Have you got clearance?

Executive summary

- The regulator aims to deal with clearance applications flexibly and responsively, striking the right balance between reducing the risk to members' benefits and not intervening unnecessarily in the conduct of employers.
- The regulator can penalise attempts to avoid pension scheme liabilities and enforce financial arrangements to cover pension liabilities.
- A clearance statement protects a corporate transaction from the regulator's anti-avoidance powers.

The Pensions Act 2004 created the office of the Pensions Regulator and gave it a range of powers to protect pension benefits and the Pension Protection Fund, and ultimately to improve confidence in work-based pension schemes. These powers enable the regulator to gather accurate, up-to-date information about schemes and employers, to tackle risks and to prevent problems from developing.

ANTI-AVOIDANCE POWERS If the regulator believes there is an attempt to avoid pension liabilities, it can deploy two main powers:

- **Contribution notice:** This can be issued where the regulator believes an action (or failure to act) has taken place designed to avoid pension liabilities. Anyone who is a party to the attempt to avoid liabilities can be issued with a contribution notice that requires payment of an amount up to the full buyout debt (that is, the amount needed, as estimated by the scheme actuary, to secure the promised pensions with an insurance company).

- **Financial support direction:** If – for example, as a result of restructuring – the pension scheme's sponsoring employer is insufficiently resourced, or is a service company within a group of companies, the regulator can issue a financial support direction requiring financial arrangements to be put in place by associated companies to support the employer's pension liabilities.

Contribution notices can be issued for events taking place up to six years in the past, although there is a 'backstop' of 27 April 2004, which is the date on which the powers were announced. The regulator will issue such notices sparingly and take a risk-based, proportionate approach.

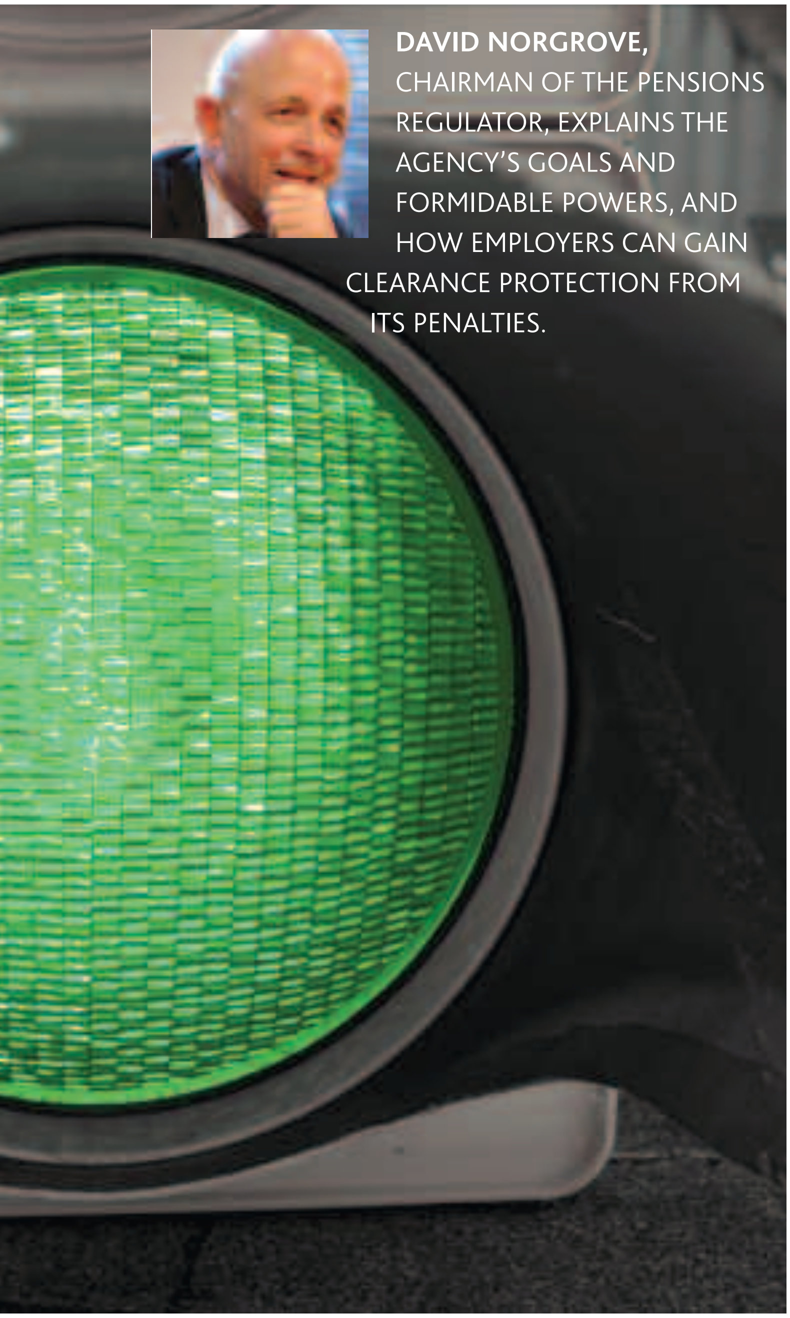
The legislation requires the regulator to consider a range of factors to establish whether it is reasonable to issue a contribution notice or a financial support direction. In the case of a contribution notice, a person's degree of involvement in the attempt to avoid liability and their relationship with the employer and the scheme would be considered. In the case of a financial support direction, any benefits the person has received (directly or indirectly) from the employer and any connection they have with the scheme would be considered. And in all cases the person's financial circumstances would have to be taken into account.

