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Current issues

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Articles this month:

Stronger Regulator to protect DB schemes

The Department for Work and Pensions (DWP) has announced the outcome of a consultation exercise on proposed new powers for the Pensions Regulator.[1] It will create new notifiable events, require '*declarations of intent*' to be made before some corporate transactions, introduce additional penalties (including criminal offences) for non-compliance, revise the Regulator's 'moral hazard' powers, and boost its information-gathering abilities.

Corporate transactions

Notifiable events

There will be two new events about which employers must notify the Regulator. They will occur when a decision is made to (i) sell a material proportion of the business or assets of an employer that is responsible for funding at least twenty per cent of a pension scheme's liabilities; or (ii) grant security over a debt that gives the creditor higher priority than the scheme. It will no longer be necessary for employers to given notification about wrongful trading.

A proposal to require notification to be given at an early stage (rather than after the event, as is common practice now) has been parked whilst the DWP and the Regulator consider the best approach. The Government recognizes the need for suitable definitions of phrases (e.g. '*material proportion*') used in the new notifiable events; another consultation exercise will follow on the details. The consultation outcome document also mentions the possibility of new scheme-related events and others specific to commercial DB consolidators.

Declarations of intent

The two new notifiable events, as well as an existing one that applies when a company decides to relinquish control of a sponsoring employer, will also trigger the obligation to produce a '*declaration of intent*'. It will be addressed to the trustees, with a copy sent to the Regulator. The contents of the declaration have yet to be settled, but the idea is that it will describe the proposed transaction and how any harm to the scheme will be alleviated.

Guidance

The Regulator is to revise *Code of Practice No. 2: Notifiable Events* and associated guidance to set out its expectations for the timing of notifiable events and declarations of intent, and stress the importance of collaboration

[1] <assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/777758/response-protecting-defined-benefit-pension-schemes.pdf>.

between trustees and sponsors. The Government plans to formally assess the likely effects on businesses. The Regulator will also review its guidance on the clearance process for corporate transactions.

Fines & Offences

The DWP will allow the Regulator to impose civil penalties of up to £1 million for some '*serious breaches*', including '*wilful or reckless behaviour in relation to a pension scheme*'; failure to comply with contribution and financial support notices or the notifiable events or 'declaration of intent' rules; and knowingly or recklessly providing false information to trustees or the Regulator. Non-compliance with a contribution notice, and '*wilful or reckless behaviour* …' will also become *criminal* offences, which could be met with *unlimited* fines and, in the case of wilfulness/recklessness, by imprisonment for up to seven years.Contribution notices

A contribution notice essentially demands that an employer (or an associate of the employer) pays a specified amount to a DB scheme because its actions were intended to prevent full recovery of a 'section 75' (buy-out-based) deficit, or were materially detrimental to its ability to pay members' accrued benefits. The payment required by a contribution notice can be all or part of the scheme's buy-out deficit.

The DWP is planning to amend the legislation on contribution notices to clarify some issues. It will specify that the effect of a party's actions on a scheme is relevant when determining the amount payable, and that the 'material detriment test' would be met if the amount recoverable by the trustees in a hypothetical employer insolvency, or the value of the employer relative to the scheme's 'section 75' deficit, has been materially reduced by an act or omission.

At the moment, the sum specified in the notice is calculated at the time of the act or omission in question, which can be some time in the past. The DWP proposes to allow the calculation to take place closer to the date of the Regulator's decision to issue the notice. It is considering whether and how to specify a method for uprating the sum specified to take account of delays in payment.

Financial support directions/notices

A financial support direction obliges that some form of additional support is put in place for sponsors that are service companies, or are otherwise '*insufficiently resourced*' relative to their scheme liabilities. Unlike a contribution notice, a financial support direction carries no implication of wrongdoing, and cannot ordinarily be addressed to individuals. At present, financial support directions can take several forms. The recipient of the direction is expected to put forward its plan for providing the required support, and the Regulator either approves or rejects the proposed arrangements.

The DWP intends to amend the legislation to make it a single-stage process, under which the Regulator will either require the recipient to provide a cash payment or become joint and severally liable with the employer. As it will become less of a direction and more of a demand, the power will be rebranded as a 'financial support *notice'*. The possible targets for the notice will be broadened to include individual controlling shareholders of the employer, but not its directors; if, however, a financial support notice is not complied with, the Regulator will be able to issue contribution notices against the original recipient and any person (including individuals) associated with it.

