Government goes ahead with moral hazard powers

The Government has decided to implement its proposals to extend the moral hazard powers in a significantly different manner than initially intended. However the proposals themselves are little changed from those set out in April except for two important changes:

- the new test is expected to apply in limited situations – the original intention had been that the limitations would only apply from 14th April 2008 until the legislation came into force; and
- the situations themselves will be documented in a new Pensions Regulator Code of Practice.

Through both of these changes the Government hopes that the impact of the extended powers will be focussed on the intended targets – in particular certain types of non-insured buyouts.

A 51-page response to the consultation summarises the Government’s April proposals, the views of respondents and the Government’s reasoning for the course of action on which it has now decided.

At a glance

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Key Actions

- **Parties to a corporate transaction involving a defined benefit scheme**
  Carefully consider how the imminent legislation and regulatory guidance might affect the corporate transaction and prepare accordingly. This could include building Pensions Regulator ‘clearance’-related matters into the overall time line.

- **Trustees of defined benefit schemes on becoming aware of a relevant corporate transaction**
  Take advice on the extent to which the new provisions may further assist the trustees in ‘securing the pension promise’. For example by obtaining better cash funding and/or other mitigation from the scheme sponsor.

The Detail

The Government has decided to implement its proposals to extend the moral hazard powers but in a significantly different manner than had been proposed when Parliament broke up for the summer recess. The core proposals are little changed from those set out in April except for two important changes in relation to the new ‘material detriment’ test (see below):

- the new test is expected to apply in limited situations – the original intention had been that the limitations would only apply from 14th April 2008 until the legislation came into force; and
- the situations themselves will be documented in a new Pensions Regulator Code of Practice.

A 51-page response to the consultation summarises the Government’s April proposals, the views of respondents and the Government’s reasoning for the course of action on which it has now decided.
Pensions Bill changes

The Government’s intention now is for much of the detail to be set out in the Pensions Bill. This follows widespread opposition both from within and outside Parliament to the Government’s original plans to take potentially wide-ranging powers in primary legislation and fill in the detail by regulations.

The amendments to the Bill provide, in relation to Contribution Notices, for:

- the Pensions Regulator to be able to issue a Contribution Notice if an act or failure to act has “detrimentally affected in a material way the likelihood of the accrued scheme benefits being received”;

  This new ‘material detriment’ test is an alternative (not a replacement) to the current ‘debt avoidance’ test – it means that the Pensions Regulator will also be able to consider the effect of the act or failure to act, rather than just the intention behind it;

- the introduction of a statutory defence in relation to the material detriment test;

  This will prevent the Pensions Regulator from issuing a Contribution Notice if the party concerned can demonstrate that before becoming a party to the act or failure to act it gave “due consideration” to the extent to which the act or failure might result in material detriment; it took “all reasonable steps” to eliminate or minimise the potential detrimental effects; and that, having regard to all relevant circumstances then prevailing, “it was reasonable for [it] to conclude” that there was no material detriment;

- extension of the existing reasonableness criteria that restrain the Pensions Regulator from action under either test;

  The Pensions Regulator will be required to always have regard to the reasonableness of the person’s actions in the circumstances and where relevant to have regard to the value of benefits received directly or indirectly by that person from the employer of the scheme and the likelihood and extent to which relevant creditors will be paid;

- the removal of the ‘good faith’ defence from the debt avoidance test – although this is mitigated somewhat by the extension of the existing reasonableness criteria; and

- Contribution Notices to be issued in respect of a cumulative series of acts or failures to act as well as in respect of a single act or failure to act, even if each part of the series may not justify a Contribution Notice in its own right.

The Pensions Bill amendments also confirm two announcements made in April whereby the Pensions Regulator will be able to:

- issue Financial Support Directions after looking at financial resources across the whole group of connected companies;
Presently, a Direction can be frustrated if no single company in the group, when combined with the employer directly sponsoring the scheme, has sufficient resources to meet the conditions – even if the corporate group as a whole does; and

- issue a Contribution Notice after a bulk transfer has taken place where a Contribution Notice could have been issued but for the fact of the bulk transfer. This protective provision is now also to be extended to Financial Support Directions.

Comment  Although the Government has listened to the responses it received during and following the formal consultation, the proposals in the Bill are little altered from those set out in April. The yet to be published draft Code of Practice is now the key document.

The Government also intends to consult on extending from 12 to 24 months the Regulator’s look back period when deciding whether the conditions have been met to impose a Financial Support Direction. Any action in this area will be through amendments to existing regulations.

A new Code of Practice

Significantly, a new Code of Practice, the bare outline of which has been announced by the Pensions Regulator, is intended to limit when the Pensions Regulator can apply its new ‘material detriment’ powers – the expectation being that it will be only in the following circumstances:

- the transfer of the scheme out of UK jurisdictions;
- the transfer of the sponsoring employer out of UK jurisdictions if by doing so there is a material reduction in the level of employer support or legal and regulatory protection for scheme members;
- the severing of employer support for the scheme so that employer support is removed, substantially reduced or becomes nominal;
- the transfer of liabilities of the scheme to another scheme or arrangement which does not have sufficient employer support or is not sufficiently well funded; and
- a business model or the operation of the scheme in such a way that is designed to create a financial benefit for the employer or some other person from the scheme, but where inadequate account has been taken of the interests of the members of the scheme, including where risks to members are increased.

Comment  These circumstances are very similar to those proposed in April but they now apply on a permanent rather than transitional basis. This is a welcome development but the concerns about what precisely will be caught remain and are unlikely to be displaced until the draft Code is published.

To support the extended moral hazard regime the Pensions Regulator intends to make some changes to its current clearance guidance – in particular setting out information on using the statutory defence.
Implementation

As initially proposed, the new powers are to have retrospective effect from 14th April 2008, other than the clarification that a Contribution Notice can be issued after a series of cumulative events, which is to be backdated to 27th April 2004.

Most of the changes will come into force when the Pensions Bill receives Royal Assent (expected this November). However, those matters linked to the new material detriment test will need to wait for the draft Code of Practice to be issued for formal consultation after Royal Assent and once finalised to complete its 40-day ‘sitting time’ in Parliament.

Comment

Many will welcome the Government’s fresh approach to implementation. But the main concern now is to ensure that the Pensions Regulator’s Code of Practice is drafted with sufficient clarity that parties do not feel compelled to seek clearance when the Government intends they should have nothing to fear from the new powers.

Whilst trustees should always seek mitigation for material detriment, until these changes were proposed in April it did not follow that employers should always grant it. Until the draft Code is available an essential part of the new regime remains unclear.

Companies will be especially concerned that the measures, once clarified, do not create undue difficulties where they have large pension responsibilities and, in the current financial climate, need to attract additional capital.

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