CLEARANCE When the government consulted on the regulator's powers one of the main changes made, at the request of industry, was the introduction of a statutory clearance procedure. This procedure is available for anyone who wants confirmation they will not be subject to a contribution notice or a financial support direction following a proposed transaction.

Although clearance is optional, it gives greater certainty to those who are considering transactions involving companies with defined-benefit pension schemes. Clearance is particularly valuable for the rescue of core solvent businesses and the protection of jobs, and helps to ensure that normal business can continue without excessive regulatory intervention.

THE PENSION CREDITOR An underfunded pension scheme should be treated as an unsecured creditor. The regulator's anti-avoidance powers can be applied to actions or situations that are financially detrimental to the pension creditor, and it is in relation to these events that clearance should be considered.

When assessing the deficit, and to assist parties in deciding whether to seek clearance, the regulator currently uses the FRS 17



DAVID NORGROVE, CHAIRMAN OF THE PENSIONS REGULATOR, EXPLAINS THE AGENCY'S GOALS AND FORMIDABLE POWERS, AND HOW EMPLOYERS CAN GAIN CLEARANCE PROTECTION FROM ITS PENALTIES.

Retirement Benefits accounting standard. But once the new scheme-specific funding regime is in place, the scheme's funding objective will be used to determine whether there is a deficit.

From the point of view of the pension creditor, three categories of event can affect a company:

- **Type A events:** These affect the pension creditor because they are financially detrimental to the ability of a defined-benefit scheme to meet its pension liabilities. It may be appropriate to seek clearance for such events.

- **Type B events:** These do not affect the pension creditor, so clearance is unnecessary.

- **Type C events:** These might affect the pension creditor because they point towards a deterioration in the employer's ability or willingness to support the scheme, and may be outside the control of the employer. Clearance is not available for these events unless they also fall within type A.

Type A events – those for which clearance from the regulator might be appropriate – generally have one or more of the following effects on the pension creditor:

- **Change in priority:** A change in the level of security given to creditors, resulting in the pension creditor receiving a reduced dividend in the event of insolvency. Examples include the granting or extending of a fixed charge or floating charge.

- **Return of capital:** A reduction in the overall assets of the company that could be used to fund a pension deficit, such as dividends, share buybacks, dividend strips, distribution in species or demergers.

- **Change in control structure:** A change or partial change in an employer's group structure which reduces the overall employer covenant and could affect the ability of an employer to meet a potential debt to the scheme, possibly resulting in the issue of a financial support direction by the regulator. This could happen because of a change of employer (or participating employer), or a change of parties connected or associated with the employer.

