UK Pensions Briefing: Stronger powers for the Pensions Regulator

February 2021

Introduction

The new Pension Schemes Act 2021, once fully implemented, will significantly enhance the powers of the Pensions Regulator. It will also materially increase the obligations of scheme employers to notify the Regulator and scheme trustees of planned corporate transactions.

This briefing considers what this will mean for employers and trustees of defined benefit (DB) pension schemes.

Why is the Government widening the Regulator's powers?

The new powers have their origin in high-profile insolvencies involving DB pension schemes, such as Bhs and Carillion, where the Regulator was criticised for not doing more to protect scheme members and the Pension Protection Fund. Following consultation in 2018, the Government concluded that the powers of the Regulator should be significantly strengthened to enable it to take more decisive action against companies and individual directors attempting to off-load or avoid their DB pension scheme liabilities.

To help with this, the Regulator also needs to have adequate forewarning of certain "red flag" events. This is to enable it to intervene at a point when it can still make a difference – i.e. before the pension scheme finds itself as one of many unsecured creditors of an insolvent employer. Therefore the new Act also expands the Regulator's existing early warning system – the so-called "notifiable events" regime.

When are the new powers coming into force?

The Pensions Minister, Guy Opperman, has said that he expects the powers to be available for the Regulator to enforce from this autumn.

They are contained within the Pension Schemes Act 2021 (the Act), formerly the "Pension Schemes Bill 2019-2021" (the Bill), which received Royal Assent on February 11, 2021.

This has been a long, drawn-out process. The Bill was first introduced in 2019 but its passage through Parliament was greatly delayed, due mainly to the general election and global pandemic.

The new Act provides the framework for these powers and already provides much of the detail. However, the relevant provisions will not come into force immediately. Further detail is needed on some aspects of the new powers and obligations which will be set out in regulations and guidance. Further consultations are expected in the first half of 2021.

Why is this of interest to scheme employers and trustees?

Since the Bill was first published, there has been much commentary and lobbying about the broad scope of the new Regulator powers and particular focus on the proposed criminal offences. The concern is that they could catch legitimate corporate activity.

They will also allow the Regulator to target an even wider range of companies and individuals than under its existing powers.

Meanwhile – though perhaps less headline-grabbing – there has been concern among acquisitive corporates in particular about whether the new notification obligations will be workable in practice, Material fines could apply where there is a breach.

What are the new criminal offences?

Perhaps the most widely talked-about aspect of the Act is the introduction of three criminal offences:

- Avoiding an employer debt
- Conduct risking accrued scheme benefits, and
- Failure to comply with a "Contribution Notice" (one of the Regulator's existing powers, which will also be widened – see below).

All three offences are punishable by unlimited fines, and the first two can also attract a prison sentence of up to seven years.

Avoiding an employer debt

This offence is committed by a person who by their act or conduct (or failure to act) prevents a so-called "Section 75 debt" from becoming due or reduces the amount that becomes due, prevents the recovery of all or part of an existing Section 75 debt or compromises the debt.

The person must have intended that their actions would have such an effect.

A Section 75 debt is, broadly, an employer debt measured on the insurance company "buy-out" basis and it can be triggered in various circumstances including employer insolvency.

Conduct risking accrued scheme benefits

An offence is committed where a person's actions (or failure to act) have a materially detrimental effect on the likelihood of accrued benefits being received.

The person must have known or ought to have known that their actions would have the detrimental effect.

Why have these new criminal offences caused so much concern?

These offences go much further than the original intention expressed in the White Paper, which was to punish *"wilful or grossly reckless behaviour"* in relation to a DB pension scheme.

They are very widely framed.

For example, the new criminal office of conduct risking accrued benefits could potentially catch a transaction that aims to improve the prosperity of the corporate group to which the DB scheme belongs but which later turns out to be a bad business decision and has the opposite effect. It can be easy to identify bad decisions with the benefit of hindsight, but that is arguably not always so apparent at the time.

This is a particular concern in a distressed scenario, where difficult decisions frequently have to be made, and where all of the available alternatives to an immediate insolvency may involve some level of foreseeable detriment to the DB pension scheme and its Section 75 debt recoveries if the restructuring plan is unsuccessful. The risk of criminal sanctions may make immediate insolvency (and a resulting reduction in scheme benefits) the safer option for the decision-makers, compared with a restructuring plan which would have a much better outcome for the scheme if successful but where success is not guaranteed.

