

# Code of practice 12: Application of the material detriment test

Consultation document

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## **Introduction**

This is a consultation document on the code of practice which outlines when the Pensions Regulator ('the regulator') expects to issue contribution notices under the new material detriment test.

The material detriment test was introduced by the Pensions Act 2008 ('the Act') on 26 November 2008 and will come into force at the same time as the code of practice.<sup>1</sup>

The Act requires the regulator to publish a code of practice relating to the circumstances in which it expects to issue contribution notices as a result of being of the opinion that the material detriment test is met in relation to an act or failure to act.<sup>2</sup>

The full text of the proposed code of practice follows in Appendix A.

## **Background to the material detriment test**

The Act introduced changes to the regulator's contribution notice and financial support direction powers which adapt the powers available to the regulator since April 2005.

The Government's amendments were designed to adapt the regulator's powers to an evolving pensions market, seeking to ensure that the anti-avoidance measures remain appropriate and effective.<sup>3</sup> In particular the material detriment test has been introduced in response to the emergence of new business models, as alternatives to standard pensions buyout. These new business models may, among other features, reduce the security provided by the pension scheme's sponsoring employer. This can be detrimental to scheme members' benefits, and have a cost consequence for the Pension Protection Fund (PPF) and for those responsible for paying the risk-based levy. The risks represented by these models may not be within the power of trustees to address.

New business models are often complex and some of the steps they undertake, when taken in isolation, are indistinguishable from ordinary corporate activity. This has meant that it has proved impossible to define the models in a meaningful way. The Government therefore considered that the most appropriate way to tackle the

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<sup>1</sup> The material detriment test was introduced by section 126 and Schedule 9 of the Act amending section 38 of the Pensions Act 2004

<sup>2</sup> See section 90(2)(aa) of the Pensions Act 2004 as amended by paragraph 3 of Schedule 9 of the Pensions Act 2008

<sup>3</sup> See sections 126 and Schedule 9 of the Act

emerging risks was to amend the existing anti-avoidance provisions, including introducing the material detriment test, to enable the regulator to keep pace with the evolving market.

On 25 April the Government published a consultation document which set out its policy proposals to amend the regulator's powers.<sup>4</sup> The response document can be found at <http://www.dwp.gov.uk/consultations/2008/govt-response-tpr-powers.pdf>.

This consultation by the regulator on the code is on the appropriateness of the draft code in delivering the policy and legislative intention.

The Government and the regulator have been clear in their announcements that the changes to the contribution notice power are expected to impact upon only a small number of schemes where pension liabilities are being actively avoided or put at unacceptable risk. The regulator has a statutory requirement to use its powers reasonably, and it is not our intention that by implementing the new powers we will hamper appropriate market activity or innovation.

## **Context**

Consideration of the code of practice is one step that the regulator must take in order to decide whether to issue a contribution notice. Where a contribution notice under the new material detriment test is being considered, there is a series of protections for companies, individuals and other parties including, three layers of legislative filters, and a consideration of the reasonableness of issuing the notice. Where parties feel more certainty is necessary, it is possible to apply for clearance in respect of a particular transaction.

The three legislative filters to ensure that the material detriment test are appropriately targeted are as follows:

- First, the regulator is required to publish a code of practice relating to the circumstances in which the regulator expects to issue contribution notices as a result of being of the opinion that the material detriment test is met in relation to an act or failure;
- Secondly, the test would engage only where there is a material detriment to the likelihood that members will receive accrued scheme benefits; and

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<sup>4</sup> 'The powers of the Pensions Regulator – Amendments to the anti-avoidance measures in the Pensions Act 2004'

- Thirdly, the Act has introduced a statutory defence: this provides that a contribution notice must not be issued on grounds of material detriment if the regulator is satisfied that certain conditions for the defence are met.

Those conditions provide for a three-step process for establishing a defence. It requires that:

- Before becoming party to an act or failure, the person gave due consideration to the extent to which there may be a resulting material detriment to the likelihood that the pension scheme members would receive their accrued benefits;
- Where as a result of that consideration there was considered to be a potential detriment, that the person should take all reasonable steps to eliminate or minimise the potential detrimental effects that the act or failure might have on the likelihood that the pension scheme members would receive their accrued benefits; and
- At the time of the act or failure the person, having regard to all the relevant circumstances prevailing at that time, could reasonably conclude that the act or failure would not detrimentally affect in a material way the likelihood of members' accrued benefits being received.

This approach allows the relevant party to demonstrate with evidence that it was reasonable to conclude at the time that the effect of the act or failure to act would not be materially detrimental.

The regulator expects that the sorts of due diligence and discussions with trustees that are already undertaken by responsible employers would in many cases satisfy the statutory defence. Further information about assessing the impact of a transaction, including covenant reviews and discussions with trustees, is available in the regulator's clearance guidance.