The DWP intends to re-define '*service company*' and '*insufficiently resourced*', in the latter case to focus more on the scheme's funding position rather than (as currently) the value of the employer relative to its estimated section 75 debt. It will re-consider whether to allow the Regulator to look back further than two years to identify the existence of the conditions necessary for a financial support notice.

Information gathering

The Regulator will be given new powers to require people to submit to an interview (subject to prior written notice) and to inspect premises (without notice, if it thinks that an unannounced visit is necessary to ensure that documents are preserved). Those who fail to co-operate will incur new fixed and escalating penalties; the maximum fines have yet to be decided, but are likely to be commensurate with those that can currently be imposed

under auto-enrolment and master-trust legislation (£400-to-£500 fixed penalties, and escalating penalties capped at £10,000 per day in some cases).

Most of the changes have broad industry support. Many will, however, require primary legislation, or further rounds of consultation, or both; and it may be that 6 April 2020 is the earliest possible date on which they can come into effect. Meanwhile, the Regulator is already committed to a '*clearer, quicker and tougher*' approach.

Defined contribution pensions: investments and consolidation

The Department for Work and Pensions (DWP) is seeking views on some possible changes affecting the investment and general governance of defined contribution (DC) occupational pension schemes.[2] The proposals are intended to encourage trustees to consider, firstly, opportunities for investment in illiquid assets; and secondly, whether their members' interests would be better served by scheme consolidation.

Illiquid investments

The DWP is concerned that, when schemes invest almost entirely in highly liquid assets, members lose out on the illiquidity premium that comes from investment for the long term. Sectors of the economy such as those involving smaller firms, housing and infrastructure also miss the opportunity to access pension scheme investment flows.

The Government therefore moots the idea of requiring trustees to make statements about the extent to which their investment strategies involve consideration of illiquid investments. The obligation would fall upon occupational schemes with a DC element above a certain magnitude. The relevant measure of size might be DC assets above, say, £250m or £1bn; or it could be based on total scheme membership, with the threshold set at, for example, 5,000 or 20,000 members. Public service pension scheme and those for which the only money purchase benefits are derived from additional voluntary contributions are likely to be exempted from the requirement.

The suggestion is that the trustees' policy on illiquid investments could become a mandatory part of their statement of investment principles (SIP). Under changes that are already set to come into force on 1 October 2019, SIPs will have to be made freely available online; and with effect from 1 October 2020, trustees will have to report, annually, on how their SIPs have been put into practice. In this implementation statement, which will also have to be made available to all, online, trustees would be required to report the approximate percentage holdings of illiquid assets in their default investment arrangements, broken down to whatever degree they feel is appropriate.

The DWP also mentions, in passing, a current Financial Conduct Authority (FCA) consultation paper on proposed changes to the 'permitted links' rules, intended to allow unit-linked funds to invest in a broader range of long-term assets.[3] It remains open for comments until 28 February 2019.

Performance fees & the charge cap

The Government is aware that the charge cap that applies to the default investment arrangements of schemes used for auto-enrolment compliance may deter investment in illiquid assets. This is because funds offering illiquid investments often incorporate a performance-related fee within their charging structures, which can be hard to accommodate within the cap. Whilst the DWP is not proposing to exclude performance fees from the charge cap, it is considering the introduction of a new method of assessment specifically for them. It proposes to allow for a performance-related fee to sit alongside a charge on funds under management, but not to permit other possible combination charging structures involving performance fees. Statutory guidance could cover appropriate fee structures and the details of the charge-cap calculation.

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[2] *Defined contribution pensions: investments and consolidation* <assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/776181/consultation-investment-innovation-and-future-consolidation.pdf>.

[3] *CP18/40: Consultation on proposed amendment of COBS 21.3 permitted links rules* <www.fca.org.uk/publication/consultation/cp18-40.pdf>.

Consolidation of smaller schemes

The DWP is concerned too that smaller schemes are less able to produce good outcomes for members (harking back to the earlier part of the consultation paper, it notes that they are, for example, limited in their ability to take advantage of the potential returns offered by illiquid investments). It proposes that those below a certain threshold (perhaps £10m in assets or 1,000 members, initially) could be required to assess whether it might be in their members' interests to consolidate. It could be made part of the 'value for members' assessment that must be included in the trustees' annual statement on governance (A.K.A. the Chair's statement), and might have to be repeated at least triennially, and after significant changes in the scheme's demographics.

