July 2009

Review

Human Capital (Pensions)

Material detriment - What's it all about?

EXECUTIVE SUMMARY

The Pensions Regulator has issued a Code of Practice, high level guidance and illustrative examples to clarify its approach to the material detriment test introduced by the Pensions Act 2008. The material detriment test is a new alternative ground for the issue of Contribution Notices based on whether a sponsoring company's actions or failures to act have a materially detrimental effect on the likelihood of members receiving their benefits. The new test significantly widens the circumstances in which the Regulator can issue Contribution Notices in that it focuses exclusively on the effect of action taken by an employer. The test was introduced on 29 June 2009 but applies retrospectively to 14 April 2008.

The Code of Practice sets out the circumstances in which the Regulator expects to issue a Contribution Notice (once it has formed the opinion that a material detriment test is met).

The high level guidance sets out the matters that companies should consider in advance of a corporate transaction and includes a simple flowchart of these issues, ending with a statutory defence or a clearance application.

The illustrative examples show a non-exhaustive list of corporate and scheme activity that the Regulator would (and would not) consider to meet the material detriment test.

FURTHER DETAIL

Background

Let's start by setting the scene. Since April 2005 the Regulator has had the power to issue a Contribution Notice, requiring payment of up to the full buy-out debt, where it considered that there had been a deliberate attempt to avoid pension liabilities. The power only covered acts or a failure to act where one of the main purposes of the act or failure was to prevent the recovery of all or part of a section 75 (buy-out) debt or to prevent such a debt from becoming due.

Why has it changed?

The introduction of the new test was in direct response to the emergence of new business models which potentially introduced new risks to members' benefits and to the Pension Protection Fund. From the Regulator's viewpoint the new powers are necessary to ensure it can react appropriately to changes in the market.

What has changed?

The new test will allow the Regulator to issue a Contribution Notice where the act (or failure to act) has detrimentally affected in a material way the likelihood of the accrued scheme benefits being received.

In deciding whether the "material detriment" test is met the Regulator must consider "such matters as it considers relevant". In general terms these "relevant matters" include the effect of the act or failure on the scheme's assets or liabilities, and the effect on any ability to discharge scheme liabilities or obligations to make payments or transfer assets.

If the material detriment test is met then a Contribution Notice can only be issued if there is no **statutory defence** (see explanation below), and if the Regulator decides that it is reasonable in the circumstances to impose the Contribution Notice.

In addition, the existing clearance regime will continue to be available to provide assurances that Contribution Notices will not be issued in relation to particular events.

Code of Practice

As required by legislation, the Regulator has issued a Code of Practice setting out the circumstances in which it expects to issue Contribution Notices because it is of the opinion that the material detriment test is met.

The circumstances are summarised as follows:

- Transfer of an occupational pension scheme outside of the jurisdictions of the UK.
- Transfer of a sponsoring employer outside the jurisdictions of the UK or the replacement of the sponsoring employer with an entity that falls outside these jurisdictions.
- Sponsor support[1] is removed, substantially reduced or becomes nominal.
- The transfer of scheme liabilities to another scheme or arrangement which leads to a significant reduction of the sponsor support or a reduction of the funding to cover these liabilities.
- A business model or other situation that is designed to create a financial benefit for the employer or another person where proper account has not been taken of the interests of scheme members.

Practical Examples

The illustrative examples (necessarily caveated and not exhaustive) set out in plainer English the practical issues that might have to be considered.

The **not** normally materially detrimental list includes: routine company dividend payments to shareholders; companies losing customers due to market conditions, and companies granting security in the form of a charge over assets (having provided mitigation to the scheme for the reduction in covenant). Also, **not** normally detrimental is the trustees agreeing to a (well thought out and prudent) change in investment strategy or buying-out pensioner liabilities with annuities purchased from a regulated insurer (after conducting proper due diligence and considering the interests of all beneficiaries).

The following **would** be considered to fall within the circumstances outlined in the Code of Practice.

Removal of covenant. Example - A moderately profitable company sponsors a scheme with a large deficit. The parent company (which has no legal link with the scheme) substitutes it as sponsoring employer with a shell company with a much weaker covenant. The moderately profitable company is then sold off with profits going to the parent company and its shareholders.

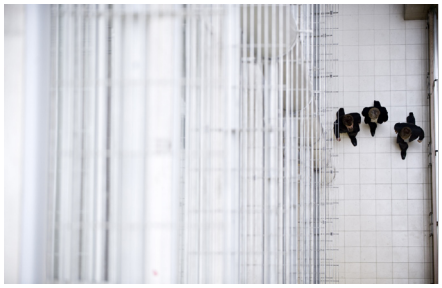
Risking Member's benefits. Example - An "inappropriate" scheme investment strategy is followed by the trustees and a company with a very weak covenant. If a surplus is generated it will mean profit for the employer and shareholders. If a deficit is created it will force the company's insolvency and the scheme's entry into the PPF.

Restructure and transfer. Example - Company X transfers its employees and their respective pension liabilities to Company Y. Company Y is highly leveraged and offers a much weaker supporting covenant to the scheme. No mitigation has been provided for the weakening position.

COMMENT

The publication of practical examples is to be welcomed. However, the illustrations cover obvious scenarios and it would be helpful if the Regulator had set out examples which were less "black and white", particularly in relation to circumstances where there may be an arrangement with an apparent reduction in sponsor support. It is to be hoped that the Regulator will publish further illustrative examples once it has greater experience of looking at corporate activity in the context of the new test.

1 Sponsor support includes obligations towards any other pension scheme where scheme benefits have been transferred in respect of persons who were members of the scheme before the act or failure to act.



A few words of explanation…

A **statutory defence** occurs if the Regulator is satisfied that the following conditions are met.

Before becoming a party to the act or failure, the person gave reasonably diligent consideration to any detrimental effect on the likelihood of the accrued scheme benefits being received; and

he either took steps to minimise or eliminate the detrimental effect; or

he considered all the facts available at the time and reasonably concluded that it would not result in a materially detrimental effect.

FURTHER INFORMATION

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