In addition to the above, the regulator cannot issue a contribution notice to any person unless the regulator decides it is reasonable to do so. The legislation lists certain factors that the regulator must have regard to where relevant, and this has been extended to include any benefit from the employer or the scheme, and the outcome for other creditors. There is also a new mandatory requirement for the regulator to consider the reasonableness of the person's actions in the circumstances.

The existing clearance regime will continue to be available in relation to type A events to provide assurance that contribution notices or financial support directions will not be used in relation to particular events. 'Clearance' is the term used to describe the voluntary process of obtaining a clearance statement from the Pensions Regulator. A clearance statement gives assurance that, based on the

information provided, the regulator will not use its anti-avoidance powers to issue, to the applicants for clearance, either contribution notices or financial support directions in relation to a particular event. Events include transactions, agreements, decisions, and other acts or failures to act.

The regulator's planned guidance materials will address subjects including the statutory defence to the material detriment test, some practical guidance on transactions that might fall within the second ground for contribution notices (following the removal of 'otherwise than in good faith').

## Content of the code

It may be useful to consider the aim of the definition of circumstances in considering whether improvements could be made to their drafting:

- (i) The transfer out of the jurisdictions of the United Kingdom of the scheme.
- (ii) The transfer out of the jurisdictions of the United Kingdom of the sponsoring employer if by doing so there is a material reduction in the level of **employer support** or legal and regulatory protection for scheme members.

These first two paragraphs aim to ensure that we identify circumstances in which a change in jurisdiction reduces or removes the protection of the UK regime including the regulator and the PPF. Neither these provisions nor any else in this code should be taken as affecting EU rights and obligations.

- (iii) The severing of **employer support** for the scheme so that **employer support** is removed, substantially reduced or becomes nominal.

This wording originates in our abandonment guidance to cover the removal or substantial reduction of overall employer support by any method. Does this description enable us to capture situations where schemes are being abandoned or placed at substantial risk?

- (iv) 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.

This aims to capture all situations where there is a transfer which results in significant risk to members' benefits.

- (v) 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.

This currently is the closest to a definition of what is commonly understood as a new business model. However, it may not happen in all cases, and this situation may only arise once other risks have occurred, for example scheme abandonment or other transactions which are materially detrimental. Therefore we believe it is necessary to include the other circumstances above.

## **Timetable**

The regulator published draft content for the code of practice on 20 October 2008 to help inform consideration of the amendments. The circumstances in the draft code of practice are the same circumstances contained in the regulator's publication on 20 October 2008.

Once the consultation period has ended, if the regulator determines to proceed, it must send the code to the Secretary of State for his approval and it is then laid before Parliament for a period of 40 days. During that period, if neither House resolves that further proceedings need to be taken on the draft code, then the Secretary of State may by Order bring it into force.

The Act provides that the material detriment test will be brought into force by a commencement order, and the Secretary of State intends to commence it at the same time as the final code of practice comes into force. The Act further provides that the material detriment test will apply retrospectively to 14 April 2008. Until the code comes into force, the regulator's statement of 25 April 2008 continues to apply in relation to the application of the new test.

## **Consultation questions**

The full text of the proposed code of practice follows in Appendix A.

We welcome views on the code of practice and particularly on the following matters:

- i) Does this draft code meet the requirements of the Act?
- ii) Does the code identify correctly those circumstances where the regulator should consider the use of the material detriment test?
- iii) 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?

- iv) 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?

## Responding to the consultation

Responses may be made in either of the following ways:

- By email to [materialdetrimentcode@thepensionsregulator.gov.uk](mailto:materialdetrimentcode@thepensionsregulator.gov.uk)
- By post to Carl Davey, The Pensions Regulator, Napier House, Trafalgar Place, Brighton BN1 4DW

We may need to share the feedback you send us within our own organisation or with other Government bodies. We may also publish this feedback as part of our response to the consultation. If you wish your comments to remain anonymous, please state this explicitly in your response.

If you wish your response to be kept confidential, please make this known and we will take the necessary steps to meet your request. However, please be aware that, should we receive a formal request under Freedom of Information legislation, we may be required to make your response available.

When responding, please advise whether you are responding as an individual or on behalf of an organisation (and if the latter, which organisation).

## Closing date

The closing date for this consultation is **Friday 6 February 2009**.

The consultation has been limited to a period of 8 weeks on the grounds that the draft list of circumstances which forms the basis of this code has been in the public domain for some time; there has been extensive consultation on the policy intent behind the new test and the code, and we have worked closely with representative industry bodies in preparing the list of circumstances.

## Enquires about specific situations

This consultation is about the principles and drafting detail of the code of practice. If you have any questions about a particular transaction that you are involved in, the regulator is able to answer enquiries sent to:  
[clearance@thepensionsregulator.gov.uk](mailto:clearance@thepensionsregulator.gov.uk).

