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Dear Pensions Regulator Powers team

SPP RESPONSE TO DWP CONSULTATION: STRENGTHENING THE PENSIONS REGULATOR'S POWERS: NOTIFIABLE EVENTS (AMENDMENTS) REGULATIONS 2021

We welcome the opportunity to respond to this consultation.

Executive Summary/Key Messages

The proposed regulations do appear to capture the intention to promote early involvement of trustees and the Pensions Regulator ("TPR") in employer related events that are likely to impact on the employer covenant and the subsequent reporting of steps taken to mitigate any detriment.

However, the current definition of employer, as set out in legislation, may mean that the proposed regulations may not be applicable to employers of defined benefit schemes that are closed to future accrual which could represent a fundamental weakness.

The requirement to notify when a decision in principle is made creates huge uncertainty for corporates and the regulations are likely to require significant changes for corporates when approaching transactions due to the risk of failing to notify and the exposure to potential significant fines. This is likely to prompt a high volume of notifications, particularly as the main terms of a deal tend to evolve during a transaction requiring multiple statements to be submitted and given our concerns over the current proposed level of materiality noted below. This could place significant strain on TPR's resources. Concern was raised whether TPR has the capacity to deal with the expected number of notices and statements although we recognise that TPR is likely to initially rely on the trustees, who are to receive the notices with statements simultaneously to TPR, to commission appropriate advice. This could potentially be addressed through setting different thresholds for trustee notification and TPR notification although this would add further complexity.

Affected parties will need to know whether the existing Condition A and B tests for an exemption will be extended to the new Notifiable Events (or if the existing direction will continue to apply to the Notifiable Events to which it currently applies). This is not currently covered within the consultation.

The key matters of concern that arise from the proposals are in respect of the following:

Materiality:

The definitions refer to materiality as being based on 25% of revenue (business disposal) or 25% of gross assets (asset disposal). There is no test that looks at materiality based on a measure of profitability which is a key factor for covenant.

25% appears a high threshold. Commercial lenders looking to include material group entities in a security net will look at much lower levels of group revenue, profit and/or asset values to determine whether an entity is material and should be included in the security net.

Relevant security

As currently proposed, the notifiable events regime will not apply to the refinancing of secured debt, nor will it apply to cases where an employer becomes an obligor or guarantor of debt on an unsecured basis.

A refinancing that involved a significant increase in debt or a substantial change in the terms of the debt could adversely impact on the ability of the employer to meet its obligations to the scheme and could significantly reduce the likely recoveries to the scheme in the event of an insolvency due to prior ranking claims.

In cases where the employer, or its subsidiaries, have become obligors or guarantors of debt on an unsecured basis, the potential recovery to the scheme in an insolvency scenario could be adversely affected due to claims under the guarantee ranking either alongside the scheme's claim, in the case of the employer guarantee, or ahead of the scheme's claim if a lender claims under a guarantee provided by a subsidiary entity, due to structural subordination.

Detailed Response

Q1: do you think that the definitions capture the policy intention? If not, please explain why.

We think there may be a significant omission in the draft regulations (also an issue under the current regime but now increased) in that 'employer' is not extended (which there is power to do in the primary legislation) to include any former employers for the purposes of this legislation.

"Employer" is defined as being an "employer of persons in the description of employment to which the scheme in question relates", which the Courts have held does not include deferred members (or pensioners) unless they are able to recommence active membership if they wish. It therefore seems to be the case that the employer-related notifiable event obligations have no application to a defined benefit scheme under which all such accrual has ended, which is the case for most private sector defined benefit schemes, and there is no proposal to change this. Given that former employers can, and often do, still have actual or potential obligations to fund such a closed scheme, it seems that the regulations may fall a long way short of meeting the policy intent.

If making use of the power to extend the definition of 'employer' to include former employers, care will need to be taken only to capture those entities that have an ongoing or potential legal obligation to fund the scheme, and not those whose potential liability has ended, for example after payment of a section 75 debt or an apportionment arrangement. We suggest that taking the same approach as is used for section 75 Pensions Act 1995 may be appropriate, but this will need careful consideration.

