

April 2008

Clearance : Updated guidance published March 2008

The Pensions Regulator has published updated guidance for trustees and employers on the clearance process following the draft updated guidance published in September 2007. The guidance does not fundamentally alter the clearance process but instead formalises the way the clearance process has been operating in practice for a number of years.

Background

Clearance is a voluntary process whereby an employer approaches the Pensions Regulator in order to seek formal confirmation that a proposed act (or failure to act) will not result in the Pensions Regulator applying either a "contribution notice" or a "financial support direction" in relation to the act. The Pensions Regulator has always considered clearance to only be necessary where an act is of material financial detriment to the ability of the pension scheme to meet its obligations to the members.

Clearance is only binding on the Pensions Regulator on the basis of the facts disclosed at the time of application and protections fall away if the situation turns out to be materially different from that disclosed.

Clearance applications can only be made by parties connected or associated with the scheme and the employer to the scheme as these are the only parties that can be subject to a "contribution notice" or a "financial support direction". The Pensions Regulator has clarified that whilst corporate trustee companies could in some circumstances be deemed connected or associated this is somewhat notional given the nature of these trustee companies and therefore applications for clearance from corporate trustee companies are not appropriate.

The guidance effectively codifies how the Pensions Regulator has been operating the clearance process in practice for the last couple of years and does not make any fundamental changes. Indeed the guidance is designed solely to clarify matters where the previous guidance was somewhat opaque.

Type A Events

The concept of "Type A" events, being those where there is material financial detriment to the ability of the scheme to meet its obligations, has been retained although the Pensions Regulator has eliminated the restrictive definitions previously supplied that, in practice, had been ignored for some time.

The previously defined "Type B" and "Type C" events have been removed from the guidance given that they were rarely used in practice and created confusion.

Under the new guidance any material detrimental event could be a "Type A" event. A detrimental event will have one of the following impacts:

- It prevents the recovery or the trigger a Section 75 debt or reduces or compromises the amount of any Section 75 debt that would otherwise become due;
- It weakens the employer covenant either because it impacts on the ability of the employer to meet its funding commitments to the scheme or reduces the dividend payable to the scheme in the event of employer insolvency.

These detrimental impacts (assuming that they are material in the context of the scheme and the employer) are further subdivided into employer and scheme related events.

Employer related events are deliberate acts (or failures to act) by the employer that result in a weakening of the covenant such as leveraging of the business, payment of capital returns to shareholders and group restructurings. Such events do not include those that result from normal commercial activity that may result in a weakening of the covenant where these are outside the control of the employer (loss of key customer for example). Such normal commercial events should however be considered by the trustees and the employer as part of their usual process of monitoring the covenant provided to the scheme.

Employer related events only become "Type A" events if they are material and there is a "relevant deficit" (see below).

Scheme related events, if of material financial detriment, are always "Type A" events whether there is a "relevant deficit" or not. Scheme related events are typically any arrangements that result in the Section 75 debt that would otherwise become due being altered in some fashion (typically a compromise agreement or an apportionment agreement).

Relevant Deficits

As with the previous guidance a "relevant deficit" is the highest deficit measured either on the accounting basis (FRS 17 or IAS 19), the Pension Protection Fund basis (Section 179) or the scheme funding basis (the technical provisions).

The Section 75 basis (winding-up cost or buy-out basis) becomes the relevant deficit where there is reasonable doubt as to whether the employer will continue as a going concern, where the scheme is in winding-up or where the event may result in scheme abandonment.

The exception to these simple rules, which has been apparent from the actions of the Pensions Regulator over the past few years, most notably in the creation of the Marconi plc escrow account and the settlement reached with the trustees on the acquisition of Boots plc, occurs where the detriment to the employer covenant is of such significance that the usual definition of the relevant deficit is no longer appropriate.

Examples of such circumstances include:

- The replacement of equity capital with very significant amounts of debt capital for example in a highly leveraged buy-out (similar to Boots plc);
- The sale of the majority of the employer's business with the proceeds returned to the shareholders or other third parties (similar to Marconi plc).

In such cases the relevant deficit will be determined on a stronger basis as seen as appropriate by the trustees. In our recent experience a very significant detrimental event is likely to see the Pensions Regulator looking for trustees to define the relevant deficit as that amount which would allow the scheme to run on self-sufficiently, no longer having to rely on the employer covenant.

The amount required for self-sufficiency is likely to be somewhere roughly equidistant between the FRS 17 position and the Section 75 position. Such a measure would be based on a very low risk investment strategy (AAA rated bonds perhaps) with a reserve held for future administrative expenses and a very prudent mortality assumption.

This is an important stance not detailed in the guidance but has been operated in practice for a considerable time.

Mitigation

Where a "Type-A" event is identified and the employer wishes to apply for clearance then the trustees and employer are required to negotiate appropriate mitigation to restore the security position of the scheme. In reality the clearance process results in confirmation from the Pensions Regulator that the agreed mitigation is reasonable and appropriate.

The amount of mitigation required will depend on the materiality of the detrimental impact on the scheme as well as the size of the appropriate relevant deficit. For a reasonably significant detriment this might mean paying off the deficiency over a relatively short time frame – anything between three and five years. Larger detrimental impacts may require additional security measures on top of the accelerated deficit payments or immediate payment of the whole relevant deficit.

Whilst additional cash contributions are often the preferred form of mitigation for trustees they will not be appropriate in all circumstances and the Pensions Regulator suggests in its guidance that some of the following could be included within a package of mitigation measures:

- Assets placed in escrow;
- Letters of credit, guarantees or insurance;
- Negative pledges or performance thresholds;
- Amendments to scheme rules to strengthen trustee powers;
- Group guarantees or making all participating employers joint and several.

The package of mitigation measures that are appropriate in each particular circumstance are entirely dependant on the circumstances of the scheme, the employer and the nature of the "Type-A" event.

Practical guidance

The guidance also contains a host of practical guidance for trustees and employers.

Of particular note are the sections that describe the clearance process itself and the practicalities involved which will be useful for trustees, employers or advisers going through the clearance process for the first time.

Trustees having to assess their employer covenant in detail for the first time are also provided guidance as to how best to proceed with such a process.

Conclusion

The reality is that the updated guidance does not change how the clearance process has been working in recent times but instead codifies current practice of the Pensions Regulator into formal guidance.

We welcome however this clarification and the re-focusing of the guidance on "material financial detriment" in the widest sense together with the elimination of the somewhat simplistic rules of thumb previously given to determine a "Type-A" event in the initial guidance. Corporate actions often have extremely complex impacts on the scheme that cannot be captured in simple rules of thumb. This is a welcome move towards a more holistic view of the employer covenant and its impact upon the scheme.

One area in which the guidance is somewhat lacking, and in our experience an area for significant conflict between trustees, the employer and the Pensions Regulator, is clarification of where the material impact is such that the relevant deficit needs to be altered. We recognise that one cannot set out detailed proscriptions but the headline focus on FRS 17 is often in conflict with the Pensions Regulator's position in practice creating confusion for trustees and employers.

Where can I get further information?

This briefing note is provided for general information only and should not be relied upon as advice on your specific circumstances. For specific advice, please get in touch with your usual Punter Southall Transaction Services contact

Email info@pstransactions.co.uk or visit our website at www.pstransactions.co.uk