The DWP also puts forward the possibility of identifying the schemes that might need to consider consolidation based on other criteria, such as the extent of their trustees' knowledge and understanding, or whether they are closed to new members and have particular demographic characteristics (e.g. lots of younger members). It notes that such an approach, whilst having some advantages, would be hard to apply and police.

Next stages

Comments upon the consultation proposals should be submitted to the DWP by 1 April 2019. Draft legislation will be produced for any proposals that are taken forward, and it too will be subject to consultation.

Illiquid assets or patient capital can significantly improve DC member outcomes at retirement. Investment in smaller- and medium-size unlisted firms, for example, can improve the return expectations for young members with long investment horizons. Similarly, infrastructure can be useful to deliver an inflation-linked income stream that can be beneficial when members retire. More illiquid investment by DC schemes could also make a big difference in society given their potential to contribute to projects such as renewable energy.

We are supportive of any proposal to remove non-regulatory barriers to pension investment, including difficulties associated with daily pricing or dealing in illiquid assets. However, the costs of illiquid assets are currently so high that even the largest DC schemes cannot allocate meaningful amounts to them. In our view, a five-to-ten per cent allocation to illiquid assets will not sufficiently improve risk and return characteristics. The pricing needs to improve so that DC schemes can allocate a meaningful amount into these assets. Furthermore, we need to recognize that illiquid assets come with added governance requirements, and fiduciaries must be comfortable with the risks attached to such investments.

Regulator highlights recent DB funding interventions

In its latest Compliance and Enforcement Bulletin, the Pensions Regulator focuses on recent activity intended to compel employers to improve the funding of their defined benefit (DB) pension schemes.[4] The moral drawn from the highlighted cases is a warning that the Regulator '*will take action*' if it sees '*substantial dividends with low scheme contributions and long recovery plans.*'

The Regulator expects that schemes with strong employers will have short recovery plans. The 5.9-year average recovery plan length for strong employers is mentioned as a yardstick: anything longer is likely to attract its attention. It also expects to see a shorter recovery plan if the employer's dividends are high relative to its deficit-reduction contributions.

During the fourth quarter of 2018, says the Regulator, its intervention led to shorter recovery plans and higher contributions-to-dividends ratios for '*a number*' of schemes. It also claims some successes in encouraging front-end rather than back-end loading of recovery plans (that is to say, contributions started high and reduced over the periods covered by the plans).

[4] *Compliance and Enforcement Quarterly Bulletin: October to December 2018* (published February 2019) <www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/compliance-and-enforcement-quarterly-bulletin-october-to-december-2018.ashx>.

The Regulator highlights its involvement with Southern Water, where it threatened to use its statutory powers in order to impose a recovery plan.[5] In the event it was not necessary, as the employer agreed to make higher deficit-recovery contributions over a shorter period. Southern Water also put in place a mechanism under which the payment of dividends beyond a certain threshold will trigger an acceleration of its DRCs.

The Regulator's involvement in the other case study mentioned in the Bulletin was triggered by concerns about the scheme's 2014 valuation, and the employer's reluctance to discuss them. It also detected a lack of rigour about the trustees' employer covenant assessment. As a consequence, it decided to get more involved in the 2017 valuation process, and '*strongly objected*' to the employer's plans to pay dividends, The result was (as with Southern Water) a dividend-sharing agreement, and a recovery plan that was of the same length (nine years) as that which followed the 2014 valuation, but involved deficit-recovery contributions of £13m rather than £5m per annum.

The Regulator closes its discussion by encouraging trustees to read the annual funding statement that is due to be published in the spring before finalizing their recovery plans.

The Regulator is clearly keen to plant a flag warning employers to treat their pension schemes fairly relative to other stakeholders.

