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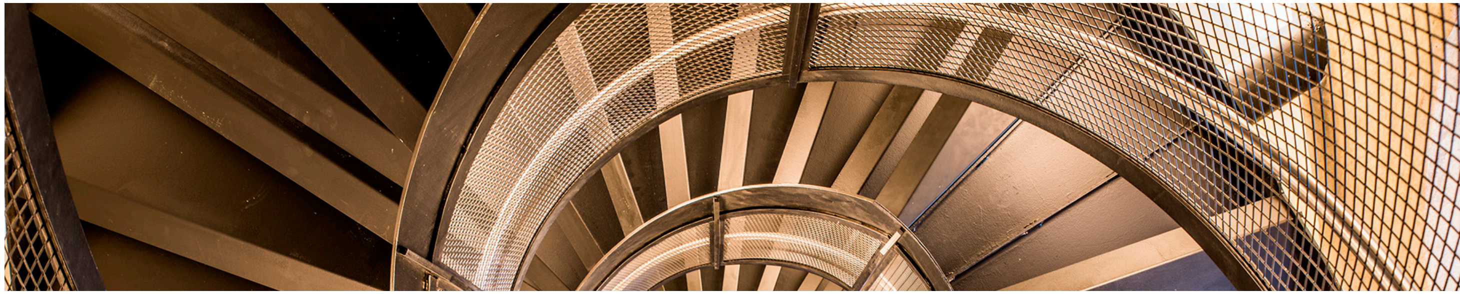
New powers for the Pensions Regulator: evolution or revolution?



In the wake of the BHS and Carillion scandals, and the ensuing criticism of the Pensions Regulator's "tentative and apologetic approach" in those cases, the Government promised to strengthen the Regulator's powers. The result is the Pension Schemes Act 2021, which received Royal Assent on 11 February.

The Act includes a package of measures aimed at bolstering the Regulator's powers to enable it to be more proactive. Many of the key provisions came into force on 1 October.

There has been a lot of dramatic media coverage of the Act, particularly in relation to the new criminal offences, with commentators concerned about the Regulator becoming too powerful, trustees being thrown in jail and potential trustees being scared away. Addressing these concerns, David Fairs, the Regulator's Executive Director for Regulatory Policy, Analysis and Advice, emphasised that the Regulator's new powers are not going to change the behaviour it investigates, even though they will fundamentally change the options available to the Regulator. David concluded that the new powers are evolutionary rather than revolutionary.

In this issue, we summarise the new regulatory framework and consider its impact on trustees and sponsoring employers of defined benefit (DB) pension schemes.

New criminal offences

The new criminal offences introduced by the Act have generated the most column inches. Given that the offences are punishable by an unlimited fine or up to seven years' imprisonment (or both) – and the Regulator can also impose a civil penalty of up to £1m on individuals who are party to such acts (including those who knowingly assist in the act) – this is perhaps unsurprising. The broad description of the offences has added to the concerns, with critics highlighting that routine business activity could be caught.

The Act provides for two new criminal offences, both of which apply to acts (or failures to act) occurring on or after 1 October 2021. The first of these, the offence of "**avoidance of employer debt**", will be committed if a person:

> does an act or engages in a course of conduct that prevents the recovery of a Section 75 debt, prevents a Section 75 debt becoming due, compromises or settles a Section 75 debt, or reduces the amount of a Section 75 debt that would otherwise become due; and

> intends the act or course of conduct to have such an effect; and

> does not have a reasonable excuse.

The second criminal offence introduced by the Act, that of "**conduct risking accrued scheme benefits**", will be committed if a person:

> does an act or engages in a course of conduct that detrimentally affects in a material way the likelihood of accrued scheme benefits being received;

> knew or ought to have known that the act or course of conduct would have that effect; and

> does not have a reasonable excuse.

Taken literally, the scope of these offences is very wide. For example, continuing a scheme rather than winding it up "prevents a Section 75 debt becoming due" and an investment decision that results in losses to the scheme could "detrimentally affect in a material way the likelihood of accrued scheme benefits being received". It is also notable that any person can potentially commit the offences: they are not limited to employers who sponsor DB pension schemes (or those connected or associated with the employer).

