Pensions and dividends: New risks for companies

The Pension Schemes Act 2021 gives the Pensions Regulator ('TPR') significant new powers from October 2021.

This includes two new Contribution Notice tests, one of which (the new 'Insolvency Test') means payment of dividends (and similar) may be at risk of regulatory action.

Companies with Defined Benefit ('DB') pension schemes may need to enhance their governance processes around paying dividends in order to mitigate this new regulatory risk.

In practice this may mean that in some circumstances companies wishing to pay dividends will also need to consider potential mitigation to the pension scheme (eg a cash payment). It would be advisable for companies to document the process they work through, including if they decide it is appropriate not to mitigate.

How can companies manage the pensions risks around dividends?

Companies will wish to review governance around dividends to ensure any potentially material dividends are identified early and the impact on the DB pension scheme is assessed.

Many companies will need to work this through (and document) prior to the dividend decision being made and documented at company board level.

The chart overleaf outlines a possible approach for introducing the pension scheme into the governance process around dividends. The first step is to undertake **insolvency analysis** for each potentially material dividend, to test the insolvency recovery position for each DB pension scheme which the company sponsors (see box overleaf for an outline of what this analysis can involve).

Where the insolvency analysis shows that the impact on the scheme is clearly material, or where there is a concern that TPR could view the impact as material, the company directors should consider:

- Building a case for the file as to why, in the company directors' view, it would be unreasonable for TPR to take regulatory action (there are various reasons why this might be the case).

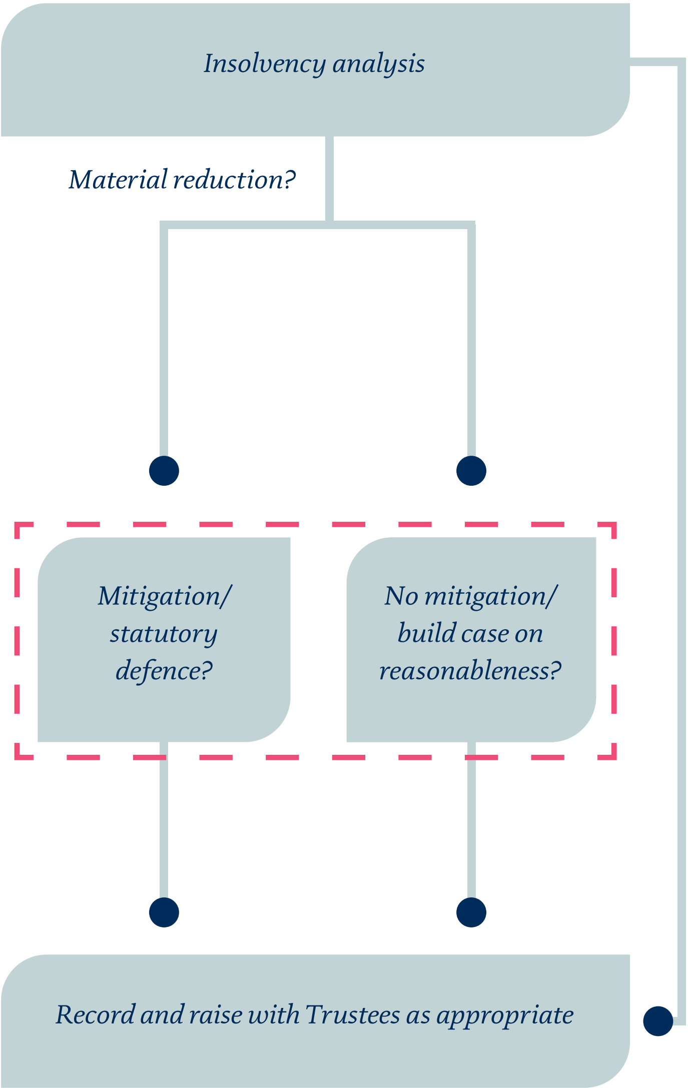
and/or

- Raising with the trustees and, if appropriate, offer and agree mitigation for the scheme - both could help support a 'statutory defence' of the company's actions.[1]

All dividends are potentially in scope of the new Insolvency Test. This includes:

- *ongoing regular dividends;*
- *inter-group dividends, particularly paid by companies that form part of the covenant to a DB pension scheme; and*
- *special dividends, for example those which might be paid following a transaction.*

Other forms of 'covenant leakage' could also be in scope. For example internal group restructurings (on terms which are not 'arm's length') or replacing trade or tangible assets with inter-company debt (likely to realise less in an insolvency scenario).



What is insolvency analysis?

- The analysis considers the likely recovery to the pension scheme on a hypothetical insolvency of the employer, the day before/after the proposed dividend or covenant leakage (irrespective of the likelihood of insolvency).
- The creditor stack and group structure will need to be factored into the analysis in enough detail to ensure the estimate is reasonable (analysis can be complex and may need specialist pension covenant advice).
- This typically includes scenario testing to consider a realistic range of possible outcomes.
- There is no definition of a 'material reduction' in the insolvency recovery to the scheme (which is the trigger for the test), and so this would ultimately be decided by TPR if ever in dispute.

It will be important to have a clear audit trail of the analysis conducted and rationale for the conclusions drawn, including details of any discussion/ engagement with the trustees. This should be appropriately reported to the company board. The aim of this would be to reduce regulatory risk in case this was ever required, to protect the company and directors from Contribution Notices, civil or criminal charges and reputational risk.

For dividends (or other distributions around the group) which are clearly 'material', or those which are considered at 'high risk' of potentially being considered 'material' by TPR, the company may consider applying to TPR for 'Clearance'.[2]

Even where the impact on the scheme is considered to be immaterial, it would be advisable to keep evidential records as a defence against future TPR action (and the company may wish to consider what should be shared with the trustees in respect of the process taken by the company).

The new tests take the recommended pension considerations of dividend and covenant leakage beyond the position TPR has previously advocated in its recent Annual Funding Statements to a new more stringent level.

What about schemes in surplus?

A scheme in a funding surplus, or in deficit but with a short recovery plan, may have previously seen the strength of their ongoing funding position as persuasive arguments to support companies being able to pay larger dividends.

However, the insolvency analysis for the Insolvency Test is performed in the context of the scheme's 'buyout deficit' (otherwise called the 'Section 75 Debt') – and so this analysis is still required for schemes which are in an ongoing funding or accounting surplus and/or where little or no deficit repair contributions are due.

What should companies be doing now

Many companies are likely to initially wish to work through the analysis required in some detail ahead of discussions on dividends payable after 1 October 2021 (and so which will be paid under the 'new regime'). This upfront analysis under various possible dividend levels should help to provide some context and comfort around which levels of dividend would potentially present regulatory risks.

Footnotes:
(1) The statutory defence broadly requires that reasonable steps have been taken to eliminate or minimise the potential for the dividend to materially reduce scheme insolvency recoveries.
(2) Clearance provides assurance that TPR won't impose a Contribution Notice for the act (in this case the payment of a dividend).

Want to find out more?

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