

**EXPLANATORY MEMORANDUM TO THE
PENSIONS REGULATOR (FINANCIAL SUPPORT DIRECTIONS)
REGULATIONS 2005**

2005 No. 2188

1. This explanatory memorandum has been prepared by the Department for Work and Pensions and is laid before Parliament by Command of Her Majesty.

2 Description

- 2.1 The Pensions Act 2004 (the Act) provides for a new Pensions Regulator which replaced the Occupational Pensions Regulatory Authority (Opra) from 6 April 2005. The Regulator's statutory objectives and functions, set out in the Act, establish a framework for its regulatory activity. It has inherited Opra's existing powers and has, in addition, a number of new ones.
- 2.2 Sections 43 to 50 of the Act provide the Regulator with new powers to issue a financial support direction to the employer and persons connected and associated with the employer.
- 2.3 A financial support direction allows the Regulator to direct that associated and connected persons put in place arrangements to support the pensions liabilities of an employer who is insufficiently resourced or is a "service company" as defined in the legislation. If the Regulator's direction is not complied with then the Regulator will be able to issue a "non-compliance contribution notice" to any person named in the direction requiring them to pay a specified amount into the pension scheme direct. However, the Regulator will only be able to do this if it believes that it is reasonable to do so, having regard to a number of factors that are specified by the legislation.
- 2.4 A financial support direction cannot be issued to an individual save in certain circumstances, for example where the employer is an individual. The Regulator can only issue a direction to a person if it considers it is reasonable to impose the requirements on that person. Once the Regulator has issued such a direction, those to whom it is issued must put forward proposals for financial support for the whole or part of the employer's pension liabilities. The Regulator must approve these arrangements in a notice.
- 2.5 These Regulations make further provision about section 43 and related sections of the Pensions Act 2004 ("the Act"), known as one of the anti-avoidance provisions. The Regulator has the power to issue financial support directions.
- 2.6 The Regulations are also, in relation to all the anti-avoidance provisions (that is, contribution notices, financial support directions and restoration orders)

extend the meaning of employer to include former employers in specified circumstances and modify those provisions of the Act in their application to multi-employer schemes.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None

4 Legislative Background

4.1 The Secretary of State for Work and Pensions is empowered to make regulations under the Pensions Act 2004. In this case the Secretary of State for Work and Pensions is exercising the powers conferred upon him by sections 43(1)(b), (3)(c) and (9), 44(3)(a) and (4), 45(2)(b), (c) and (d), 307(1)(b), 315(2) and (4) and 318(1) and (4)(a) of the Pensions Act 2004.

4.2 The Regulations identify the various prescribed requirements in connection with the Regulator's power to serve a financial support direction. These include:

- a. how to determine, calculate and verify the value of resources;
- b. events that persons have to inform the Regulator about if there are changes to circumstances;
- c. the period during which the person must meet the "insufficiently resourced" test;
- d. the percentage of the estimated section 75 debt for the purposes of determining whether an employer is insufficiently resourced;
- e. arrangements for financial support.

4.3 These requirements enable the policy objective to be maintained but also factor in the requirement of reasonable cost to the employers of occupational pension schemes (and their associates).

4.4 A key factor is the test to establish "value of resources" of both the employer and the "associated and connected" persons. This is set out in section 44(3) of the Pensions Act 2004 and means that an employer is insufficiently resourced if both of the following criteria are met:

- the value of resources of the employer is less than a prescribed percentage of the estimated section 75 debt of that scheme; and

- there is an associated person whose value of resources is at least equal to any shortfall calculated above.
- 4.5 An employer is, therefore, only considered insufficiently resourced in the context of the Act when it is itself ‘poor’ but there is an associated person that is ‘rich’. The Act leaves the definition of value of resources to be prescribed by regulations.
- 4.6 During debate in Parliament, it was concluded that the measure of value would need to encompass more than amounts recorded as net assets in a person’s balance sheet. Net assets may understate value if based on the historic cost convention rather than current fair value. Certain types of business may be very valuable but have little assets and these businesses needed to be captured in the test.
- 4.7 Before the Secretary of State makes any regulations by virtue of the Pensions Act 2004, he may be required to consult such persons as he considers appropriate. There is no formal requirement to consult in this case because the regulations will be made within six months of the sections of the Act coming in to force under which the regulations are made. However, extensive consultation has been undertaken.