However, we think properly managed businesses and well-advised trustees have little to fear from the new criminal offences. This is because:

> The Regulator would have to show that the accused had the required intention or knowledge. Where employers are carrying on legitimate "business as usual" and trustees are properly managing schemes having taken appropriate advice, this is likely to be difficult. In the example of an investment decision that results in losses to the scheme for instance, it would be highly unusual for the trustees to proceed with an investment decision where they know it will have a detrimental impact on the scheme.

- > Even if the Regulator can show the necessary intention or knowledge, the accused would be guilty only if they did not have a reasonable excuse for their behaviour. In the example of continuing a scheme rather than winding it up, trustees who (having taken legal and covenant advice) conclude that it is appropriate not to exercise a power to wind-up the scheme are likely to have a reasonable excuse.
- > During the passage of the Bill through Parliament, the Government minister (Earl Howe) confirmed that "it is absolutely not the Government's intention to interfere with routine business activities" and gave several examples of the types of acts that could fall within the criminal offences. These included: the purchase of a company, subsequent mismanagement of that company and extraction of value prior to it going into administration; and the stripping of assets from the employer, resulting in a substantial weakening of support for the scheme. The focus was clearly on more egregious forms of behaviour.
- > The Regulator itself has said that: "The intent of the new criminal offences is not to change commercial norms or accepted standards of corporate behaviour. Rather it is to tackle the more serious examples of intentional or reckless conduct that puts members' savings at risk".
- > In practice, we expect the Regulator to use its powers to issue contribution notices (CNs) and financial support directions (FSDs) before resorting to fines and prosecutions. The Regulator's statutory objectives include protecting members' benefits and the Pension Protection Fund; this is likely to be better achieved in most cases by providing financial support to the pension scheme itself in order to ensure benefits can be provided to members. It is also likely to be easier for the Regulator to pursue a CN or FSD, as it wouldn't need to show knowledge or intention and it would only need to prove the case on a balance of probabilities before the Determinations Panel (rather than beyond a reasonable doubt in the criminal courts).

Of course, there will be behaviour that will be caught by the new offences, such as the examples given by Earl Howe. And trustees and advisers who conspire with the employer to the detriment of the scheme are clearly at risk of prosecution too. This is certainly a fundamental change: the risk of criminal liability is a new and significant one for those involved with DB pension schemes.

Hopefully the risk of criminal sanctions will deter those acting at the boundaries of proper behaviour. It is also likely to push the DB scheme further up the agenda, perhaps leading to earlier, more proactive and more detailed consideration of the impact of financially significant decisions on the scheme.

However, the important point to recognise is that the change largely relates to consequences rather than scope: where the Regulator's arsenal was previously limited to issuing CNs and FSDs, it now has power to pursue criminal prosecutions as well. In practice, though, we think prosecutions are unlikely unless the behaviour of the accused has been outstandingly bad.

Contribution notices

Since 6 April 2005, the Regulator has been able to issue CNs and FSDs as a means of imposing DB funding liabilities on any employer who sponsors a DB pension scheme, and any person connected or associated with the employer. In the case of a CN, these potential targets include individuals as well as companies.

The Act makes several changes relating to CNs, most of which came into force on 1 October:

- > **New grounds for issuing a CN:** we consider these in more detail below.
- > **Changes to the reasonableness test:** the Regulator may only issue a CN if it considers it reasonable to do so having regard to certain "reasonableness" criteria. The Act amends these so that the Regulator must also consider:
  - > any failure to comply with the new corporate transaction notification requirements (this change is not yet in force); and
  - > the effect of the act or failure on the scheme's assets or liabilities.
- > **Change to the relevant time for calculating the amount due under a CN:** the amount payable under a CN can be anything up to the full buy-out deficit in the scheme. Previously, this was calculated as at the date of the act or failure. The Act changes this so that the buy-out deficit is calculated as at the end of the scheme year which ended most recently before the Regulator issues the CN (which could potentially be many years later).
- > **New sanctions for failing to comply with a CN:** the Act provides that failure to comply with a CN allows the Regulator to impose a civil penalty of up to £1m on top of the amount in the CN. Non-compliance is also now a criminal offence punishable by an unlimited fine.

The most significant of these changes are the two new grounds for issuing a CN. These will be met where the Regulator is of the opinion that the target was a party to an act (or a failure to act) and either:

- > immediately after the time of the act or failure, the value of the assets of the scheme was less than the amount of the liabilities of the scheme and, if a Section 75 debt had fallen due from the employer at that time, the act would have materially reduced the amount of the debt likely to be recovered by the scheme (the "**employer insolvency test**"); or
- > the act or failure reduced the value of the "resources of the employer" (broadly, the annual profits of the employer before tax) and that reduction was a material reduction relative to the estimated Section 75 debt in relation to the scheme (the "**employer resources test**").

