applications could be avoided. This would require clear and objective legislation and/or regulatory guidance on how the statutory defence could be successfully used.

However, if the relevant legislation/guidance is not sufficiently clear, employers and trustees will be reluctant to place reliance on it. We would then be very concerned that the proposed statutory defence effectively places the burden of proof on the employer – they are considered guilty unless they can prove their innocence.

It is far from clear why the Pensions Regulator should not be required to demonstrate that the party should reasonably have foreseen the consequences of their actions. The Government's argument, that this could frustrate the Pensions Regulator in cases where it has clear evidence of detriment to members, is not compelling. This suggests that the powers may well be used with the benefit of hindsight, despite the reassurances discussed above – if there was clear evidence of detriment to members <u>at the point at which the decision was taken</u> then the Regulator should have little difficulty showing that the consequence of the decision should reasonably have been foreseen.

A9 The proposed clarification of s.38 of the Pensions Act 2004.

We support this clarification that a course of conduct could lead to a Contribution Notice. However, it would help to have some clarity on whether, for example, paying 'normal' dividends while the scheme remains in deficit could be considered a course of conduct which could lead to a Contribution Notice. We understand that this is not the intention.

A10 The proposal that the use of Contribution Notices should not be prevented by effecting bulk transfers.

We support this proposed amendment. This appears to be closing a loophole that may have been discovered by some offering non-insured buyout solutions.

A11 The proposal that the Regulator should be able to issue a Contribution Notice against a party that effects a bulk transfer that is not in the interests of members.

We are not so sure about this proposal and reserve our views until we have had sight of the draft regulations.

For the most part, such transfers will be under the no consent route and so subject to GN16 certification. Although GN16 is not concerned with benefit security, the scheme actuary and the legal advisers are likely to bring this and related matters to the trustees' attention, so we are not sure at this point whether there is any mischief in reality for which you need these additional powers.

Furthermore whether a bulk transfer is in the interests of members is likely to be a subjective judgement. To obtain reassurance that a subsequent Contribution Notice will not be issued, employers may need to apply for clearance. It is also unclear which party the Contribution Notice would be issued to in these circumstances – it appears that the trustees of the transferring scheme would be the most obvious target, unless scheme rules gave an employer the power to effect a bulk transfer. This should be clarified.

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Appendix B – Impact of the proposals

B1 Ensure members' benefits are protected, and trust and confidence in pensions is sustained

Although the proposed amendments appear to improve the security of members' benefits we have significant concerns over some of the proposals. In our view, the introduction of a necessarily subjective 'effect test', the removal of the 'good faith test' and the addition of a test for bulk transfers being in the interest of members will add a considerable regulatory burden, particularly if the vast majority of well intentioned employers conclude that clearance needs to be obtained for each of the events potentially affected. There is little to gain from having the most secure regulation of benefits, if this means that defined benefits are not provided in future.

B2 Retain the central role for trustees in protecting members' interests

If obtaining clearance becomes a significantly more frequent occurrence, this may undermine the trustee role to some extent. On the other hand, the additional powers which would be available to the Pensions Regulator might help to strengthen trustees negotiating positions.

B3 Enable appropriate innovation in the pensions market, while maintaining regulatory oversight.

There is a real danger that the proposed approach will discourage employers from continuing defined benefit schemes.

B4 Equip the regulator with the powers it needs to protect members' interests and the PPF, while ensuring these powers are proportionate.

The proposed changes would certainly give the regulator significant new powers to protect members' benefits. We are not convinced that the proposed powers are proportionate.

B5 Avoid undue burdens on sponsors of defined benefit pensions and help employers to retain defined benefit schemes – in part by reducing risk to the PPF

There are potential benefits for well run schemes and related employers through reduced PPF levies. However, it is likely that the proposed powers will impose a significant regulatory burden and discourage employers from continuing defined benefit schemes.

B6 Avoid impeding normal business activity

There is a significant risk that normal business activity will be impeded by aspects of the proposed legislation. It is unclear why the Government does not expect a major increase in the number of events being brought to the Pensions Regulator for clearance as a result of the changes.

B7 Deliver effective legislation

The decision not to carry out a full impact assessment on the grounds that the proposals will only have a negligible impact on private and voluntary sectors (para 1.43) is highly debatable. The number of clearance applications is likely to increase significantly, imposing large additional costs, both in terms of time and money. Any corporate transaction involving the sale of a business from a stronger to a weaker employer could potentially be caught although we understand that this is not the intention. A full impact assessment is certainly required and the additional costs of clearance are likely to be significant.

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