THE SOCIETY OF PENSION PROFESSIONALS
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Dear DB team

SPP response to DWP consultation: Strengthening The Pensions Regulator's Powers: Contribution Notice and Information Gathering Powers Regulations 2021

Key Messages

We welcome the opportunity to response to the above consultation. The summary of our key message on Employer Resources is:

- The proposed measure is too simplistic and is open to manipulation. It risks creating the perception that profit is the only relevant measure. It is also historic and does not reflect any changes in the resources of the employer and its covenant strength, since the production of the accounts. Profit is also not a relevant concept for certain companies, such as charities and not-for-profits.

- The proposed test is both over-narrow and over-vague. Both 'normalised' and 'materiality' are concepts that are open to interpretation and debate, meaning that that employers, trustees and their advisers will be unable to judge reliably whether a proposed action would fall foul of the test or not.

- Normalised PBT does not capture the range of circumstances that may impact an employer's resources, for example shareholder distributions, refinancing and M&A activity. It is strongly advisable to include cash flow and balance sheet measures, noting also that a range of measures is less open to manipulation by the employer.

- The test should allow for support provided by the wider sponsor, not just the employer.

- Our recommendation is for a range of tests, with the triggering of any one, or a combination, to lead the Regulator to make an assessment. This would also provide an opportunity to incorporate materiality into the test.

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Detailed Response

The Employer Resources Test

1) Do the draft regulations achieve the stated policy aim?

In our opinion, the draft regulations do not meet the stated policy aim.

The consultation states the following justification for the employer resources test:

> *An additional issue faced by The Pensions Regulator is the difficulty in forecasting the medium and long-term performance of a business for the purposes of the existing 'material detriment test'. The "employer resources test" introduced in the Pension Schemes Act 2021 is therefore designed to assess this on a snapshot basis, removing the need to forecast how the employer might or might not have performed in the future absent the act or failure to act.*

Normalised profit before tax cannot be assessed on a 'snapshot' basis. By definition, it is a continuous measure. In very many cases there will be influences on profit before tax that may not be disclosed as exceptional items within the accounts, for example:

- refinancing
- company restructuring
- M&A activity
- the effect of losing a major customer
- broader changes in the economy (e.g. the Covid-19 pandemic).

The need to assess how the employer might or might not have performed absent the act or failure to act therefore does not go away. Indeed, it is the very essence of any assessment of what is 'normalised'.

The consultation also states that the proposed test "meets the policy intent of allowing the Pensions Regulator to take swifter action and to be more efficient." We do not agree. The proposed test gives the Pensions Regulator very wide discretion to determine what is 'normalised' profit and also to "estimate the value of the resources of an employer" that does not produce annual accounts. (It is not clear whether this is intended to include smaller companies that do not need to file full accounts, meaning that profit information may not be publicly available.) However, we anticipate that this will commonly lead to potential targets challenging the Pension Regulator's assessment of resources, a process that is unlikely to be either swift or efficient for the Pension Regulator.

We also expect that employers and schemes will struggle to reach a reliable conclusion as to whether proposed action will trigger the test or not. This will reduce the effectiveness of the test in regulating employer group behaviour.

Finally, the consultation states that the Pensions Regulator would put forward an argument on materiality particular to the facts of the case, as is currently done with the material detriment test. Materiality is a concept that is open to interpretation and debate, particularly where relating profitability to a s75 debt. There will need to be some guidance on how this materiality will be defined and assessed.

2) Can you see anything that means that these draft regulations will not work?

It is stated that profitability would be something akin to the employer's ability to support the scheme which is examined as part of assessing employer covenant, however, covenant advisers typically take more of a holistic approach, not dissimilar to the approach that lenders (and credit rating agencies) would take and would also look at measures capturing balance sheet strength and cash flow relative to the pension scheme deficit to better assess affordability.

Normalised profit before tax may be an inappropriate measure for a range of employers, for example:

- charities
- not-for-profit companies
- toll manufacturers and other companies whose trade is internal within a group
- loss-making companies

3) Do you foresee any unintended consequences in this approach, if so please provide details?

Normalised profit before tax after adjusting for non-recurring or exceptional items is felt to be too simplistic and open to manipulation and interpretation particularly in the context of defining “exceptionals”. It also does not take account of dividends, significant capex flows or other cash flow items that impact on the employer's ability to service deficit repair contributions. The test purely focuses on the profitability of the employer but it does not take account of any support (e.g. parent company guarantee to the pension scheme) or other funding that the employer may be reliant on from its parent (employer vs sponsor).

The approach potentially runs the risk of sponsors seeking to ‘game’ the test – for example, manipulating the profit of businesses being disposed (artificially suppressing using provisions, transfer pricing, lack of visibility over profit and cost attribution between business units) to avoid tripping the proposed test, which would be challenging to identify from public information.

As it stands, the test currently will catch some activity that is not covenant-detrimental – such as:

- disposal of a declining business unit with the intention of reinvesting proceeds in the sponsor
- cessation of a large but less profitable contract in order to deploy resource on more profitable work.

Whilst it is to be assumed TPR would not seek to pursue such cases, it will be important to consider how to ensure that this ‘artificial’ trigger does not deter appropriate business activity.