These new grounds sit alongside the existing grounds for issuing a CN. These existing grounds exist where the Regulator is of the opinion that the target was a party to an act (or a failure to act) and:

- > the main purpose (or one of the main purposes) of the act or failure was to prevent the recovery of a Section 75 debt which was (or might become) due, prevent such a debt becoming due, compromise such a debt, or reduce the amount of such a debt that would otherwise become due (the "**main purpose test**"); or
- > the effect of the act or failure was to detrimentally affect in a material way the likelihood of accrued scheme benefits being received (the "**material detriment test**").

The main purpose test and the material detriment test are scheme focused – they look at the impact of the act or failure to act on the scheme. In contrast, the new tests are employer focused – they look at the impact of the act or failure on the sponsoring employer.

More importantly, the new tests look at the impact of the act or failure at the time the act takes place, like a snapshot. In contrast to the material detriment test, there is no need for the Regulator to forecast how the employer might or might not have performed in the future absent the act or failure. The policy intention is to make it easier for the Regulator to show that one of the tests has been met.

Although the new tests are very wide, we think the changes to the CN regime (like the new criminal offences) are best viewed as an evolution of the Regulator's existing CN powers. While the changes may make it easier for the Regulator to show that one of the tests has been met, the types of cases in which the Regulator might expect to issue a CN are unlikely to change significantly. Indeed, the Regulator has said it doesn't expect the new tests to lead to a significant change in its current approach to assessing potential CN cases.

Corporate transaction notifications

The Act requires employers (and associated or connected persons) to give notice to the Regulator of certain events as soon as reasonably practicable after becoming aware of them. These provisions are not yet in force, but draft regulations set out the proposed events as follow:

> the intended sale by the employer of a material proportion of its business or assets;

> the intended granting or extending of a relevant security by the employer over its assets, where the grant or extension would result in the secured creditor being ranked above the scheme in the order of priority for debt recovery; and

> the intended relinquishing of control of the employer company (or, where the controlling company relinquishes such control without a decision to do so having been taken, the relinquishment of control of the employer company).

Corporate transaction notifications will have to be accompanied by a statement describing the event (including the main terms proposed), any adverse effects of the event on the scheme, any adverse effects of the event on the employer covenant, any steps taken to mitigate those adverse effects, and any communication with the trustees about the event. The employer (or other person) must give a copy of the notice and statement to the trustees at the same time. They must also notify the Regulator of any material change to any previously notified matter.

Changes are also being made to the existing notifiable events regime, so that there will effectively be a two-stage reporting process for the events described above: an initial notification will be required when a "decision in principle" is made, followed by a more detailed corporate transaction notification once "the main terms have been proposed".

The Regulator will be able to impose a civil penalty of up to £1m for failure to comply with these new requirements, or with the existing notifiable events regime.

In practice, the vast majority of employers already inform trustees about significant business transactions and discuss with them the impact (if any) on the scheme. In cases where there may be some detriment to the scheme, most employers will agree the appropriate mitigation for this with the trustees either as part of the transaction process or at the next valuation. The changes should not therefore drive a fundamental change in behaviour. However, companies will need to adapt their approach to ensure compliance with the detail and timing of the new requirements.

Other changes to the Pensions Regulator's powers

Several other changes aimed at strengthening the Regulator's powers came into force from 1 October:

> an extension of the Regulator's information-gathering powers, including its powers to inspect premises and require individuals to attend an interview;

> a new power to impose fixed and escalating civil penalties (as an alternative to criminal sanctions) for non-compliance with the Regulator's information-gathering demands; and

> a new civil penalty of up to £1m for the provision of false or misleading information to the Regulator or the trustees.

As with the other changes we've discussed, these changes bolster the Regulator's existing powers rather than fundamentally altering the pensions landscape.

Conclusions

We agree that the new powers are evolutionary rather than revolutionary.

While the criminal offences in particular have understandably caused concern in the industry, we think properly managed businesses and well-advised trustees have little to fear. Perhaps the biggest change will be to push the DB scheme higher up the corporate agenda, leading to more thorough processes and earlier engagement with the trustees.

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