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UK Pensions Briefing

Revised Code of Practice on Contribution Notices clarifies the new tests for dividend payments

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Update: Pensions Regulator’s revised code of practice now in force

The Pensions Regulator’s revised Code of Practice 12 came into force on November 25, 2021.

This sets out when the Regulator expects to issue a contribution notice where it believes that the material detriment test, the employer insolvency test or the employer resources test have been met.

The finalised Code states that only the material detriment or employer insolvency tests would be relevant to dividend payments. The consultation draft had suggested that the employer resources test could also be a trigger and this previously seemed the more natural route for the Regulator to take if minded to consider a contribution notice in relation to a dividend payment.

This revision is helpful in that companies considering dividend payments can now focus their analysis on the two tests called out in the Code.

Background: contribution notices and the Pension Schemes Act 2021

Companies which support defined benefit (DB) pension schemes need to be aware that their decisions about dividends are impacted by new rules in the Pension Schemes Act 2021 about when the Regulator can issue contribution notices. The new rules came into force on October 1, 2021.

A contribution notice is an order for either an employer of a scheme or someone connected with it – for example, a director or another group company – to pay money into the scheme.

Companies will need to factor these changes into their decision making and audit trail.

What is the Pensions Regulator’s view on dividends?

The Regulator has long been concerned that some companies are not treating their DB schemes fairly compared to shareholders, paying generous dividends which are disproportionate to the level of deficit repair contributions made to the scheme. While the Regulator has stopped short of seeking explicit restrictions on dividends, it continues to be concerned about this form of covenant leakage.

Can the payment of dividends result in a contribution notice

Potentially, yes.

Prior to October 1, 2021, if an employer paid a substantial dividend and this made it materially less likely that members would receive their scheme benefits, the Regulator could issue a contribution notice against the employer or connected parties. This is called the material detriment test.

Under the new rules, the circumstances in which the Regulator can issue a contribution notice are being widened. This makes it more likely that a dividend payment could risk enforcement action.

So what's changed?

The draft Code and related guidance published on May 21, 2021, said that three tests for a contribution notice (material detriment, employer resources and employer insolvency) could be triggered if:

"Employer P pays a significant dividend to its parent company which is much larger than dividends paid in previous years and is greater than the company's net profit generated during the same reporting period".

The final Code published on September 28, 2021, confirms that "*some instances of paying a cash dividend or return of capital by the sponsoring employer*" can trigger the material detriment test and the employer insolvency test – but no mention is made of the employer resources test.

Why have the contribution notice rules changed?

The Regulator has not been altogether happy with the pre-October contribution notice tests, which focus on the impact on the scheme rather than the employer and require the Regulator to show what would have happened to benefits in the future. This can make it difficult for the Regulator to prove its case.

The Regulator wanted a simpler snapshot test, focussed on the immediate impact of an action on the employer covenant.

How does the new employer insolvency test work?

A new employer insolvency test has slotted in alongside the existing contribution notice provisions.

This new test is met where – broadly – in the Regulator's opinion:

- The scheme was underfunded on a buy-out basis immediately after the act.
- If (hypothetically) the employer was insolvent immediately after the act and had triggered a section 75 debt, the act would have materially reduced the amount of the debt likely to be recovered by the scheme.

A section 75 debt is, broadly, an employer's share of the deficit in the scheme, measured on the conservative buy-out basis (the cost of securing benefits with an insurer).

Is the new test problematic for dividends?

There are two main issues to keep in mind.

First, what would be a material reduction in (hypothetical) scheme recoveries is not explained in the legislation or the updated Code and guidance. The line between an acceptable and unacceptable dividend is unclear, so each dividend will involve a judgment call.

Second, as the test looks at a hypothetical insolvency scenario, the test is relevant for strong employers, not just those for whom insolvency is likely.

However, the strength of the employer is relevant when making a judgment call about paying a dividend. Arguably so long as the dividend does not damage the company's ability to support the DB scheme, it should not be a cause for concern and should not trip the test for a contribution notice.

It is not the case that a contribution notice will automatically be issued where the employer insolvency test is met. The Regulator will only do so if it considers this reasonable. We would expect the Regulator to take into account factors such as the strength of the employer's covenant, its balance sheet and remaining assets at that stage. However, having to rely on the Regulator's assessment of what is reasonable is an uncertain and undesirable position to be in.

Is there any defence available?

Yes. There is a statutory defence if, broadly, the company:

- Considered the impact of the act on scheme recoveries in the hypothetical insolvency situation.
- Took all reasonable steps to minimise this impact.
- Reasonably concluded that the act would not materially reduce scheme recoveries.

What steps should companies that support DB schemes take if they want to pay a dividend?

Companies need to think about the statutory defence and consider it in relation to the steps they are taking when deciding to pay a dividend.

A good audit trail will be very important, so the steps taken and rationale should be carefully documented. The Regulator has highlighted the importance of contemporaneous records.

Where a proposed dividend is high risk, the company may consider applying to the Regulator for clearance, although the resultant costs and delays would require careful thought.

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