5 Extent

- 5.1 This instrument applies to England, Wales and Scotland. Corresponding provision will be made for Northern Ireland (NI) by a statutory rule consequential on equivalent provisions contained in the Pensions (Northern Ireland) Order 2005 and under powers contained in NI pensions legislation which correspond to those under which this instrument is made.

6 European Convention on Human Rights

6. As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7 Policy Background

- 7.1 The Regulations are necessary. To do nothing is not an option as this could lead to employers passing on their pension liabilities to the Pension Protection Fund without the Regulator having any power to recover money from parent or connected companies.
- 7.2 In order to determine the full value of an entity’s resources it is necessary to perform a business valuation. However, as this can be a time-consuming and costly process for certain types of business, it is suggested that this should not be required if sufficient value to meet the criteria set out in the test can be demonstrated using alternative, more

readily available sources of information. Such sources might include statutory accounts, updated accounts and consideration of fair value of individual line items.

- 7.3 To minimise unnecessary disruption and expense to the employer and its associated persons, the Regulations set out a staged approach for establishing the value of resources, giving choice to both the employer and its associates and the Regulator as to the details of the calculations to be performed and only requiring full entity valuation where the earlier stages demonstrate the test is not met, or where the person whose resources are being valued choose to conduct a full entity valuation.
- 7.4 It is impossible to estimate at this stage how many financial support directions the Regulator is likely to serve as it is a new power and the industry is just getting to grips with it. However, results from April 2005 (when the Regulator came into power) to date are encouraging in that in potential financial support direction cases where clearance has been sought a large percentage have voluntarily put some additional support into the pension scheme. Of those where no support has been forthcoming, – there has been no money available to do so e.g. no person could be identified on whom a financial support direction could have been issued in any event.
- 7.5 A financial support direction can be issued on any employer who has a defined benefit scheme (with a few exceptions) and on most persons who are connected or associated with the employer. A financial support direction can only be served on an individual where the employer itself is an individual.

8 Impact

- 8.1. An assessment of the impact on business, charities or the voluntary sector of the provisions in these regulations is included in the Regulatory Impact Assessment attached at Annex A.
- 8.2 The regulations will have no impact on the public sector.

9 Contact

- 9.1. The policy official responsible for these Regulations is:

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REGULATORY IMPACT ASSESSMENT

THE PENSIONS REGULATOR (FINANCIAL SUPPORT DIRECTIONS) REGULATIONS 2005

Issue

2. This Regulatory Impact Assessment (RIA) sets out the likely costs to business of the requirement to carry out a “value of resources” test and the other requirements which enable the Pensions Regulator (the Regulator) to serve a financial support direction on an employer and associated or connected persons in relation to an occupational pension scheme.
3. Sections 43 - 50 of the Pensions Act 2004 provide the Regulator with the power to issue a financial support direction to the employer and persons connected and associated with the employer.
4. A financial support direction allows the Regulator to direct that associated and connected persons put in place arrangements to support the pensions liabilities of an employer who is insufficiently resourced, or is a “service company” as defined in the legislation. If the Regulator’s direction is not complied with, then the Regulator will be able to issue a “non-compliance contribution notice” to any person named in the direction requiring them to pay a specified amount into the pension scheme direct. However, the Regulator will only be able to do this if it believes that it is reasonable to do so, having regard to a number of factors that are specified by the legislation.
5. A financial support direction cannot be issued to an individual save in certain circumstances, for example where the employer is an individual. The Regulator can only issue a direction to a person if it considers it is reasonable to impose the requirements on that person. Once the Regulator has issued such a direction, those served must put forward proposals for financial support for the whole or part of the employer’s pension liabilities. The Regulator must approve these arrangements in a notice.