Additionally, focusing the test narrowly on the profit impact of an action risks creating a perception that this is the key factor in understanding whether an action has impacted the covenant. Given the importance of the impact of actions on a sponsor’s **prospects** and **cash generation** this would risk actions being perceived as ‘not damaging’ to covenant if they did not breach the narrow proposed test of impact on historical profits.

4) If the approach is not workable, please provide your views on what would be an appropriate alternative approach?

In our view, there is no simple, unarguable and objective test that could completely remove the challenges you are seeking to address. We have noted here why having a test based on normalised PBT gives challenges for some types of sponsors (e.g. NFP) and is potentially subject to interpretation and manipulation.

Having a narrow focus on the current profit impact of an action also ignores the extremely relevant contribution to covenant that comes from a sponsor’s cash generation, balance sheet strength and its future prospects. We think that it would be better to have a range of tests incorporating profitability, balance sheet and cash flow. These could be assessed in combination, for example if any one, or any two are breached, or within a matrix or ‘scorecard’. (It may be necessary to have different matrices for different types of employer, similarly to the PPF insolvency risk scorecards.) This could have the additional benefit of incorporating materiality within the definition of the tests.

Options for such additional tests include:

- EBITDA/(DRC + total debt service cost) cover test
- a balance sheet related test such as material reduction in absolute net assets to support financial debt + s75 pension debt (similar in principle to a debt/equity calculation), or
- an increase in balance sheet gearing
- a cash flow test e.g. (EBITDA –maintenance capex)/(DRC + total debt service cost)

In all cases it would be necessary to define underlying EBITDA.

An alternative to EBITDA in the above tests would be free cash flow available to service deficit funding (CFADS)

The Pensions Regulator (Information Gathering Powers and Miscellaneous Amendments) Regulations 2021

5) Do you agree that the requirements in draft regulation 3 (1) cover all the essential information that the interviewee should be made aware of? If not, please indicate which additional items of information you consider should be included.

We have no additional interview notice content to suggest. As regards item (g) – the section 310 statement – we think that the notice should be required to explain to the person what section 310 says. As currently drafted, the notice could merely say "any statements made by you during the interview will be subject to section 310 Pensions Act 2004", leaving it to the person to try to find out what that means. Section 310 confers important rights. We therefore think that something like the following should be added at the end of (g): ", including an explanation of the content of that section

6) Do you think that the draft regulations ensure that The Pensions Regulator has the same inspection powers under section 73(6)(d) to (f) regarding any employer of a multi-employer scheme as it has where there is only a single employer?

This appears to reflect existing multi-employer scheme language under the Pensions Act 2004. As such, we have no comments.

7) Do you agree that £400 is an appropriate level for a fixed rate penalty under new section 77A of the Pensions Act 2004?

We do not wish to comment on the figures specified, except to confirm that we agree with the statements made in the explanations provided as to their derivation.

8) Do you agree it appropriate that the fixed penalty under section 77A is aligned with the fixed penalty under section 40(1)(d) of the Pensions Act 2008 for failure to comply with similar information gathering requirements in connection with Automatic Enrolment?

We do not wish to comment on the figures specified, except to confirm that we agree with the statements made in the explanations provided as to their derivation.

9) If not, please state the level you think would be appropriate and why.

We do not wish to comment on the figures specified, except to confirm that we agree with the statements made in the explanations provided as to their derivation.

10) Do you agree that £200 is an appropriate level for an escalating penalty to be imposed on an individual under section 77B?

We do not wish to comment on the figures specified, except to confirm that we agree with the statements made in the explanations provided as to their derivation.

11) Do you agree it is appropriate that the escalating penalty for an individual under section 77B is aligned with the escalating penalty under section 41(1)(d) of the Pensions Act 2008 for failure to comply with similar information gathering requirements in connection with Automatic Enrolment?

We do not wish to comment on the figures specified, except to confirm that we agree with the statements made in the explanations provided as to their derivation.

12) If not, please state the level you think would be appropriate and why.

We do not wish to comment on the figures specified, except to confirm that we agree with the statements made in the explanations provided as to their derivation.

13) Do you agree that the escalating penalty regime proposed is appropriate for persons who are not individuals who continue to fail to comply with The Pensions Regulator's requests for information? If not, please indicate the level of penalty you think is appropriate and why. If you think a different approach for non-individuals is more appropriate, please give details along with your reasons.

We do not wish to comment on the figures themselves except to note that they start high and escalate quickly to very large numbers. These penalties will often be being sought in circumstances where the Regulator will also be seeking to secure recoveries for the scheme in question from the same party. Requiring the target(s) to pay very high fines, which payments will not get passed on to the scheme, could materially reduce assets available to support the scheme. Of course, the Regulator does not have to seek escalating penalties and can be expected to consider this potential issue when making its decision. But where it does seek escalating penalties, it will have to seek the high sums specified – there is no option to demand less. This could, therefore, deter it from exercising its power in the circumstances noted earlier. Smaller, or more slowly escalating, figures might therefore be more effective because the Regulator might be more inclined to use the power. The Regulator's own views on this will of course be important.

Response ends

If we can support with the development of these matters in any further way, please do not hesitate in contacting us.

Yours sincerely

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