We understand the policy intention is to capture those instances where corporate behaviour is not consistent with good practice. Such good practice would ideally involve all stakeholders, including trustees, being made aware of an event that may impact on them in sufficient time for them to assess that impact and partake in relevant discussions with the parties as to any concerns that may arise. The definitions would appear to capture this intention.

The definition of decision in principle would appear to be at a relatively early stage of the process and may lead to unnecessary notifications. A decision in principle may be made to sell a business but subsequent testing of the market may result in abandonment of such a plan. Perhaps a better trigger would be the point at which there is meaningful engagement with a potential counterparty or prior to any material negotiations. Otherwise, for example, there could be a decision in principle to sell, which would require notification, even where there are no interested buyers.

In practice, the response of the Trustees to a potential event may be critical to the success of that event and therefore early engagement is to be encouraged. The notification requirements following a decision in principle (Section 69) currently only require the event to be notified to TPR and do not require notification to the trustees. This is in contrast to Section 69A, which requires notification to both trustees and TPR. This may lead to delays in the involvement of the trustees and weaken their position as regards the terms being agreed.

However, we recognise that employers may be unwilling to notify trustees at this early stage due to concerns over issues of confidentiality in disclosing plans prior to any formal negotiations and the potential adverse impact on the business if information regarding a possible sale were to become public knowledge amongst competitors, customers or employees.

<u>Q2. can you see any unintended consequences of these amendments?</u>

As stated above a decision being made to explore a potential sale of a business could be before exploration of the practicalities and market appetite for such a sale. There could be many instances when further deliberation by management determines that a sale is not feasible. It is unclear whether the requirements mean that these instances would still have to be notified to TPR which would potentially give rise to a high number of notifications that do not lead to a statement and may involve unnecessary engagement with TPR. TPR will, no doubt, expect trustees to commission advice in response to notices with statements which TPR may seek to utilise in order to gauge the extent of any intervention required.

The regulations will require additional diligence by employers. There is a risk that a decision is made elsewhere within a group of companies that would trigger a notifiable event, but which has not necessarily been communicated to the employer. Careful consideration will need to be given to who is making the decision in principle and who is closing the main terms as it may not necessarily be the sponsoring employer, but someone higher in the corporate group, possibly even at private equity level.

There is a risk that, in the midst of a transaction, the legislative requirement to notify TPR of a decision or proposal is forgotten or the precise trigger point is missed, thereby exposing the employer to a potential significant fine.

Q3: are there any unintended consequences of this approach? What is the impact on multi-employer schemes and the employers? Is there a simple way of apportioning liabilities which would work for all multi-employer schemes?

Question 3 refers to removal of the threshold of applying the regime only to an employer responsible for at least 20% of the scheme's funding.

Forcing all employers to comply with the notifiable events regime could mean that some employers with a relatively small share of the scheme funding obligations (such as those with only a few members) would be required to report in full. It is unclear whether the potential impact on a scheme of such transactions (and the likely benefit of Regulator involvement from early engagement in the case) is sufficient to justify the additional work involved.

Whilst it may be difficult to confirm the 20% threshold in some cases, there would be nothing to prevent an uncertain employer from reporting a Notifiable Event, it would just avoid disproportionate work for cases that were clearly below such a cut off.

Under the original proposal, there could be potential multi-employer scheme scenarios where the position is established within a group such that, despite there being relatively few employers, each one is deemed responsible for less than 20% of the scheme funding and so the notifiable events regime would not apply. Removing the 20% threshold avoids such a scenario.

The level of information required for the notice and statement would potentially be disproportionate in cases where the company is very large relative to the exposure to scheme liabilities. However, if the implications of the event on the scheme are limited, it should be relatively simple for the employer to demonstrate that there is no adverse impact on the overall employer covenant.

