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PENSIONS BULLETIN

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# PENSIONS BULLETIN

**QUICK LINKS**


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Contribution Notice issued to German parent company after management buy-out

GMP equalisation: conversion Bill receives Royal Assent

Supreme Court allows HMRC's appeal in overseas dividends test case

Administrator unable to recover transfer payment subject to unimplemented Pension Sharing Order

Pension legislation and regulation watch list



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In this month's Pensions Bulletin, we cover:

1. Pensions Regulator's Annual Funding Statement – key messages for trustees and employers on valuations and risk management in the light of current market challenges.
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6. List of legislation and regulation expected from 2022 to 2023.

## THE PENSIONS REGULATOR'S ANNUAL FUNDING STATEMENT 2022

*The Pensions Regulator's (TPR's) 2022 Annual Funding Statement repeats familiar themes for trustees and sponsors of DB schemes. The Statement highlights significant risks facing schemes, including interest rate and inflationary pressures. It emphasises the importance of monitoring employer covenant and the treatment of deficit repair contributions as compared to dividend payments and other distributions. The Statement does not have force in law, but provides a useful insight into TPR's regulatory approach to valuations.*

TPR's Annual Funding Statement, published on 27 April 2022, provides guidance for schemes with valuation dates between 22 September 2021 and 21 September 2022 (Tranche 17) and for all schemes undergoing significant changes. TPR estimates that the aggregate funding level for all T17 schemes was ahead of that expected three years previously.

The Statement highlights key considerations for schemes currently undertaking a valuation:

- The effect of **high rates of inflation and interest rates** on costs for employers and on scheme assets and liabilities. The impact will depend on investment strategies and the level of hedging in place. Trustees need to understand how inflation hedging works in the context of inflation exceeding caps applying to benefit increases.
- Although, for most schemes, investments linked to **Russia and Ukraine** are likely to form a small proportion of investments, indirect effects on inflation, volatility and liquidity may have an impact on a broader range of assets. Sanctions may have an impact on short-term employer liquidity as well as a longer-term effect on the covenant. This may not be immediately obvious, so trustees should engage with management.
- Employer operations may still be disrupted by **COVID-19**. The withdrawal of Government support coupled with trade recovery may mean that some employers may be experiencing working capital pressures, exacerbated by the need to repay loans. Long-term health effects are still uncertain.
- The full impact of **Brexit** on employers' competitive position, supply chain, and access to the European market and its labour forces may not be fully understood until regulatory issues are clear and the impact of COVID-19 on trade has normalised.

There is a table of the key risks TPR considers trustees and employers should focus on, and actions to take, divided into the five levels of covenant strength and sub-divided according to whether the scheme is immature or mature. This is the same as for the 2021 Statement, the only change being a decrease in the average recovery plan length, to six years. Further, as in the 2021 Statement, TPR asks trustees to categorise market volatility on the **employer covenant** in one of three ways:

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| **Limited impact** with no balance sheet weakening and cash flow remaining strong | Trustees to take a "business as usual" approach to setting recovery plans, with deficit repair contributions (DRCs) remaining unreduced. Where possible, trustees should try to reduce the length of recovery plans, especially where there are concerns that, "*the scheme is being treated inequitably relative to other stakeholders*". |
| **Material impact** but trading has recovered or is recovering strongly, or any impact is expected to be short-lived. Any weakening of the balance sheet can be repaired over a short period, and medium-term prospects have not been affected | Where employers are experiencing short-term affordability constraints, trustees should consider carefully any requests to accept a temporary reduction in contributions. Any requests should be short term, with higher contributions in subsequent years limiting any extension to recovery plan end dates. TPR will continue to view shareholder distributions as being inconsistent with the scheme receiving lower contributions, and expects any deferred DRCs to be repaid - ideally before any shareholder distributions recommence. |

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| **Material impact** and the pace of recovery is uncertain and could take years, or the business may never fully recover. Short-term affordability is stressed. The balance sheet has weakened due to measures taken to raise additional liquidity and to secure lender support. Medium-term prospects are unclear | Where employers continue to request liquidity support from the pension scheme through DRC deferrals and/or lower ongoing DRCs as part of a revised recovery plan, TPR expects trustees to obtain suitable mitigations (as set out in the 2021 Statement). |

TPR expects that employers should provide trustees with financial projections and business plans to enable them to assess the employer covenant. Any changes should be notified to the trustees as soon as possible. Given recent trading volatility, it may be difficult to test management's forecast assumptions against prior year performance.