The material detriment test and other changes introduced by the Pensions Act 2008 have not changed the way in which the regulator operates clearance.

## Appendix A

### Draft code of practice 12: Application of the material detriment test

#### Introduction

- i. This code of practice is issued by the Pensions Regulator, the body that regulates work-based pension schemes.
- ii. The Pensions Regulator's statutory objectives are to protect the benefits of pension scheme members, to reduce the risk of calls on the Pension Protection Fund (PPF), and to promote the good administration of work-based pension schemes.<sup>5</sup>
- iii. The Pensions Regulator has a number of regulatory tools, including issuing codes of practice, to enable it to meet its statutory objectives. The Pensions Regulator will target its resources on those areas where members' benefits are at greatest risk.
- iv. Codes of practice provide practical guidelines in relation to the exercise of functions under pensions legislation and set out the standards of conduct and practice expected of those who exercise such functions.<sup>6</sup>

#### Background and purpose of the code

- v. The regulator may issue a contribution notice only when it is of the opinion that:<sup>7</sup>
  - a. There is an act or failure a main purpose of which was to prevent the recovery of all or part of a section 75 debt which was or might become due from the employer in relation to the scheme;
  - b. There is an act or failure a main purpose of which was to prevent such a debt becoming due, to compromise or otherwise settle such a

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<sup>5</sup> See section 5 of the Pensions Act 2004

<sup>6</sup> See section 90(1) of the Pensions Act 2004

<sup>7</sup> See section 38 of the Pensions Act 2004 as amended by paragraph 2 of Schedule 9 of the Pensions Act 2008

debt, or to reduce the amount of such a debt which would otherwise become due; or

- c. The material detriment test is met.
  
- vi. The material detriment test is met in relation to an act or failure if the regulator is of the opinion that the 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).
  
- vii. This code of practice sets out the circumstances in which the regulator expects to issue contribution notices under the material detriment test.
  
- viii. The code is designed to help trustees, employers and other related parties to understand the practical application of the material detriment test. It does not relate to other functions of the regulator.
  
- ix. It is not the regulator's intention that the material detriment test for issuing a contribution notice must be considered for all corporate transactions. The regulator expects to consider the test in circumstances where there could be significant risks to members' benefits or the PPF, for example as the result of the potential abandonment of a scheme or the creation of models in which risk is underwritten by members or the PPF whilst others seek to profit from the arrangement.

### **Status of the code**

- x. When considering issuing a contribution notice under the material detriment test the regulator will take the relevant part of this code of practice into account. This code of practice is also admissible in evidence in any legal proceedings and must be taken into account by a court or tribunal where it is relevant to any question arising in those proceedings.<sup>8</sup>
  
- xi. In this code of practice, references to the law that applies in Great Britain should be taken to include corresponding legislation in Northern Ireland.

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<sup>8</sup> See section 90(5) of the Pensions Act 2004

## The circumstances in which the regulator expects to issue contribution notices

1. The circumstances in which the regulator expects to issue contribution notices on the **material detriment test** are any of the following (terms shown in **bold** are defined on the following page):
  - (i) The transfer out of the jurisdictions of the United Kingdom of the scheme.
  - (ii) The transfer out of the jurisdictions of the United Kingdom of the sponsoring employer if by doing so there is a material reduction in the level of **employer support** or legal and regulatory protection for scheme members.
  - (iii) The severing of **employer support** for the scheme so that **employer support** is removed, is substantially reduced or becomes nominal.
  - (iv) 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.
  - (v) 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.

## Defined terms

2. **Employer support** consists of:

- (i) the **scheme obligations** of the employer or any other person,  
and
- (ii) the likelihood of recovery in full for the scheme under the **scheme obligations**

so that if either or both of (i) and (ii) is reduced there is an overall reduction in employer support.

3. **Scheme obligation** is defined in the section 38A(5) of the Pensions Act 2004, as inserted by paragraph 2 of Schedule 9 to the Pensions Act 2008 .
4. The statutory defence to the material detriment test would also apply to each of the above circumstances.
5. **Material detriment test** means the new ground for contribution notices set out in section 38(5) and further detailed in section 38A of the Pensions Act 2004, as inserted by paragraph 2 of Schedule 9 to the Pensions Act 2008.

## Annex to code of practice

GB Legislation	NI Legislation
<b>The Pensions Act 2004 (c. 35)</b>	<b>Pensions Act 2004 (Northern Ireland) Order 2005 (S.I. 2005/255 (N.I. 1))</b>
Section 38	Article 34
<b>The Pensions Act 2008</b>	
Schedule ( <i>Contribution notices and financial support directions under Pensions Act 2004</i> ) of the Pensions Act 2008	