

Code of practice No. 12

Circumstances in relation to the material detriment test

Consultation response

May 2009

www.thepensionsregulator.gov.uk 

Contents

Executive summary	3
Main changes to the code as result of consultation.....	3
Introduction	4
Draft code and consultation.....	5
Response to consultation	6
Summary of responses to questions	6
General themes raised in the responses.....	8
Appendix A: Summary of detailed consultation responses	10
Appendix B: Illustrative examples of application of the code	12
Appendix C: List of respondents to consultation, and stakeholder representative groups engaged	14

Executive summary

There has been much market innovation in dealing with pension scheme risk over the last four years. Whilst innovation is welcome, during the course of 2008, the Government recognised that some market changes had introduced new risks to members' benefits and to the Pension Protection Fund (PPF).

The government, therefore, legislated to ensure that the anti-avoidance powers of the Pensions Regulator (the regulator) remained applicable and appropriate to mitigate unacceptable risks and to correct weaknesses in the existing powers.

The amendments to the powers require¹ the regulator to produce a code of practice ('the code') to set out the circumstances where the regulator expects to apply the new material detriment test.²

The draft code was issued for consultation³ from 15 December 2008 to 6 February 2009. The regulator received 29 formal responses along with feedback from various stakeholders at face-to-face meetings. Responses were generally supportive of the code. However, concerns were raised about the clarity and breadth of the definitions of the circumstances and their potential to capture routine business transactions. Some of this concern was linked to uncertainty on how the code operates within the context of the legislative framework and its safeguards.

The code has been developed and amended taking on board the comments made during the consultation process. The regulator also intends to take up suggestions to produce specific guidance for employers, and illustrative examples to aid interpretation of the code.

Main changes to the code as result of consultation

- The code has been restructured to ensure that it is clear and accurately reflects the policy intent.
- The addition of the concept of 'replacement' of the employer to the circumstance dealing with the transfer of the sponsoring employer out of the jurisdiction.
- Changing of 'sufficient' to 'significant reduction' in sponsor support in relation to the transfer of liabilities of the scheme.
- Replacement of the term 'employer' with 'sponsor' support, and its consistent application throughout the code.
- Explanation for all legislative referencing.
- Further clarifications of defined terms.

The code of practice is currently laid in Parliament and the Northern Ireland assembly. Both are publicly viewable documents.

¹ Section 90(2)(aa) The Pension Act 2004; article 85(2)(aa) P(NI)O 2005. References to legislation dealing with the material detriment test introduced by the Pensions Act 2008 are not yet in force. The government intends to bring this power into force by commencement order.

² Contribution notices issued where the regulator is of the opinion that an act or failure '[has detrimentally affected in a material way the likelihood of accrued scheme benefits being received (whether the benefits are to be received as benefits under the scheme or otherwise)'; section 38A(1) of the Pensions Act 2008

³ <http://www.thepensionsregulator.gov.uk/pdf/MaterialDetrimentCOPConDoc.pdf>

Introduction

The Pensions Act 2008 and the Pensions (No.2) Act (Northern Ireland) 2008 amended the regulator's anti-avoidance powers in order to ensure that they remain fit for purpose. There is a requirement to review the material detriment test and the statutory defence, within four years of their commencement⁴.

The government's main concern which led to the amendments arose from *"the emergence of new business models, which among other features, may reduce the security provided by the pension scheme's sponsor employer. This may be detrimental to scheme members' benefits, and have a cost consequence for the Pension Protection Fund (PPF), and those responsible for paying the risk-based levy... There was also a particular concern that the models had highlighted weaknesses in the current legislation."*⁵

The government held an eight week consultation on changes to deal with these risks from 25 April 2008. As a result the government concluded that it was impossible to define the models that caused concern, in a meaningful way. The government, therefore, determined that the most appropriate way to tackle the risk was to amend the anti-avoidance powers whilst ensuring that legislation included appropriate safeguards and requirements to appropriately target the use of these powers.

