

The Pension Schemes Act 2021: New risks for not for profits (NFPs)

September 2021

- The Pension Schemes Act 2021 gives The Pensions Regulator (TPR) significant new powers from October 2021.
- This includes two new Contribution Notice tests, intended to capture material ‘covenant leakage’ where value leaves employers impacting their ability to support their defined benefit (DB) pension schemes.
- Sponsors of DB pension schemes may need to enhance their governance processes around reviewing actions that could lead to changes in an employer’s net income or assets in order to manage these new regulatory risks.
- This will involve incorporating analysis of the impact of any changes on the pension scheme, where previously this may not have been a consideration within strategy discussions.

What are the new TPR powers?

The Pension Schemes Act 2021 introduces new powers for TPR which will be effective from 1 October 2021.

This includes two new Contribution Notice tests which are expected to trigger in a far wider range of circumstances than the current tests.

A Contribution Notice is a legal requirement to make an additional cash contribution to a DB pension scheme.

TPR will be able to impose a Contribution Notice on NFP employers, other entities within the group, charity trustees or directors of a sponsor of a DB scheme (eg housing association boards) if it decides any one of the two new tests are met. The tests are triggered by changes in an employer’s income or assets:

- The Employer Resources Test benchmarks an employer’s net income relative to the scheme’s buyout debt. For NFPs, if an event takes place that materially reduces the net income then TPR could seek to impose a Contribution Notice
- The Insolvency Test would trigger if actions were taken that were expected to materially reduce the insolvency recovery position for the scheme

The Contribution Notice tests are supported by two new criminal offences which raise the stakes in the circumstances where TPR considers the old or new Contribution Notice tests have been triggered.

In practice, even if there is no increase in the number of Contribution Notices actually issued, the threat of a Contribution Notice under a wider set of scenarios – and the possible threat of new criminal offences – is likely to change the dynamic of employer and pension

scheme trustee negotiations around events which may previously have been considered as ‘business as usual’ activity.

And in cases where TPR becomes involved, we would expect the threat of a Contribution Notice to be leverage to seek additional cash and/or protections for a pension scheme.

This note concentrates on the types of activity that could lead to a breach of the Employer Resources Test or the Insolvency Test.

What actions could cause material changes to net income or insolvency outcomes?

- Introducing new debt, particularly if secured, could materially impact a scheme’s return in an insolvency because the secured debt would rank ahead of the pension scheme’s creditor claim and get first call on an employer’s assets
- Increased debt could also significantly increase interest costs, impacting annual earnings
- Selling assets to pay down a creditor other than the pension scheme
- Running down charitable reserves to cover operating shortfalls
- Paying dividends or gift aiding profits from an employer, for example a commercial subsidiary, to its parent
- Changes to the employer structure or movement of assets around the group

What do not for profit employers need to do?

NFPs will need to review governance processes to ensure any potentially material 'covenant leakage' events are identified early and the impact on the pension scheme is assessed. This all needs to be worked through and documented prior to any decisions being made and documented at Board level.

The chart overleaf outlines an approach for introducing the pension scheme into the governance process (there will be other approaches possible).

The first step is to undertake analysis to establish what the impact of the event will be on the net income and insolvency position. Whilst in some cases it may be relatively simple to test the impact on net income, understanding the insolvency position is more complex. Insolvency analysis will need to be carried out for each potentially material event, to test whether there is a material impact on the insolvency recovery position for each DB pension scheme which the employer sponsors (see call out box for an outline of what this analysis involves).

It is important to note that the new 'Insolvency Test' takes no account of the actual likelihood of sponsor insolvency – it is based on a hypothetical insolvency scenario, and comparing the position the day before and the day after the covenant leakage event. It takes no account of the relative probability of the sponsor going insolvent at any point in time.

Where the insolvency analysis shows that the impact on the scheme is clearly material, or where there is a concern that TPR could view the impact as material, the NFP should consider a combination of:

- Raising with the pension trustees and, if appropriate, offer and agree mitigation for the scheme - both could help support a "statutory defence" of the employer's actions¹
- Building a case for the file as to why it would be unreasonable for TPR to take regulatory action (there are various reasons why this might be the case and are likely to draw upon wider covenant protections in place for the scheme, e.g. a contingent contribution agreement, negative pledges)
- Seeking "Clearance" for the proposed action from TPR.²

It will be important to have a clear audit trail of the analysis conducted and rationale for the conclusions drawn, including details of discussion/engagement

with the pension trustees. This should be clearly documented and reported to the "NFP's board". The aim of this would be to reduce regulatory risk in case this were ever investigated by TPR, to protect the employer and its directors or charity trustees from contribution notices, civil or criminal charges and reputational risk.

Even where the impact on the scheme is considered to be immaterial, there is a need to keep evidential records as a defence against future TPR action (and the employer will need to consider what should be shared with the pension trustees in respect of the process taken by the employer).

What is insolvency analysis?

- The analysis considers the likely recovery to the pension scheme on a hypothetical insolvency of the employer, the day before/after the potential covenant leakage event irrespective of the likelihood of insolvency.
- The creditor stack and group structure will need to be factored into the analysis in enough detail to ensure the estimate is reasonable (analysis can be complex and may need specialist covenant advice).
- This typically includes scenario testing to consider a realistic range of possible outcomes.
- There is no definition of what constitutes a 'material reduction' in the insolvency recovery to the scheme (which is the trigger for the test), and so this would ultimately be decided by TPR if ever in dispute.