Objectives

6. The Regulations identify the various prescribed requirements in connection with the Regulator’s power to serve a financial support direction. These include:

- a. how to determine, calculate and verify the value of resources;
 - b. events that persons have to inform the Regulator about if there are changes to circumstances;
 - c. the period during which persons must meet the “insufficiently resourced” test;
 - d. the percentage of the estimated section 75 debt for the purposes of determining whether an employer is insufficiently resourced;
 - e. additional kinds of financial support.
7. These requirements enable the policy objective to be maintained but also factor the requirement of reasonable cost to the employers of occupational pension schemes (and their associates).
 8. A key factor is the test to establish “value of resources” of both the employer and “associated and connected” persons. This is set out in section 44(3) of the Pensions Act 2004 and means that an employer is determined to be insufficiently resourced if both of the following criteria are met:
 - a. the value of resources of the employer is less than a prescribed percentage of the estimated section 75 debt of that scheme; and
 - b. there is an associated person whose value of resources is at least equal to any shortfall calculated in (a).
 9. An employer is, therefore, only considered insufficiently resourced in the context of the Act when it is itself ‘poor’ but there is an associated person that is ‘rich’. The Act leaves the definition of value of resources to be prescribed by regulations.
 10. During debate in Parliament, it was concluded that the measure of value would need to encompass more than amounts recorded as net assets in a person’s balance sheet. Net assets may understate value if based on the historic cost convention rather than current fair value. Certain types of business may be very valuable but have little assets and these businesses needed to be captured in the test.
 11. In order to determine the full value of an entity’s resources it is necessary to perform a business valuation. However, as this can be a time-consuming and costly process for certain types of business, it is suggested that this should not be required if sufficient value to meet the criteria set out in the test can be demonstrated to the Regulator using alternative, more readily

available sources of information. Such sources might include statutory accounts, updated accounts and consideration of fair value of individual line items.

12. To minimise unnecessary disruption and expense to the employer and its associated persons, the Regulations set out a staged approach for establishing the value of resources, giving choice to both the employer and its associates and the Regulator as to the details of the calculations to be performed and only requiring full entity valuation where the earlier stages demonstrate the test is not met, or where the person whose resources are being valued choose to conduct a full entity valuation.

Risk assessment

13. If the proposed requirements contained in the Regulations are not implemented this will dilute the protection of members benefits under occupational pension schemes and also increase the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund.

Options

13. The Regulations are necessary. To do nothing is not an option as this could lead to employers passing on their pension liabilities to the Pension Protection Fund without the Regulator having any power to recover money from parent or connected companies.
14. It is very difficult to determine precise costs to business of these Regulations. The size and nature of the business and the stage at which the “resources” are to be valued are essential criteria and vary from case to case. The following endeavours to identify possible costs and burdens on business.

Valuation of Employer’s resources

15. The regulations allow ‘resources’ to be valued via a staged process. In order for the test to be met an employer’s resources must be less than 50% of the estimated section 75 debt – if after any stage of the test the resources are greater than 50% and this is verified no further calculations need to be carried out.
16. Stage one of the test uses the employer’s latest statutory accounts that must be prepared in accordance with the Companies Act 1985 (therefore no or very little additional cost or burden). The test is essentially the net assets of the business plus any pension liability (or less any pension surplus). Any capable finance director can perform this test within a matter of minutes. Any cost to perform this exercise would be negligible. If the result is greater than 50% of the estimated section 75 debt the

calculation will need to be verified – see verification below. If the result is less than 50% of the estimated section 75 debt, stage two will need to be carried out.