The legislative changes proposed included a new ground for issuing a contribution notice on the basis of the regulator being of the opinion that the act, or failure to act, has been materially detrimental to the likelihood of the accrued scheme benefits being received.⁶

Over the summer the government worked with stakeholders to refine the proposed legislation and safeguards which include:

- A list of factors the regulator must consider when relevant to determining whether an act or failure is materially detrimental
- A requirement for a statutory code of practice setting out the circumstances in which the regulator intends to use its power
- An opportunity for parties to raise a statutory defence
- Additional reasonableness factors as well as a new mandatory reasonableness test

The code of practice is intended to narrow the application of contribution notices in relation to the material detriment limb and give greater clarity of the regulators approach. A draft of the code of practice was developed during the consultation with certain stakeholders, drawing on the statement that the regulator produced in April 2008.

The amendments to the Pensions Act 2004 ('the 2004 Act') were debated in the House of Lords in October 2008. A draft version of the code was published at the same time that amendments were laid so that parties could understand the aim of the legislative safeguards in their entirety.

⁴ Section 127 Pensions Act 2008

⁵ Paras 2 and 4, 'Amendments to the anti-avoidance measures in the Pensions Act 2004: Government response to the Consultation, October 2008' at:

www.dwp.gov.uk/consultations/2008/govt-response-tpr-powers.pdf

⁶ Section 38A(1) The Pensions Act 2004; article 34A (1) P(NI) O 2005

In practice any party who believes that they are at risk from a contribution notice on the ground of material detriment should consider all the legislative safeguards alongside the code, as the regulator can only issue a contribution notice when all the relevant conditions set out in legislation are met, and no statutory defence has successfully been raised.

The regulator began formal consultation on the draft code on 15 December 2008. In addition to the 29 written responses, we also held 10 face to face meetings with stakeholder representative bodies to discuss issues raised by the code in more detail. We received much useful feedback not only on the clarity and effectiveness of the code itself but also its interaction with the other legislative safeguards. We have, therefore, dealt with some of these issues in our response. We would like to thank everyone who took the time to express their views and help us improve the code of practice.

Subject to parliamentary approval we believe that the code, and the associated powers, will commence by the summer of 2009. We aim to publish further guidance and examples at this time.

Draft code and consultation

The regulator published a statement in April 2008, when the policy intent of the amendments to the powers was being considered. This set out the actions or situations in relation to which the regulator would consider use of any amended powers before they commence, in order to provide parties with greater certainty on the application of the powers in this period.

When legislation was drafted and it became clear that a code of practice would be required in this area, the regulator worked with certain stakeholders to develop a draft code based on the situations published in April 2008. This draft was published on 20 October 2008.

As stated above, formal consultation on the draft code commenced on 15 December 2008 and ran for 8 weeks until 6 February 2009. The regulator received 29 formal responses and held 10 face to face meetings.

A list of formal respondents and stakeholder engagement can be found in Appendix C.

In addition to the draft code of practice, the consultation document provided:

- background to the material detriment test;
- context of where the code sits within the legislative framework, including the operation of the statutory defence;
- an explanation of the contents of the code;
- an indication of further guidance that may be provided; and
- an outline of the regulatory timetable.

Response to consultation

We asked four specific questions in the code consultation document and we have sought to summarise the answers to these questions below, as well as picking up some common themes. Further specific and useful comments on the drafting of the code have been detailed in Appendix A.

General comments on the code taken from a cross-section of respondents

'We support the recent change in legislation to extend the protection given to pension scheme members and the introduction of the new code of practice.' *Hymans Robertson*

'The NAPF supports the governments stated aim... However, we are concerned that the continued provision of defined benefit pensions in the UK is not inadvertently discouraged by the granting of powers which may be unnecessarily wide.' *NAPF*

'TPR has a track record of demonstrating that these moral hazard powers will only be used where appropriate.' *ICAEW*

'...reservations about uncertainty of scope are not fully assuaged by the terms of the code of practice, however [we] welcome the reassurance as to the proposed application of the material detriment test within the consultation document.' *BVCA*

'We support the introduction of the code of practice as it provides additional security for members of occupational pension schemes.' *Royal Mail Pension Trustees*

Summary of responses to questions

Question 1: Does this draft code meet the requirements of the Acts⁷?

All but one respondent agreed that in their view the code met the requirements of the Acts.