DWP to issue guidance on 'GMP equalization'

It has been confirmed that the Department for Work and Pensions (DWP) will publish guidance on a possible method for equalizing pensions to eliminate differences arising from guaranteed minimum pensions (GMPs).[6]

Baroness Buscombe, the DWP's spokesperson in the House of Lords, said that it '*will provide guidance in the near future for schemes wishing to use the method upon which the department consulted in November 2016.*' The consultation document to which she referred contained a possible methodology, drawn up by an industry work group, for achieving 'GMP equalization'.[7] It entails a one-off exercise that compares the values of members' relevant benefits with those of their opposite-sex *doppelgängers*, and converts the higher of those values in each case into actuarially equivalent, non-GMP benefits. It is intended to avoid the administrative complications of setting up and maintaining multiple records for each member, and corresponds to the '*D2*' method discussed by the judge in the recent *Lloyds Banking Group* judgments.[8]

The DWP also intends to make some changes to the GMP conversion legislation '*as soon as a suitable opportunity presents itself.*'

The legislative changes mentioned by the Baroness are presumably intended to clear up certain ambiguities that were discussed in the first Lloyds judgment, about whether the statutory conversion provisions could apply to survivors' GMPs that have come into payment (the judge said that they could). They may also change the law's requirement for member consultation to one of communication.

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[5] For more information, see *The Southern Water Pension Scheme: Regulatory Intervention Report Issued Under Section 89 of the Pensions Act 2004* (December 2018) <www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/regulatory-intervention-section-89-southern-water.ashx>.

[6] *Hansard*, HL Deb, 14 February 2019, column 1961 <bit.ly/2SFJr0r>.

[7] <www.gov.uk/government/uploads/system/uploads/attachment_data/file/572751/consultation-occupational-pension-schemes-draft-regulations-and-related-issues.pdf>; the proposed method was set out in Annex D <www.gov.uk/government/uploads/system/uploads/attachment_data/file/564536/ten-stage-possible-process-for-resolving-the-gmp-inequalities-issue-for-comment.pdf>.

[8] *Lloyds Banking Group Pensions Trustees Limited v Lloyds Bank PLC and others* [2018] EWHC 2839 (Ch), and *Lloyds Banking Group Pensions Trustees Limited v Lloyds Bank PLC and others* [2018] EWHC 3343 (Ch).

PPF update

In this article we compile a number of recent news items concerning the Pension Protection Fund (PPF).

Hampshire ruling

We have written before about the *Hampshire* judgment, in which the European Court of Justice said that the PPF must provide compensation worth at least 50 per cent of the value of members' accrued scheme benefits.[9] We also wrote that the PPF had announced plans to compare expected benefit and compensation values, and increase rates of compensation if their values fall below the fifty per cent mark.[10] It issued a brief progress report just before Christmas 2018.[11]

It seems that there has been a legal challenge to the PPF's proposed approach.[12] For now, it is continuing with its plans, but will limit the size of arrears payments so as to avoid the need to recover overpayments if the courts decide that its method is incorrect.

Levy ceiling & compensation cap

The '*levy ceiling*' for the year beginning 1 April 2019 will be £1,058,176,617.[13] This is a limit on the maximum amount that the PPF can seek to raise via its pension protection levies, and is the result of increasing the levy ceiling for the preceding year in line with earnings inflation. More relevant at the moment, however, is another restriction which says that the PPF cannot increase its levy estimate from one year to the next by more than 125 per cent. Both constraints are in practice somewhat academic, currently, as the PPF's actual levy estimate for 2019/20 is £500 million, which is less than its estimate for 2018/19 (£550 million).

The standard amount of the compensation cap will be £40,020.34. This is the cap at age 65, without taking any account of long service, and before application of the 90 per cent factor that affects the compensation of members who are below normal pension age when the PPF steps in (it also takes no account of the changes required by the aforementioned *Hampshire* ruling).

Insolvency-risk services re-tendered

The PPF announced in a recent newsletter that, following a compulsory competitive-tendering process, it has appointed Dun & Bradstreet (D&B) to provide it with insolvency-risk services, with effect from the 2021/22 levy year.

D&B occupied the same role prior to 2015/16, when Experian replaced it. The PPF says explicitly that D&B will reproduce the existing PPF-specific insolvency-risk model, rather than reverting to its previous methodology. Changes will be made only if the PPF considers that they have merits (specifically, that they improve its ability to predict insolvencies), and will be subject to consultation. Schemes should not see big changes to their levies as a result of D&B's appointment.

Experian will continue to provide services until 2021/22.

Email addresses

The PPF is changing its email addresses so that they will end in '*ppf.co.uk*'.[14] It is part of a wider change to government email, involving the retirement of its '*.gsi*' (government secure intranet) addresses.