"Reasonable excuse" defence

The Pensions Minister explained during the parliamentary debates in the autumn that *"it is certainly not the intention to frustrate legitimate business activities where they are conducted in good faith."* Indeed, under the Act these actions will only be capable of being criminal offences if the person taking them *"did not have a reasonable excuse".*

The difficulty is that there is a lack of clarity over how these powers will be applied and what will count as a "reasonable excuse". This is not explained in the new Act. We understand this will be explained in Regulator guidance which will be consulted on in the first half of 2021. However, it remains to be seen whether this will be prescriptive enough to reassure those potentially in scope for criminal sanctions that they will not be imprisoned for well-intended decisions taken in the course of their job.

Wide reach of the new criminal powers

Added to this, the range of companies and individuals who are within the Regulator's reach for exercise of these new powers is much wider than under the current "moral hazard" regime.

The new laws deliberately catch "any person" who takes the prohibited actions. This means that anyone involved in decisions that affect a DB scheme – including company directors, scheme trustees, the employer's lenders and even professional advisers – can potentially be targeted. Only insolvency practitioners are specifically exempted.

The breadth of the legislation was much debated in Parliament and attacked by lobbyists. The Government has stood firm, wanting to maximise the Regulator's powers and their deterrent effect.

What are the other key new powers?

Penalties of up to £1 million

As an alternative to pursuing a criminal case, the Regulator will have the power to impose penalties of up to £1 million in broadly the same – but even slightly wider – circumstances.

Penalties of this size may also be imposed where the notifiable events regime is breached or for providing false or misleading information to the Regulator or trustees.

Wider powers to issue contribution notices

The Act will significantly widen the circumstances in which the Regulator can require a third party to make a payment into the scheme under a "contribution notice". The power to issue contribution notices is one of the Regulator's existing "moral hazard" powers, but two new triggers are now being added. These are:

1. The "employer insolvency test"
   This is where the Regulator concludes that an act (or failure to act) has materially reduced the amount of any Section 75 debt that an underfunded scheme would be likely to recover, if such a debt were to fall due after the act.

   This is aimed at actions which would worsen the scheme's position in an employer insolvency scenario, e.g. creating new security that ranks ahead of the scheme.

2. The "employer resources test"
   This is where the Regulator concludes that an act (or failure to act) has materially reduced the resources of the employer relative to the scheme's estimated Section 75 debt. Further regulations will need to explain what is meant by the "resources of the employer" and how these are to be calculated.

   This is aimed at actions that divert resources away from the scheme, such as the employer company paying excessive dividends to its shareholders, intra-group loans or other forms of "covenant leakage".

Unlike the existing contribution notice tests which focus either on the likelihood of scheme benefits being received or on the main purpose of the act, these new tests compare the employer covenant before and immediately after the act and are potentially met where the covenant is weakened, even if members are still likely to receive benefits. Again, the concern is that these powers are too widely drawn and could catch a range of legitimate business decisions, particularly where hard choices have to be made in an insolvency situation.

For example, the payment of a substantial dividend from a cash-rich employer to its parent company could materially reduce the resources of the employer relative to the scheme's estimated Section 75 debt (thereby meeting the "employer resources test") but in circumstances where the employer's resources and covenant still provide ample coverage for the debt and the dividend therefore does not put the scheme at risk. It seems odd that such an action could in principle trigger consideration of a contribution notice.

Wide discretion for the Regulator

The Regulator cannot issue a contribution notice unless it is reasonable to do so, which gives some comfort to decision-makers acting in good faith. Although many business activities could on the face of it be caught by the new triggers, only in a minority of cases will it be reasonable for those activities to give rise to a contribution notice.

However, in line with the existing moral hazard regime, it is the Regulator who decides whether it is reasonable to issue a contribution notice. This gives the Regulator a wide discretion.

Availability of a defence

Both new triggers are subject to a statutory defence. This is (broadly) that the potential target of the contribution notice demonstrates to the Regulator's satisfaction that it appropriately considered the impact of its actions on the amount of the Section 75 debt that could be recovered or on the employer's resources (as appropriate), and then either took all reasonable steps to minimise that impact or reasonably concluded there would be no material impact.

A wide range of targets

As for existing contribution notices, the range of potential targets is wide (albeit narrower than the potential targets for the Regulator's criminal powers). All those companies or individuals who are "connected or associated" with an employer of a DB pension scheme are within the Regulator's reach. This is a wide net and generally includes – at a minimum – all companies in a corporate group and their directors.

It seems likely that the Regulator will at some point issue revised guidance on how it envisages using these additional contribution notice powers, but this has not been confirmed.

What will the impact of these new powers be in practice?

We share the concern that – at least in the short term – the breadth of the new laws and lack of prescription in the defences could discourage legitimate corporate activity or distressed company rescue plans where DB pension schemes are involved.