A few respondents considered that the circumstances needed to be more tightly defined, and should make reference to 'new business models'. Most respondents supported the view that the code needed to be appropriately drafted to ensure that actions that might bring about unacceptable levels of risk are covered, and to ensure that the code was not so prescriptive in nature that it created its own loopholes as well as ensuring that the code could deal with future risks as far as possible.

The regulator is satisfied that the code discharges its legal obligation under the 2004 Act.⁸

Question 2: Does the code identify correctly those circumstances where the regulator should consider the use of the material detriment test?

Although there were some questions about definition and the scope of the code, respondents agreed that the correct circumstances had been identified. Where we were able to discuss the circumstances more generally in bilateral meetings, stakeholder representative groups all agreed that the circumstances could raise unacceptable risks for members' benefits and the PPF.

⁷ The 2004 Act as amended by the Pensions Act 2008; and related Northern Ireland legislation

⁸ Section 90(2)(aa) PA2004; article 85(2)(aa)P(NI)O 2005

Question 3: Do you think the circumstances described include any areas where the regulator should not be considering use of the material detriment test, and if so, how should the circumstances be narrowed?

This was the area of greatest concern for respondents: some felt that the circumstances were unclear, open to interpretation and that there was a risk that ordinary corporate transactions may be caught by the code.

The regulator welcomed these comments and has used this feedback to ensure that the code captures the intended scope of the risks we are seeking to mitigate by considering a contribution notice on this new ground. Appendix A provides more detail on these comments.

It appears from many responses that the intended application of these powers and the interaction with other legislative safeguards has not been fully understood. As a result we have taken steps to simplify the structure of the code to demonstrate more clearly how it sits in the wider legislative context. In addition we will be publishing examples and information which we hope will provide the necessary comfort to employers.

Question 4: Are there any further circumstances which you think may present unacceptable risks to members' benefits or the PPF where the regulator should consider the material detriment test?

None of our respondents identified any additional circumstances or areas of risk which should be captured in the final code.

General themes raised in the responses

These themes relate to comments either directly made by respondents or discussed in the stakeholder meetings.

‘New business models’ and ‘routine business transactions’

A handful of respondents suggested that it would be necessary to refer to ‘new business models’ or ‘non-insured buyouts’ within the code in order to differentiate the circumstances in which the regulator expects to act from ‘routine business transactions’. The government considered this point during the spring consultation and worked with stakeholders to establish if such models could be described. No workable definition was found which could mitigate the risk, without other unintended consequences. The government, therefore, concluded that the most appropriate course of action was to amend the legislation and add in further safeguards including the requirement for a code of practice. The resulting legislation is focused on the risks that tend to be associated with such models rather than the models themselves, and therefore, it is not appropriate to refer to the models in the code.

It is not the aim of the amended contribution notice powers to capture ‘routine business transactions’. The code, legislative safeguards and statutory procedures offer protection to those undertaking such transactions. The regulator intends to publish more information and examples to assist parties in their understanding of the application of the material detriment test. Appendix B contains example types.

How the code relates to material detriment and statutory defence

Some parties appeared confused about the purpose of the code; for instance certain respondents expected that the code would explain what material detriment was and how it related to the legislation. The code sets out the circumstances in which the regulator expects to issue a contribution notice⁹ as a result of being of the opinion that the material detriment test is met.

We simplified the structure of the code to make its purpose in relation to the requirements of the Pensions Act 2004 and equivalent Northern Ireland legislation clearer. Material detriment and consideration of reasonableness are legislative tests which the regulator must consider before issuing a contribution notice. These tests should be considered alongside the code as the regulator will only have the power to issue a contribution notice when all the relevant conditions set out in legislation are met, and no statutory defence is successfully raised.

Legal status of the code

The legal status of the code was questioned during stakeholder meetings. The regulator will take the relevant part of the code into account when considering issuing a contribution notice under the material detriment test. The code must be taken into account by a court or tribunal, if it is relevant to the matter being decided. The code sets out how the regulator expects to act. It is possible that in exceptional circumstances the regulator may wish to act outside the circumstances set out in the code. However, the regulator would still need to meet all the underlying legal requirements and demonstrate why it was reasonable for it to be acting outside the code.

