

September 2007

Proposed Revisions to the Pensions Regulator's Clearance Guidance

On 10th September 2007 the Pensions Regulator ("the Regulator") issued a consultation document on proposed revisions to its existing guidance on clearance statements. The initial guidance was intended to give clarity on the approach the Regulator would take towards the clearance process and explain in more detail how the process would operate in practice. The revisions follow on from the Regulator's comments earlier in the year clarifying that clearance should be considered where there was a significant weakening of the employer's covenant (such as in a highly leveraged transaction) regardless of the funding level of the pension scheme.

Background

The clearance process was introduced in response to industry-wide concerns arising from some of the powers given to the Regulator as set out in the Pensions Act 2004. These powers, generally known as anti-avoidance powers, enabled the Regulator to issue a contribution notice ("CN") or financial support direction ("FSD") to connected or associated parties to a defined benefit pension scheme in certain circumstances.

With the aim of giving greater certainty to organisations and individuals considering corporate transactions involving defined benefit schemes the clearance process was developed whereby the Regulator could be approached on a voluntary basis to give assurance that, based on the information provided, it would not issue a CN or FSD in respect of a particular event.

The Regulator issued its original guidance on clearance in April 2005. The original guidance set out a system for classifying events which may be considered to be financially detrimental to the pension scheme as a creditor. In particular, the guidance introduced the concept of "Type A" events which are financially detrimental to the ability of the pension scheme to meet its pension liabilities and for which it may be appropriate to seek clearance.

The guidance also set out the relevant basis for determining a scheme's deficit when considering the concept of "financially detrimental". This was defined as being the higher of the scheme's FRS 17 deficit or ongoing funding deficit.

Proposed Changes

The Regulator recognises that the original guidance has resulted in some applicants and advisers interpreting the

guidance more restrictively than intended. This may result in an inadequate consideration of the financial security of the pension scheme by both trustees and employers. The revised guidance attempts to address this issue by adopting a principles based approach rather than prescriptive tests. This is in line with the approach that PSTS has always followed when advising on clearance, recognising the spirit of the original guidance.

The overall concept set out in the original guidance is unchanged, namely, that an application for clearance may be considered to be appropriate where an event occurs that is materially detrimental to the ability of the scheme to meet its pension liabilities.

The most significant changes to the guidance are outlined below:

Definition of Type A Events

The definition of Type A events has been amended and now includes two sub divisions; scheme-related events and employer-related events.

Scheme-related events include:

- compromise agreements;
- deficit apportionments;
- the non-payment of a Section 75 debt for an unreasonable period; and
- an arrangement that results in preventing a Section 75 debt from being triggered.

The Regulator notes that this list should not be considered exhaustive and full descriptions of each of these events are included within the guidance to facilitate greater understanding of the type of events to be considered.

Employer-related are less narrowly defined and should be assessed by:

- comparing and contrasting the pre- and post-event employer covenant;
- assessing whether any weakening of the employer covenant would be considered to be materially detrimental; and
- identifying whether the scheme has a relevant deficit.

Such events may include a change in priority, a return of capital and a change to the group structure which were previously considered in the original guidance. However, the revised guidance also specifically refers to a number of other events (including the granting of intercompany loans, phoenix events whereby an employer re-emerges following an

insolvency event, business and asset sales) whilst again recognising that the list included in the guidance should not be considered to be exhaustive.

Employer-related events will not be considered to be Type A events unless the scheme has a deficit on a relevant measure (see below). Scheme-related events will be considered to be Type A events regardless of the level of funding of the scheme.

Relevant Deficit Measure

For an employer-related event to be considered to be a Type A event the pension scheme must have a deficit on a relevant measure. The revised guidance extends the bases to be considered to include the scheme's deficit on the Section 179 basis as well as the originally used measure of the greater of the scheme's deficit on the FRS 17 or funding bases. This reflects the experience of the Regulator to date. Initially it was expected that the Section 179 basis would always result in lower deficits than the FRS 17 or funding basis but actual case studies have shown that this does not always hold true.

As before, the Regulator also recognises that there will be times when other, higher measures should be considered. This would be the case if the event is considered to be significantly detrimental to the pension scheme or if an apportionment is being considered. In these cases the buy-out deficit may be the most appropriate measure.

Removal of Type B and C Events

Type B events were defined in the original guidance to be events that do not affect the pension creditor and therefore an application for clearance would not be considered to be appropriate. Type C events were defined to be events that might affect the pension creditor and generally involve a deterioration in the employer's covenant.

The Regulator has removed these definitions from the guidance since in practice these events were rarely recognised. However, the terminology of "Type A" events is to be retained since this has been widely used and recognised by pension experts.

Materiality

For each scheme-related event the exact circumstances leading to the event being considered to be materially detrimental are set out in the guidance.

For employer-related events the employer covenant pre- and post- the event will need to be considered to see if the impact is materially detrimental to the pension creditor.

It is therefore necessary for the trustees and the employer to receive advice on the strength of the employer covenant although it is expected that this is an area where both the trustees and employer will gain expertise as they become more familiar with the clearance process.

It should be noted that this is a significant shift in approach in the Regulator's guidance moving away from the more quantitative tests that were included in the original guidance

e.g. if a change in priority involved more than 25% of the total assets of the employer. This approach places more responsibility on the parties involved to make a judgement on the overall impact of the event.

Level of Mitigation Expected

The Regulator states that where a Type A event has been identified the employer and trustees should negotiate the most appropriate mitigation. The Regulator lists a range of actions that may be considered appropriate including direct financial actions such as additional cashflows, improvements in priority and the use of escrow accounts to more indirect actions such as a change to the scheme rules and performance thresholds.

In addition, the Trustees have the option of reopening an agreed recovery plan and triggering a new scheme valuation at any time. However, it is recognised that this could be a timely and costly course of action and it may be better to consider mitigation in isolation.

General comments

The move by the Regulator to emphasise a principles based approach is a sensible one encouraging all parties and their advisers to consider the pension scheme as a creditor in its broadest sense. We welcome the additional clarity provided by the Regulator in the proposed guidance and the confirmation that our approach to advising on clearance remains rigorous within this new framework. We also note that this approach reiterates the need for good quality advice on the assessment of the pension scheme as an unsecured creditor of the employer in the overall context of the employer's covenant rather than the often seen "tick box" approach by some advisors.

Finally, it is worth reiterating that the clearance process is voluntary, designed to give comfort to companies and individuals that the Regulator will not issue a CN or FSD. Therefore, the cost of obtaining clearance should always be considered against the security that such comfort would provide.

Next Steps

The deadline for responses to the consultation is 2nd November 2007 and we would expect the Regulator to move quickly to finalise the revised Guidance. Depending on the results of the consultation we would expect the new Guidance to be in force by the end of the year.

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.

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