17. Stage two of the test builds on the work carried out at stage one. It requires the employer to identify one or more assets and / or liabilities that, when valued at fair value as opposed to historic cost, would result in the resources being more than 50% of the estimated section 75 debt. This stage would require revaluations of one or more assets / liabilities to ascertain fair values.
18. Under UK Generally Accepted Accounting Principles (GAPP) most assets and liabilities are held at historic cost which may be significantly below fair value. However accounts prepared under International Financial Reporting Standards (IFRS) are required to record more (but not all) of their assets and liabilities at fair value.
19. From January 2005, groups with securities listed on regulated exchanges in Europe are required to prepare their consolidated accounts under IFRS, however adoption for entity accounts is optional. It is too early to determine how many companies will adopt IFRS in their entity accounts but many are expected to defer the change or not change at all. Developments in IFRS over the next few years are expected to increase the scope of fair value accounting, and there is a UK GAAP convergence project which will, in time, lead to more assets and liabilities being held at fair value whatever GAAP is adopted. Until the accounting frameworks have been revised the entity and consolidated statutory accounts of groups and their companies will continue to be prepared predominantly on an historical cost basis and obtaining fair values for most assets will have to be done at additional time and expense.
20. The effort needed to obtain fair value information will depend on the nature of the assets to be valued and whether recent valuations have been performed. Valuation exercises may range from the straightforward (e.g. investments held in quoted shares) to the very complex (e.g. a brand acquired some years ago). In order to minimise the burden on companies, the regulations require that management only revalue such assets as are required to pass the insufficiently resourced test. It is expected that management should at little cost be able to identify those assets which are recorded at significantly below market value before embarking on a valuation exercise and that, if choosing to stop at stage 2, they will 'cherry pick' those assets which they believe will lead to the test being passed at the least effort and expense.

Valuation of Associate's Resources

21. Once again this is ascertained using a staged process to ensure costs and burdens are kept to a minimum. Stages one, two and three are the same as above where the associate carries out a business. Calculations

may stop after any stage if the result (once verified) demonstrates that the associate has sufficient resources to meet its part of the 'insufficiently resourced' test.

22. Where an associate does not carry on a business – the value of that person's resource is similar to 'a statement of affairs' that one would draft for self assessment / tax planning purposes. The possibility of any financial support direction being served on such a person would be very rare indeed because:
 - a. not only must that person have sufficient resources in their personal capacity to satisfy 50% of the estimated section 75 debt (less the resources of the employer),
 - b. but also it would be difficult to justify that this was reasonable resorting to 'connection with the employer' and 'benefit derived from the scheme' factors, and
 - c. the employer would have to be an individual (which includes partnerships) and less than 0.34% of defined benefit schemes have a partnership as an employer.

Verification

23. Verification will only be required once in relation to each entity. This may be after any stage where the test is met, or after the third stage where the test is not met. Verification for a business requires the directors (or persons of similar responsibility where the body has no directors) to sign a statutory declaration to the effect that the calculation has been approved by the board and that it fairly reflects the value of the resources of the entity to the stage reached in the test.
24. The declaration must be accompanied by an accountant's report verifying that the calculation was conducted using the assumptions disclosed by the directors and calculated in accordance with the Regulations. The cost of this verification will be dependant on the size of the company and stage the final result will be based. For example a stage one verification will be less time consuming and relatively inexpensive (in the region of £5,000 –£10,000).
25. Where a full business valuation is required the cost of verification could be significantly more, depending on the size and nature of the business (average around £50,000) However, it is expected that very few stage three calculations will be required. Partially due to the majority of associates putting in place financial support voluntarily and also where there is genuinely no 'rich' associate this should be evident from external evidence such as share markets, interim accounts and banking arrangements. The Regulator will only pursue those associates where it has evidence that it can afford to support a scheme and it is refusing to put in place voluntary support.

26. Verification for non-business associates is entirely at the discretion of the Regulator to limit unnecessary costs . Where it is necessary to carry out verification the cost will be small (average cost around £1,000 -£5,000)
27. Verification is required as the Regulator does not have the skills to verify accounts and calculations for each entity. The Regulator's role is to be satisfied that the test is met – it should not undertake the verification role in order to remain independent of the process. The persons best suited to know the true value of the business are the persons running the business – the statutory declaration adds weight to the verification process and the accountant's check ensures correct processes have been complied with.