⁹ See sections 38 and 38A The 2004 Act; articles 34 and 34A [P(NI)O 2005]

Information for employers and other parties

Some respondents raised concerns that the operation of the code was unclear and that employers would not be able to easily understand their duties in this area. They believe undue expense would be incurred through the cost of legal advice and clearance applications (see below) in respect of ordinary corporate transactions where the regulator should not be seeking to issue contribution notices.

If employers are concerned about the possibility of a contribution notice on the grounds of the material detriment test they may take comfort in the ability to raise a statutory defence, if they have undertaken appropriate due diligence. This encompasses giving appropriate consideration to the impact upon the scheme, documenting decisions, and where necessary, providing appropriate mitigation for the scheme. Where parties require further certainty, they have the option to apply to the regulator for clearance.

We explored the issue of guidance and further information more fully during the face-to-face stakeholder meetings. In addition, over half of the written responses included requests for further information and illustrative examples. Therefore as well as updating current guidance, we are looking to produce a high-level overview for employers as well as illustrative examples.

Increase in clearance

Some of the respondents who believed that the circumstances in the code lacked clarity argued that this would result in an increase in applications for clearance. The regulator believes that the changes made to the drafting of the code provide sufficient clarity about the circumstances in which the regulator expects to use this power.

These amended powers are retrospective to 14 April 2008 and have been subject to consultation and parliamentary scrutiny since this date. Parties have been able to apply for clearance in relation to conduct and/or circumstances in so far as this would relate to their conduct that may have been subject to the proposed changes. To date the regulator has only received a handful of enquiries in relation to the new powers, and has not experienced an increase in clearance applications related to these changes.

Appendix A: Summary of detailed consultation responses

Respondents provided detailed comments on the drafting of the code, as summarised below.

Concept of 'severing'

The inclusion of the word 'severing' within the circumstance (iii) of the draft code, which deals with employer support being substantially reduced, was believed to be confusing by the majority of respondents. The regulator has carefully considered this feedback and has removed the word 'severing' from this circumstance.

Concept of 'sufficient'

The use of the word 'sufficient' to describe appropriate levels of employer support or scheme funding in liability transfer exercises was judged too vague by many of our respondents. Additionally, some respondents thought this would better be described as a relative test so that the definition looked to worsening of circumstances as the result of a transfer. We have taken this suggestion forward and re-drafted this as a test of 'significant reduction'.

Use of the term 'employer'

Respondents observed that the use of the word 'employer' to describe the covenant associated with a scheme was inconsistent throughout the code. We have sought to rectify this by use of the term 'sponsor support' where appropriate and to define that term within appendix A of the code.

Inadequate account of members' benefits

Some respondents believed that the concept of taking 'inadequate' account of members' benefits was inappropriate and that the concept of 'proper' account of members' interests within a scheme was a better definition. We agreed, and have made this change.

Moving of the scheme outside jurisdiction

A few of our respondents asked for a further definition of the mechanisms by which a scheme could be moved out of jurisdiction, which would thereby be covered by this circumstance. We believe that adding a further detailed description to the definitions would make the test more complicated to understand. In addition it would be difficult to ensure that any such definition could cover all mechanisms by which a scheme could move out of jurisdiction. It was also considered that a more prescriptive approach may in itself create loopholes that could be exploited.

'Transfer' of the sponsoring employer outside jurisdiction

Two respondents pointed out that the concept of 'transfer' may not fully operate when considering the moving of the sponsoring employer out of the legal jurisdiction, as this could be achieved by dissolving or removing one employer and replacing that entity with another. We therefore added in the concept of the 'replacement' of an employer.

‘Substantially reduced’

Many respondents commented that ‘substantially reduced’ is a wide term and could encompass much routine business behaviour. We have considered alternative definitions for this term: however, options such as removing the term ‘substantially reduced’ altogether merely create a loophole which those who wish to abandon a scheme could exploit. We believe that the term ‘substantially reduced’, particularly when considered in the context of ‘removed’ and ‘nominal’, implies that the reduction is major, non-routine and could lead to the virtual abandonment of the scheme.

Those who financially benefit from the scheme

Almost half the respondents raised concerns that those undertaking normal scheme transactions could fall foul of the fifth circumstance of the code, which targets asymmetric risk. We do not believe this is the case. Respondents highlighted particular transactions that they believe would be at risk in this area and we are developing illustrative examples to reassure parties in this regard (see Appendix B).