Corporate decision-makers may just consider it too risky, their advisers may find it more challenging to offer the robust advice they would like to give, and lenders may feel more nervous about extending the required borrowing if the protections they need in return could later be considered to have detrimentally affected a DB scheme. Ironically, this could all harm DB schemes in the longer term, if it undermines the ability of employers to stay competitive and profitable.

It would also clearly be counter-productive if the existence of these new powers deters good candidates from taking on roles that could involve them in difficult decisions that affect DB pension schemes.

But are the fears about the new powers well-founded?

For a criminal offence to succeed, it would have to be proved "beyond a reasonable doubt". This is a very high bar. In practice we would expect the new criminal powers rarely to be used for this reason. That said, the DWP's impact assessment concluded that there could be up to five criminal convictions a year, including up to two prison sentences, which is a high number considering how infrequently the Regulator has used its existing powers to date.

We expect that the greater risk for those involved with DB schemes is a material financial penalty (up to £1 million) or a contribution notice, where the Regulator can make use of its wide discretion to decide what is reasonable.

We anticipate that at least initially there may be a surge in clearance applications in response to the uncertainty about how the new powers will be applied in practice. We saw this happen when the Regulator's existing "moral hazard" powers were first introduced in 2005, before it became clear that the Regulator would only use those powers infrequently and in exceptional circumstances. However, it is as yet unclear to what extent clearance would help mitigate the risk of a criminal sanction or a £1 million penalty.

It is also worth being aware that while the Pensions Minister recently confirmed that the new powers will not be used with retrospective effect, this is not spelled out in the legislation. Uncertainty remains about whether, for example, the Regulator would look back to events that took place before the new powers were available when deciding whether it would be "reasonable" to issue one of the new types of contribution notice.

Information gathering

Finally, the Act will strengthen existing Regulator powers to compel certain people to attend interviews and to enter premises to investigate whether there are grounds for issuing a contribution notice.

Though these powers have generated far less commentary than the criminal sanctions, if the Regulator starts to make frequent use of these powers, this could be an unwelcome call on management time.

What are the employer's new notification obligations and what impact will they have?

The "notifiable events" regime is going to be strengthened and is expected to become significantly more onerous for employers.

Employers (or those "connected or associated" with them) will have to give advance warning to the Regulator of material corporate transactions and then follow up with further notifications if the transaction is materially changed or cancelled. The employer will need to provide the Regulator and the trustee with a written statement about the transaction.

It has not yet been confirmed which transactions will be caught. This will be set out in further regulations, likely to be published this year.

The exact timing of the notifications and the contents of the written statement have not yet been confirmed either. It is expected that the employer will have to describe the event, any adverse effects it may have on the scheme and any steps taken to mitigate those adverse effects.

Although we await the final details, we anticipate that the timing of this notification may be the main challenge. If the Regulator wants to know about the transaction significantly before signing, it may be difficult in a fast-moving transaction to pinpoint when in the process there is sufficient certainty about the transaction to be able to provide the required information. Added to this, the employer may have concerns about confidentiality and commercial sensitivity.

As mentioned above, failing to comply with the notification requirements (both existing and new) could in future attract a penalty of up to £1 million. In addition, "knowingly or recklessly" providing the Regulator with false or misleading information when reporting a notifiable event will be punishable by a fine or by imprisonment for up to two years.

What are the key actions to take now?

New Regulator powers

Although the new powers are not yet in force, it would be sensible for scheme sponsors and trustees to ensure that they are already keeping a careful paper trail of any decisions they are having to take in relation to corporate activity that could have an impact on the pension scheme – not just M&A activity but also e.g. refinancings, group restructurings or "covenant leakage" (in particular substantial or unusual dividend payments where the scheme is underfunded). They should consider the impact of any such transaction with the new regime in mind. This is particularly the case where the situation could evolve to a distressed restructuring.

If undertaking a significant transaction, it would be sensible to allow additional time in the transaction timetable in case a clearance application becomes necessary, or it just takes longer for the various parties, the banks – and possibly their advisers – to scrutinise the pensions issues and get comfortable with the risks.

Trustees should check that their integrated risk management and contingency plans remain suitable and that their current information protocols with the sponsor enable them to react quickly.

It may also be sensible for employers as well as trustees to review their existing D&O insurance cover to ensure it remains appropriate.

Notifiable events

Once we have the final details of the amended notifiable events regime, both trustees and employers should update or consider putting in place notifiable events protocols to minimise the risk of breaching the notification requirements. Careful consideration should be given to who within the organisation is best placed to organise the notifications and how to ensure they are given the necessary information in good time.

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