We are not convinced that there is a simple way of apportioning liabilities for all multi-employer schemes as any such apportionment may only be relevant at a specific moment in time using the circumstances prevailing at that time and various assumptions. Whilst it is imperfect, a simplistic approach would be to use the member numbers on the scheme return as a proxy for identifying employers with sizeable exposure. The PPF use this approach in their levy calculations.

Many schemes are subject to last man standing rules which mean that an employer's share of the scheme liabilities will be highly dependent on whether other employers continue to remain liable for their share of the scheme obligation.

Q4: do you agree that "when the main terms have been proposed" is an appropriate point for the notice and statement to be issued? Can you see any unintended consequences of using this definition? At what point would it be reasonable for employers to have discussions with the trustees about the intended transaction?

There is not a 'one size fits all' approach to corporate transaction and they often develop iteratively. Furthermore, the Employer may well not be a party to the proposal as decisions may be made by entities higher in the organisation structure.

The proposal of terms does not mean acceptance or agreement of terms. There may be numerous iterations of a transaction in the period after a decision in principle is made and terms are proposed. Proposing main terms may still be well in advance of any settlement on heads of terms.

This, often fast moving and fluid situation, combined with the need to resubmit a notice and statement in the event of a change in terms, may lead to multiple submissions to TPR along with an in increased risk that the Employer misses a notifiable event trigger point.

There is likely to be concern from employers that the requirement to disclose what may be price sensitive information (or other highly confidential information) may lead to early release and breach issues which lead to employers seeking to delay notification for as long as possible within the rules. Employers may also seek multiple non-disclosure agreements from the trustees and their advisors which may give rise to practical issues. The Government had initially referenced (in its Green Paper) that it would consider the confidentiality issue but has not raised this in its consultation response. The issue remains a concern.

The Regulator may need to be resourced for a high volume of notifiable events, notices and statements. Initially corporates will be cautious and are likely to notify on everything to be safe.

The Regulator may also face practical issues around confidentiality for price sensitive transactions. There could be the potential need for internal information barriers to be put in place TPR and clarification may be needed to establish whether information submitted by the employer to TPR at their request can be shared with the trustees.

<u>Q5: Does the definition of relevant security meet the intention that it will apply to granting of security which may affect the employer's ability to support the scheme? Are there any unintended consequences? Should other specific types of security be included or excluded? Is it appropriate to specify a 25% threshold by reference to revenues or assets as proposed?</u>

There are multiple aspects of the definition of relevant security.

A relevant security is a security granted by (i) the employer or (ii) one or more subsidiaries of the employer, comprising more than 25% of either the employer's consolidated revenue or its gross assets.

This does not capture debt taken on in entities above the employer in a group structure even though there may be a debt service requirement imposed on the employer as a result. This may adversely impact on the employer covenant. It is unclear if securities granted by a parent company that materially impact an employer's ability to support a scheme would be covered.

The test for determining whether security over a subsidiary is notifiable is based on a measure of its revenue and gross assets compared to the consolidated revenue and gross assets of the employer.

For clarification the wording should specify whether it is consolidated gross assets as well as consolidated revenue.

Subsidiary entity revenue may be distorted by intercompany sales which are eliminated on consolidation.

There are various aspects of gross assets that may lead to an unintended result:

1. intangible fixed assets: intangible fixed assets, such as goodwill, may only be disclosed in the consolidated group accounts despite being related to individual subsidiary acquisitions. This could inflate the value of consolidated gross assets meaning that certain subsidiaries may not

be caught under the notifiable events regime;

2. right of use assets: Under the proposal right of use assets will be included as an asset for gross asset purposes despite being not owned by the company; these should be excluded;
3. intercompany balances: subsidiary accounts will include intercompany balances which would be eliminated on consolidation; intercompany debtor balances could inflate the value of subsidiary gross assets relative to the consolidated position leading to more subsidiaries qualifying under the test.