What about schemes in surplus or where deficit payments are being made?

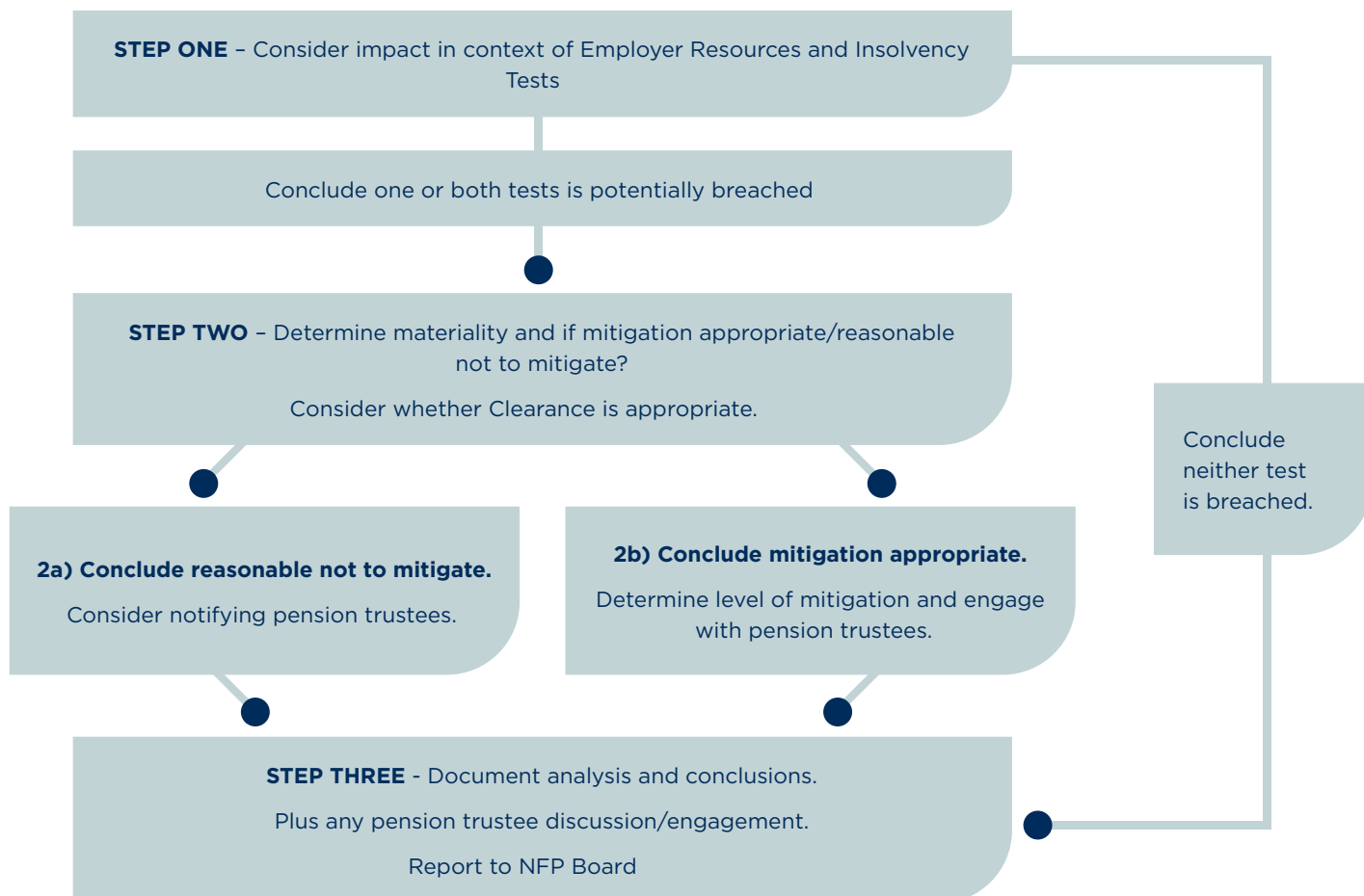
A scheme in a funding surplus, or in deficit but with significant ongoing funding contributions payable, may have previously been seen as persuasive arguments to support employers taking a less rigorous approach to including the pension scheme in the decision-making process.

However, both the new Contribution Notice tests are performed in the context of the scheme's "buyout deficit" (otherwise called the 'Section 75 Debt') – and so this analysis is still required for schemes which are in an ongoing funding or accounting surplus and/or where little or no deficit repair contributions are due.

¹ The statutory defence broadly requires that reasonable steps have been taken to eliminate or minimise the potential for the event to materially reduce scheme insolvency recoveries.

² Clearance provides assurance that TPR won't impose a Contribution Notice for the act.

Potential approach for managing the new risks



Conclusion

NFP Boards will want to understand the potential new regulatory risks which could arise through employer actions, now including even those previously considered business as usual, such as refinancing or using reserves to cover a period of operating shortfalls.

In many cases, there will be a need to revisit governance processes to demonstrate fair treatment of pension schemes within the new regulatory framework so as to reduce regulatory risks.

If you would like any assistance or further information, please contact us.

Want to find out more?

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