PARTIES TO CLEARANCE The employer and connected or associated persons could be served a contribution notice or financial support direction following a type A event, so these are the parties who may seek clearance. However, the regulator expects applicants to have discussed the proposal with the pension scheme trustees. The trustees have the prime responsibility for safeguarding members' interests and are expected to negotiate assertively on behalf of the scheme.

The trustees will want to discuss how to minimise or eliminate any impact of the proposed event on the pension creditor, and if necessary to consider how the pension scheme security may be improved. The regulator's anti-avoidance powers allow trustees to negotiate from a position of strength, and it is in the employer's interests to keep trustees properly informed of relevant details of their financial situation and plans.

The regulator's role is to consider an application and decide whether clearance will be given. The regulator aims to be a referee rather than a player in negotiations but will work with all parties towards achieving a well-funded scheme and a solvent employer. The regulator recognises that the new legislation has introduced a steep learning curve, particularly for trustees.

EXPERIENCE TO DATE Every month the regulator receives not just clearance applications, but also calls from potential applicants or trustees asking about particular circumstances. In these situations, and when we receive an application for clearance, the regulator's first consideration is to determine whether it is a type A event. If it is not, a letter will be issued confirming that, in the regulator's view, a clearance statement is not needed.

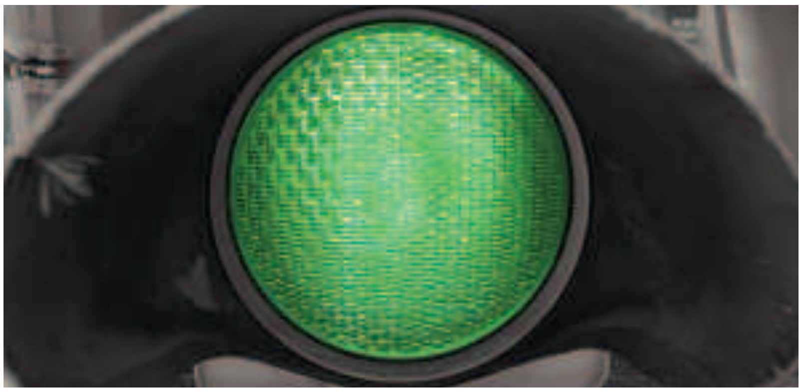
Where a type A event is occurring, the regulator considers:

- What is the pension scheme deficit?

- Do the trustees support the application and what advice have they had in coming to that view?

Most importantly, the regulator considers what mitigation is being put in place. If, for example, security is being granted above the pension scheme, the regulator might expect to see some form of guarantee for the pension scheme and a shortening of the period in which the deficit is being repaid. The regulator talks to the trustees and applicants to understand their position and explain why it believes any mitigation is insufficient and encourage the parties to come back with a revised application.

A FEW EXAMPLES… In one case, a company needed extra investment from its bank on top of its existing unsecured loan. In return, the bank wanted security over the whole debt, meaning that, in the case of insolvency, the pension scheme, as an unsecured creditor, would be unable to make any recovery. Following the regulator's involvement, security was granted both to the bank and to the scheme, minimising the increased risk to the scheme.



In another case, the regulator granted clearance to a new leveraged parent company on condition that a cash lump sum was paid into the underfunded pension scheme, an agreement was made to fund fully the FRS 17 deficit within three to five years, and a guarantee was given that the FRS 17 funding would be met in full across the parent company's organisation.

Another case involved a company which, although its pension fund was in deficit, was raising cash and granting security with the aim of paying off subordinated loans. The regulator encouraged the parties to think about appropriate mitigation and the company agreed to put a lump sum into the scheme immediately and fund its FRS 17 deficit within three years.

The regulator receives around 40 clearance applications a month. In the first six months just two have been refused. Turnaround times vary according to the complexity involved, but on average a decision is made on an application within three weeks.

The regulator is able to deal with clearance applications in a flexible, responsive and proportionate manner, and aims to strike the right balance between reducing the risk to members' benefits and not intervening unnecessarily in the conduct of employers.

David Norgrove is Chairman of the Pensions Regulator.
www.thepensionsregulator.gov.uk

Full guidance on clearance, and an application form, are available on the regulator's website, www.thepensionsregulator.gov.uk (follow the links to "codes and guidance"), or from the customer support team on 0870 6063636.