The use of 25% as a threshold appears high. Banking documentation will often include terms requiring any material company in a group to be brought into the security net provided to lenders. Typically, this will define material at a level of 5% based on a combination of tests covering revenue, profitability and asset values. An example would be as follows: “a member of the Group which has earnings before interest, tax, depreciation and amortisation (“EBITDA”) representing 5% or more of EBITDA or has gross assets (excluding intra-group items) representing 5% or more of the Group calculated on a consolidated basis”. It would be unusual for lenders to give any similar threshold test for disposal of entities out of the security net, instead requiring any disposal to be notified and agreed with the chargeholder.

Relevant security includes a fixed or floating charge over assets of the employer or the wider employer group. It is unclear as to what the “wider employer group” entails. This could be interpreted as the employer and its subsidiaries or the employer, its subsidiaries and its parent entities. Clarification should be made.

Relevant security as defined in the consultation excludes the refinancing of existing debt. A refinancing exercise that involves a significant increase in borrowing and or debt service costs could have significant adverse impacts on the affordability of deficit repair contributions and on the scheme’s potential recovery in an insolvency scenario and therefore should be captured as a notifiable event.

Relevant security also excludes security for specific chattels. It is unclear of the intention behind this exclusion. Whilst there is a case for the exclusion of security issued in respect of newly acquired chattels, security raised on existing chattels owned by the employer will potentially adversely impact on the scheme’s potential recovery in an insolvency scenario.

Instances where an employer or its subsidiaries become obligors to a debt facility or provide a guarantee of debt on an unsecured basis would not be notifiable under the proposed regulations.

Although potential claims against the employer as an obligor/guarantor would not rank ahead of the scheme’s claim in an insolvency, they would rank alongside the scheme’s claim and could significantly reduce the level of recovery to the scheme.

In instances where a subsidiary of an employer becomes an obligor/guarantor, claims that arise under such an obligation would be met in priority to any distribution to the employer as shareholder. The scheme’s claim would be structurally subordinated to the lenders’ claims even though they are not secured. This could significantly reduce the recoveries to the scheme in the event of an insolvency despite lending not being secured by way of charges.

As an obligor/guarantor the employer and/or its subsidiaries would also potentially have debt service costs that could adversely impact on the affordability of scheme contributions.

There will be a need to ensure that the definition of ‘employer’ is understood and consistent in terms of statutory employers and some group structures. In some cases, the statutory employer to the scheme may not be aware of decisions being made higher up in the group until later in the process.

Q6: do you agree this is a reasonable definition of revenue and assets? If, not, how do you consider they should be defined?

The material proportion tests are based on a test of the value of revenue (for business disposals) and of gross assets (for asset disposals) where such information is based on the most recent annual accounts.

It is conceivable that a scenario involves the sale of part of an employer's business that has a low assets base (e.g. a service industry, people-based business) that generates little revenue for the Group but at a high margin due to the expertise involved. Unless a profit related test of a material proportion is included such a sale might not be notifiable despite representing a significant transfer out of value.

Operating profit (normally disclosed in statutory accounts) or EBITDA (less readily available but still calculatable from statutory accounts) could be an additional test although these can be distorted by transfer pricing policies on intercompany trading.

The most recent statutory audited accounts would appear to be the most obvious source of information for the test, subject to those accounts being for contemporaneous periods.

However, the same issues apply in respect of gross assets as identified above under question 5.

Q7: do you consider that 25% of the revenue or assets is an appropriate level? If not, please indicate what you think is an appropriate level and why?

No – see comment above regarding material entity utilised in banking documentation.

The proposed test of material proportion does not necessarily pick out the transactions that will have the largest impact on a pension scheme as it ignores the size of the scheme exposure relative to the employer (and hence the likely impact on the employer's ability to support these liabilities).

Q8: do you agree that disposals which have taken place or agreed within 12 months of the date of the notifiable event should be taken into account when calculating the 25% threshold? If not, please explain why.

