Department for Work & Pensions

Review of the operation of sections 38A and 38B of the Pensions Act 2004

A report

June 2014

Introduction

This report fulfils the obligation placed on the Secretary of State for Work and Pensions under section127 Pensions Act 2008, which requires him to review the operation of sections 38A and 38B of the Pensions Act 2004 as inserted by section126 of and Schedule 9 to the 2008 Act and report to Parliament.

Background

The Pensions Regulator was set up under the Pensions Act 2004 with the then following statutory objectives:

- to protect the benefits of, or in respect of, members of occupational and work-based personal pension schemes;
- to reduce the risk of situations arising that may lead to claims for compensation from the PPF; and
- to promote, and to improve understanding of, the good administration of work-based pension schemes.

The 2004 Act also created the Pension Protection Fund which provides compensation for certain pension scheme members if the employer has become insolvent and the scheme is underfunded on a PPF basis.

In order to prevent employers deliberately manipulating their affairs to shift their pension scheme deficits to the PPF and increasing the levy paid by other schemes, the Pensions Act 2004 contains a number of measures to address the risk of “anti avoidance”. The main powers are:

- contribution notices which enable the Regulator to require a cash contribution to the scheme in certain circumstances
- financial support directions which are intended to enable the Regulator to direct that associated and connected persons put in place arrangements to support the pensions liabilities of an employer who is insufficiently resourced or is a “service company”.

The previous Government was concerned in 2008 that the emergence of new business models in the buyout market risked reducing the security provided by a pension scheme’s sponsoring employer, both to the detriment of scheme members’ benefits and with potential knock on costs for the PPF and its levy payers.

The Regulator could issue a contribution notice where it was of the opinion that the person concerned was party to an act or a deliberate failure to act, the main purpose of which was to:

- prevent the recovery of all or part of a debt to the scheme; or
- except in good faith, prevent a debt becoming due, to compromise or settle a debt, or to reduce the amount of the debt.

Given that the business models involved were often complex and some of the steps when taken in isolation were indistinguishable from ordinary corporate activity, the Government was unable to define the models in a meaningful way and moreover the Regulator could not determine with sufficient certainty the main purpose of the act.

The Government therefore considered that the most appropriate way to tackle this issue was to amend the anti-avoidance provisions through:

- the introduction of an alternative test for contribution notices based on the detrimental effect that a corporate act or series of acts has or would have on member benefits, regardless of the intention; and
- the removal of ‘otherwise than in good faith’ from one of the limbs of the existing test for issuing a Contribution Notice

In order to provide assurance for business the Government also proposed a future safeguard provision for a ‘statutory defence’ against the use of the new powers in relation to Contribution Notices. This would apply if a party could demonstrate that they could not reasonably have foreseen the effect of a transaction would not be the subject of a Contribution Notice. And the voluntary clearance process would continue to allow employers and others to obtain a statement from the Regulator that it would not be reasonable to issue a contribution notice or a financial support direction in relation to a particular transaction.

Consultation on the proposed amendments to the 2004 Act anti-avoidance powers took place between 25 April and 20 June 2008. Following the consultation and discussions with relevant parties, organisations and representative bodies, on 25 June 2008, the Government tabled an amendment to the Pensions Bill to give effect to the proposed changes initially through secondary legislation. However, during the Parliamentary debate on the amendment[1], the Government agreed to put the substantive changes to the anti-avoidance measures in primary legislation and refine the application of the material detriment test, including requiring the Regulator to issue a statutory Code of Practice setting out when it expected to apply the test. Additional reasonableness factors were added to the proposals following the consultation including the consideration of other creditors.

The enactment of the legislation therefore means that under section 38A of the Pensions Act 2008 the Regulator can issue a contribution notice where an act or failure to act would have a materially detrimental effect on the likelihood of members’ benefits being paid. Section 38B provides for a statutory defence which removes liability and the operation. There are important factors in the primary legislation that the Regulator must consider when determining material detriment to ensure that it is appropriately targeted.

In parallel with these legislative provisions, the Regulator’s Code of Practice on the material detriment test sets out the detailed circumstances

[1] Lords Hansard 27/10/08 Col 1430
http://www.publications.parliament.uk/pa/ld200708/ldhansrd/text/81027-0012.htm#08102730000001

in which it would issue a contribution notice if it considered the test was met:

- the transfer of the scheme out of the Regulator's jurisdiction.
- the transfer of the sponsoring employer out of the Regulator's jurisdiction or the replacement of the sponsoring employer with an entity that does not fall within its jurisdiction.
- where sponsor support is removed, substantially reduced or becomes nominal;
- the transfer of scheme liabilities to another pension scheme or arrangement which leads to a significant reduction of sponsor support in respect of, or funding to cover those liabilities.
- a business model or the operation of the scheme that creates from the scheme, or which is designed to do so, a financial benefit for the employer or another person, where proper account has not been taken of the interests of the members of the scheme, including where risks to members are increased.

The Code has legal effect in that it has to be taken into account by the Regulator for the new test, and is admissible in evidence in any proceedings before a Court or Tribunal.

Conclusion

Since its establishment in 2005, the Regulator's approach has been to seek to prevent problems from developing – through its programme of education, enablement and enforcement.

It has not found it necessary to use the anti-avoidance powers on a widespread basis, although they act as a strong deterrent that enables the Regulator to ensure the best outcome for schemes and members.

The Regulator also operates a voluntary clearance procedure to allow employers and others to obtain a statement from the Regulator that it would not be reasonable to issue a contribution notice or a financial support direction in relation to a particular transaction.

Companies that run defined benefit pension schemes have welcomed the opportunity to seek a clearance statement from the Regulator on whether a proposed course of action is likely to be considered materially detrimental to the ability of the scheme to meet its liabilities.

Once given, clearance is binding on the Regulator, providing the information provided is not materially different from the circumstances of the case.

Enquiries relating to clearance have reduced steadily and have more than halved since 2008/09[2]. This may indicate a better understanding of the clearance process and the parameters within which the Regulator considers that mitigation to manage risks to the scheme is appropriate.

The Government considers that the Material Detriment Test has proved a valuable addition to the Regulator's anti-avoidance powers, and should be retained, although, as with all the Regulator's powers, it will be kept under regular review.

[2] from 72 in 2008/09 to 31 in 2011/12 – figures taken from the Pensions Regulator's Annual Reports and Accounts http://www.thepensionsregulator.gov.uk/about-us/annual-reports.aspx