Mitigation

28. Financial support directions are effective tools for the Regulator to prevent employers and parent companies 'dumping liabilities on the Pension Protection Fund. However their presence to date (since 6 April 2005) has changed behaviour by encouraging corporate organisations to seek clearance of certain transactions from the Regulator. This has encouraged businesses to regard their pensions responsibilities seriously and negating the need for the Regulator to impose financial support directions. Via clearance applications the Regulator has involved the trustees in negotiations that have resulted in employers / parents putting financial support in place voluntarily.
29. We believe this behaviour is likely to continue as the majority of employers are responsible and wish to stand behind their pension promise. The Regulator will encourage dialogue and negotiation amongst the employers and trustees in an attempt for financial support to be put in place voluntarily. Voluntary arrangements do not need any 'value of resources tests' to be calculated or verified saving the businesses concerned any additional costs. The tests will only be applied where employers / associates refuse to voluntarily put financial support in place where the Regulator is of the opinion that it is reasonable to impose a financial support direction on that person. There are many factors it must consider, financial capability is only one. Connection to the schemes and benefit derived from the employer are other factors.
30. Around 8.9 million public and private sector employees are members of defined benefit occupational pension schemes, and 1.1 million are members of defined contribution occupational pension schemes. Most defined benefit schemes are run by large companies some of which are listed companies. It will therefore be a relatively simple exercise to ascertain the estimated value of a listed company by reference to its share price. Only if it is clear from such external evidence that there is an associate that can stand behind a struggling pension scheme and that associate did not put support in place voluntarily would the Regulator

deem it necessary for businesses to perform the value of resources tests.

31. It is impossible to estimate at this stage how many financial support directions the Regulator is likely to serve as it is a new power and the industry is just getting to grips with it. However results from April 2005 to date are encouraging in that any potential financial support direction cases where clearance has been sought a large percentage have voluntarily put some additional support into the pension scheme. Of those where no support has been forthcoming – there has been no money available to do so e.g. administration where no person could be identified on whom a financial support direction could have been served in any event.

Business sectors

32. A financial support direction can be served on any employer who has a defined benefit scheme (with a few exceptions) and on any person who is connected or associated with the employer. A financial support direction can only be served on an individual where the employer itself is an individual. An individual includes a partnership and unincorporated association. The Regulations do not distinguish between charities and voluntary sectors.

Compliance costs for business, Charities, and Voluntary Organisations

33. Where charities and voluntary organisations have a defined benefit scheme or where they are connected to a person who has a defined benefit scheme these Regulations could apply to it.

Compliance costs for a typical business

34. This is very difficult to determine for the reasons explained in this Regulatory Impact Assessment. It is estimated that costs to be business could be as follows:
 - Non business (ie individually resourced) up to £5,000
 - Small asset based business £10,000 - £20,000
 - Medium asset based business £20,000 - £30,000
 - Very large asset based business up to £50,000
 - Non asset based business £10,000 - £100,000

Other costs

35. None.

Consultation

36. There has been informal discussion with the pensions industry on the detail of the Regulations. It was accepted that a finite test is required for those organisations who do not wish to voluntarily support their pension schemes. The staged approach was welcomed by parties such as British Telecom, the Institute of Chartered Accountants (England and Wales), Alchemy and Barclays Bank. The consultation stemmed from The Right Honourable Baroness Hollis of Heigham giving an undertaking in the House of Lords last summer, during Grand Committee, to consult on all the “moral hazard” sections of the Act (employers deliberately manipulating their affairs so as to shift their deficits to the Pension Protection Fund).
37. The power of the Regulator to issue financial support directions is a particularly complex and technical area and could possibly have significant impact on business. Ministerial approval was provided to broaden the consultation to a number of finance and other directors of top UK companies.
38. The consultation document and draft Regulations were sent to the pensions and business industry on 5 April 2005, seeking comments by 20 May. Those consulted included PricewaterhouseCoopers, the Association of Pension Lawyers, British Venture Capital Association, and the CBI, as well as a number of finance and other directors of top UK companies including British Telecom, Zurich Insurance, Royal and Sun Alliance, Barclays and Freshfields (law firm))
39. The aim of the consultation was to seek the views of pensions experts and all those with an interest in occupational pensions on a range of technical issues.

Summary and recommendation

40. Following consultation with representatives in the pensions industry and the accountancy profession the assessment has indicated the need for these Regulations, though there will be additional costs to business. To do nothing is not an option as this could lead to employers passing on their pension liabilities to the Pension Protection Fund and leaving the Regulator powerless to correct / alleviate the problem.

Monitoring and review

41. The impact of the proposed legislation will be closely monitored. Its effectiveness and whether more needs to be done to meet its objectives will be reviewed regularly.

Minister's statement

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister

...*Stephen C. Timms*.....

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