12 months is a relatively short space of time for planning and completing corporate transactions. A 24-month period would be more consistent with the period for commencing action for Financial Support Directions or 36 months would be more in line with the triennial valuation cycle.

In addition, the same logic should apply to the granting of security (i.e. consider the cumulative impact of several smaller transactions that total more than 25%).

Q9: does this list provide all the information which should be notified to The Pensions Regulator? If not, what else should be included?

The list is not overly prescriptive but does contain the essential elements.

The Regulator defines covenant as the extent of the employer's legal obligation and financial ability to support a defined benefit scheme now and in the future. We would expect the statement to include reference to the impact of the event on the employer covenant available to the scheme. Items (ii) and (iii) on the requirements list refer to adverse effects on the scheme and on the employer's ability to meet its legal obligation but do not refer specifically to covenant.

<u>Q10: Do you think that this meets the policy intention or are there any unintended consequences?</u>

Question 10 refers to the requirement to notify of a material change as set out in a new paragraph (7):

“(7) For the purposes of s69A of the Act, a material change includes

(a) in relation to the events specified in sub-paragraphs (3)(a), (b) and (c)(i), a change in the proposed main terms;

(b) a change in steps taken to mitigate any adverse effects of the event.”.

It is unclear how the word ‘material’ is being used here. As worded, it would appear to cover any change set out in (a) and (b) above rather than any material change and seems to refer to any change in the main terms, even if unrelated to the pension scheme. We would expect a material change to be a change in terms that (materially) impacts on the information provided in the notice and accompanying statement under items (b) to (e).

<u>Other matters</u>

It was noted that the PDF and HTML versions of this consultation differ, with the latter being the later we think. A 2022 timescale for coming into force is mentioned in the PDF version.

There would appear to be various typographical errors and certain sections do not appear to read as intended. For example:

in draft Regulation 2(3)(a)(ii) inserting (f)(ii) the text should probably begin with the words “receipt of” ahead of an offer to acquire control.

in the same provision, we presume that the second instance of "employer company" should say "controlling company".

in draft Regulation 2(5)(b)(iii) there is superfluous text at the end in the PDF version - “[question for TPR]” which should be deleted.

TPR has prescribed , in a document "Directions issued by the Pensions Regulator under section 69(1)1 of the Pensions Act 2004", certain conditions that, if satisfied, mean certain events need not be notified. These include Condition A [assets are greater than PPF liabilities] and Condition B [no late contribution reports to TPR needed to be made in the last 12 months]. The consultation does not mention whether the existing Condition A and B tests for an exemption will be extended to the new Notifiable Events (or if the existing direction will continue to apply to the Notifiable Events to which it currently applies). Affected parties will need to know what the future position will be. Not least because fines of up to £1 million are now possible for breaches of this regime, we suggest it would be better if the content of TPR's direction were to be moved to the regulations.

The consultation is only in respect of employer related notifiable events. The SPP are of the view that there is an opportunity to revisit the wider notifiable events regime. For example, the £1.5m limit for notifying large transfers and benefits granted has not been adjusted since it was first introduced in 2005 and given the change in financial conditions since then, now results in far more notifications, particularly for larger schemes, than would have been originally anticipated, few of which will be drawing TPR’s attention to any material risks to the PPF. This is onerous for trustees, administrators, advisers and TPR, and doesn’t appear well aligned to the aim of protecting the Pension Protection Fund. Adjusting the £1.5m limit would require a change to the regulations or potentially TPR could extend its conditions, for instance to say that for such events, notification would only be required if the current conditions A or B aren’t met and total transfers out/retirements in a month say are over 5% of scheme assets. Alternatively, TPR could consider removing this as a notifiable event as it would not appear a helpful prompt for TPR action.

We are not clear about the approach applicable where events straddle the date on which the new requirements come into force. For example, where the 25% threshold test applies, do events before the commencement date count towards that? Is the accompanying statement required if the associated triggering event occurs before commencement?

Yours faithfully

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