Referencing

A few respondents were disappointed that the code referred back to legislation without explaining what it meant. Our aim is to ensure that the code is user-friendly and easy to understand, so we have taken steps to explain all necessary terms and legislation in the code. Footnotes now reference particular definitions and requirements back to the legislation for certainty in interpretation.

Appendix B: Illustrative examples under development

Several respondents and most of the stakeholder representative groups that we spoke to said it would be very useful for the regulator to provide illustrative examples that would show how the code, and consideration of the new material detriment test for contribution notices, will work in practice. We have outlined some examples in development below for illustrative purposes only, which we will build upon for when the code commences.

The types of transactions or situations which respondents raised included the following:

Payment of dividends to parent company

Company A is trading profitably and the associated pension scheme has a deficit which is being address by an appropriate recovery plan. Directors make a routine annual dividend payment to shareholders in the normal course of business.

Routine dividends in these circumstances would not normally be materially detrimental to the likelihood of members receiving their accrued benefits.

Buy-outs and Annuities

The trustees of Scheme B have chosen to buy out pensioner liabilities by annuities. The Trustees discharge the scheme liabilities through the purchase of annuities from a regulated insurer so that the insurer assumes responsibility for making payments of members' benefits. The trustees took proper account of members interests in deciding to discharge the liabilities, and conducted due diligence when selecting a product and insurer.

De-risking in this way, with appropriate account being taken of the beneficiaries of the scheme would not normally be materially detrimental to the likelihood of members receiving their accrued benefits.

Investment strategy

The trustees of Scheme C and representatives of the sponsoring employer agree an investment strategy in light of the employers ability to cover any shortfall.

A properly chosen, compliant investment strategy and prudent funding assumptions taking into account the employers ability to cope with adverse experience, is unlikely to be materially detriment to the scheme in most circumstances.

The regulator has identified further examples for development:

General poor trading

Employer E has experienced poor trading as a result of market conditions, and consequently has lost a major customer to its competitors.

It would not normally be appropriate for the regulator to impose a contribution notice on material detriment test grounds for poor trading because of market conditions.

Granting of security

Employer F grants security in the form of a first charge over some of its assets to renegotiate its borrowings with the bank. In so doing, the employer engages with the scheme trustees and provides appropriate mitigation to the scheme for the reduction in covenant.

Under the circumstances outlined, these actions would not normally be materially detrimental to the scheme.

Note: The examples in this document are for illustrative purposes only. The outline circumstances in these examples should not be directly applied to actual circumstances where other and more detailed considerations will exist. It is also noted that these examples look at situations in isolation. It may be that some of the situations above taken together, with other acts or failures to act, may constitute a series which could be materially detrimental.

Appendix C: List of respondents to consultation, and stakeholder representative groups engaged

100 Group – Edward Weiss
ABI – Hayley Shipman
ACA – Peter Williams
Alan Hayman – pension scheme member
APL – Charles Cameron
BP Group – Nick Bamfield
Buck Consultants – Jasmine Roncesvalles
BVCA – Richard Lomas
CBI – Mario Lopez-Areu
Eversheds – Tim Smith
HBOS – Robert Baxter
Hewitt Associates Ltd – Peter Williams
Hymans Robertson – Brian Nimmo
ICAEW – Liz Cole
IoD – Kathryn Allix
Mercer – Eleanor Dowling
NAPF – Alan Chart
Norwich Union – Mrs A O'Brien
Oxford University – Sam Ellis
Pensions Secretariat Services Ltd – Mr C A Amos
PMI – Stella Williams
Royal Mail Pension Trustees Ltd – Peter Metcalfe
Sacker & Partners – Georgina Beechinor
Sainsbury Pension Fund – Steve Bradbury
SPC – John Mortimer
TISA – Dee Wastnedge
Towers Perrin – Eileen Presser
TUC – Alice Hood
Watson Wyatt – Graham Everness

Stakeholders engaged face-to-face:

100 Group
ABI
ACA
APL
BVCA
CBI
GMB
IFT
IoD
NAPF
TUC
UNITE