

Employer resources and new regulations

October 11, 2021

In recent Insight articles, we have taken the opportunity of discussing new changes to the pensions landscape brought in under the Pension Schemes Act 2021 (**Act**). Here we pick up on this theme to discuss an aspect relating to the Pensions Regulator (**TPR**)'s expanded powers under the Act.

Readers will recall the Act's provision of two additional grounds for "contribution notices" (**CN**). In force on 1 October 2021 under the Act are these two new grounds, based on "employer insolvency" and "employer resources" tests. A set of regulations concerning the latter test also came into force on 1 October 2021, confirming, for instance, that the resources of interest to TPR will be the employer's profits before tax.

CNs are part of TPR's "moral hazard" armoury (or "anti-avoidance" powers) under the Pensions Act 2004. The powers give TPR a means of requiring financial support or injections of funds into a given underfunded defined benefit (**DB**) occupational pension scheme where certain conditions are met. For context and TPR's motivation for the expanded powers, it was generally noted that the original regime had focused on the impact of corporate events on the scheme rather than the employer. The intention for the expanded regime is to remedy this, concentrating on the employer. In addition, the extended grounds provide a "snapshot" measure of any immediate impact on the employer. In some ways, this is helpful because there is a test which can be checked. However, employers will still need to consider the more general theme of "material detriment", so this original concept remains important.

Discussing the employer resources test only in our article, this sits alongside the original CN provisions and is satisfied where, in TPR's opinion:

- an act or failure to act reduced the value of the employer's resources;
- that reduction was material relative to the value of the "section 75 debt"¹ at the "relevant time", measured at the point when the act or failure to act occurred or, if over a period of time, at a time determined by TPR; and
- it is reasonable to issue the CN.

Taking an employer's profitability, the test involves calculating the employer's normalised annual profits before tax and excluding any exceptional items using the last available accounts; the second step is to calculate the impact of the act on such profits; and, finally, a comparison is required between the amount of the impact on the normalised annual profits and the section 75 debt to determine if the impact is material. Materiality here essentially mirrors the "material detriment" test, looking at if/how detrimental the act or failure to act in question is on the likelihood of accrued benefits being received, but with emphasis on the level of the section 75 debt as compared to the reduction in resources.

TPR's updated Code of Practice 12 (Circumstances in relation to the material detriment test, the employer insolvency test and employer resources test) will set out TPR's intended approach to CNs. The draft Code is currently before Parliament, the related consultation having closed on 8 July 2021 with TPR having published its response to it on 29

September 2021. In its draft Code, TPR gives examples of circumstances where it would expect to issue a CN if reasonable, and if of the opinion that the employer resources test (and any of the two other tests) could be met, such as where:

- sponsor support is removed, substantially reduced or becomes nominal;
- there are some instances of paying a dividend or a return of capital by the sponsoring employer; and
- there are payments favouring other creditors of the employer over the scheme where no such sums are due to those creditors.

As for other grounds for CNs, there is a statutory defence available to the employer in the following circumstances (in the view of TPR): the employer had considered the extent to which the act/failure to act would reduce its resources; it had taken all reasonable steps to minimise this impact; and the employer reasonably concluded that the act/failure to act would not materially reduce its resources relative to the section 75 debt.

In summary, TPR now has grounds to exercise its anti-avoidance powers where a DB scheme sponsor's resources are materially reduced compared with the amount of employer debt it would owe at the time of a given action / failure to take action. However, the industry anticipates uncertainty around the extension to the CN regime, particularly in relation to the reasonableness test, and flowing from that a likely increase in "clearance" applications to TPR (formal requests for a statement from TPR that it will not use its powers). Nonetheless, commentators consider that engaged employers will continue to be able to consider any impact on their schemes of given corporate activity and, where there is potential for concern, take steps to mitigate any material impact.

We think that it will be interesting to see how the reasonableness test unfolds in such circumstances and how far TPR is able or prepared to go in considering an individual sponsor's business operations, particular challenges in the market in which it operates and any factors specific to the employer in question. We await further applications for clearance and TPR's approach to such applications to shed further light on this.

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Your Key Contacts



Eleanor Hart

Partner, London

D +44 20 7246 7166

M +44 7741 323 250

eleanor.hart@dentons.com