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[9] *Current Issues* October 2018 <www.hymans.co.uk/media/uploads/1810_Current_Issues.pdf>.
[10] *Current Issues* November 2018 <www.hymans.co.uk/media/uploads/1811_Current_Issues.pdf>.
[11] <www.ppf.co.uk/news/update-european-court-justice-ruling>.
[12] <www.ppf.co.uk/news/where-we-are-european-court-justice-ruling>.
[13] The *Pension Protection Fund and Occupational Pension Schemes (Levy Ceiling and Compensation Cap) Order 2019* (SI 2019 No. 159).
[14] <www.ppf.co.uk/news/our-email-addresses-are-changing>.

Cold-calling ban in effect

A ban on 'cold calling' in connection with pensions came into force on 9 January 2019.[15] A response to concerns about pensions fraud, the ban is not intended to prevent genuine calls arising from an existing relationship or for which the recipient has given consent.[16]

In broad terms, it is now illegal to make an unsolicited call to an individual to promote a product that would be acquired using pension funds, or offer advice on transfers or investment performance. Exceptions are made for trustees and those with relevant financial services authorizations, allowing them to make calls with the person's prior agreement, or when the person might reasonably expect an unsolicited call because of their existing relationship.

The Information Commissioner is responsible for enforcing the ban. It can impose fines of up to £0.5m.

Telling swindlers that their activities are illegal might have little effect; the significance of the ban is probably that it reinforces the message that scheme members should treat unsolicited calls with suspicion, and hang up.

HMRC newsletters

During February 2019, Her Majesty's Revenue and Customs (HMRC) published *Countdown Bulletin 42*[17] and *Pension Schemes Newsletter 107*[18].

Countdown Bulletin 42

There is more information about the financial reconciliation exercise that has been mentioned in previous Countdown Bulletins.[19] This is a calculation, as at 11 January 2019, of any contracting-out-related debts owed by schemes to HMRC, or vice versa. Trustees had until 28 February 2019 to request their financial position, and will not receive any monies due from HMRC unless they did so. On the other hand, HMRC will (naturally!) issue demands for any sum that it is owed regardless of whether a request for the financial position was submitted in time.

Countdown Bulletin 42 provides additional details about the timings of communications and payments. Notably, schemes that owe HMRC will have until 21 May 2019 to pay (in full, via 'Bacs'), otherwise the relevant contracted-out liabilities will be reinstated. Any refunds due from HMRC will be sent by cheque, by 21 June 2019.

Pension Schemes Newsletter 107

The latest Pension Schemes Newsletter contains information for administrators of schemes that operate relief at source, another reminder that the closing date for applying for master trust authorization is 31 March 2019, further guidance on reporting non-taxable death benefits, and some details of how to register as a pension scheme administrator.

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[15] The *Privacy and Electronic Communications (Amendment) (No. 2) Regulations 2018* (SI 2018 No. 1396).
[16] For a reminder of how we got here, see the August and November 2018 editions of *Current Issues*.
[17] https://www.gov.uk/government/publications/countdown-bulletin-42-february-2019/countdown-bulletin-42-february-2019.
[18] <www.gov.uk/government/publications/pension-schemes-newsletter-107-february-2019/pension-schemes-newsletter-107-february-2019>.
[19] See e.g. *Current Issues* February 2019 <www.hymans.co.uk/media/uploads/Current_Issues_-_February_2019_%282%29.pdf>.

And Finally…

In comedy and satire, law firms will often be called something like *Grabbit & Run* (which turns out to be a courier business in Cambridge). More often, in real life, the names are just rendered increasingly unwieldy through mergers; mercifully, *CMS Cameron McKenna Nabarro Olswang* goes by 'CMS' for most purposes. There are some genuinely intriguing ones out there, though.

Whenever *AF* reads a pensions briefing note from *Womble Bond Dickinson*, he invariably finds himself involuntarily humming the theme music to a 1970s BBC children's TV programme. It may not have made its way across the Atlantic to the USA, wherein the relevant partner doth reside (disappointingly, his given name is neither Orinoco nor Tobermory; he's William F. Womble Jr.). We recently came across the name *Arent Fox* whilst reading up on data privacy, and our immediate, instinctive response was 'Aren't foxes what?' (closely followed by 'Well, I'm no oil painting myself').

Upon discovering that there's a firm called *Partridge Allen* we couldn't help wondering whether, in choosing to place the names in that order, they hoped to avoid comparison with the broadcasting legend. Whereas the partners in *Rupert Bear Murray Davies* clearly realized that such efforts were futile, and courageously decided just to own it.

Our favourite, however, is *Wright Hassall*. Well, if it wasn't you wouldn't need a lawyer, would you…