In TPR's view, trustees should continue to undertake stress testing or scenario planning to understand the impact on the covenant of possible future economic environments such as prolonged high inflationary and interest rates (remembering that the impact of the same scenario on the scheme's funding position may be different). It is good practice to consider more than a single set of forecasts where uncertainty over future trading is high. Where possible, trustees should agree contingency plans to enable them to respond quickly to potential material detriment.

Where trustees place reliance on contingent assets or asset-backed contribution (ABC) arrangements, they should consider the impact of current market conditions on the value of this support, and whether it is still sufficient to cover any additional risk taken. For ABCs, trustees should also consider whether the structure and length of the income stream relative to the scheme's maturity and inflation linkage remain appropriate.

TPR notes that, following a hiatus during the pandemic, there has been an increase in employers **returning cash to shareholders** through recommencing dividends, paying "special" dividends and share buybacks. Trustees should consider "*whether their scheme is being treated fairly compared to other stakeholders*". TPR's minimum expectations, as set out in the 2019 Statement, are:

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| Where dividends and other shareholder distributions exceed DRCs | There should be a strong funding target and relatively short recovery plans. At the last valuation for this cohort of schemes, the average recovery plan length was five years. |
| If the employer covenant is tending to weak or weak | DRCs should be larger than shareholder distributions unless the recovery plan is short and the funding target is strong. |
| If the employer is weak and unable to support the scheme | The payment of shareholder distributions should have ceased. |

Trustees are warned to be alert to other forms of covenant leakage - cash pooling arrangements, group trading arrangements and management fees, for example – and TPR suggests building protections into valuation discussions (dividend sharing mechanisms or negative pledges, for example).

TPR's expectation is that trustees should take a rigorous approach to assessing the impact of any corporate transaction (independently from the valuation) and have a record of the considerations made, noting TPR's clearance guidance, updated last year because of the new powers in the Pension Schemes Act 2021. (The Statement does not go into detail on this, but trustees should note that the updated guidance has new statements on the appropriateness of different mitigation to be offered by sponsors on corporate transactions. For example, the guidance now provides that a negative pledge on its own is unlikely to represent adequate mitigation for detriment to the employer covenant but may be of value as part of a package of mitigation measures.)

On **actuarial and investment considerations**, TPR again highlights the potential impact on funding of interest rate rises and inflation rates. The Statement also updates TPR's views on the impact of COVID-19 on mortality assumptions, saying that, where changes are justifiable, TPR expects any reduction in liabilities to be no more than 2%, unless accompanied by strong supporting evidence.

In the section on **managing risks**, the Statement covers:

- **Long-term funding targets (LTFT):** Trustees should consider taking steps now, if they have not already done so, to incorporate the requirement under the Pension Schemes Act 2021 for schemes to have a LTFT, agreed with the employer. Trustees should engage proactively with the employer to understand the risks (employer-specific and more general) that could result in changes in covenant - such as whether accelerated de-risking is appropriate - and factor longer-term risks into the scheme's monitoring and contingency plans. They might also consider requesting downside protection from the employer to help manage these risks.
- **Monitoring and contingency planning:** Given that scheme funding positions and the employer covenant can change materially over a short period, trustees should monitor regularly the actual funding positions against the main asset and liability risks, and the employer's performance against forecasts and other thresholds. They should also consider the scheme's short-term liquidity needs and how these may be affected by margin calls and the need to meet short-term member benefit payments. Where trustees are concerned about longer-term covenant risks, they should consider alternative funding and investment strategies that place less reliance on the employer. Where funding positions are behind target, trustees and employers need to develop strategies to put them back on course.
- **Schemes in surplus:** In a new section this year, TPR says that even where schemes have recently achieved full funding, or are expected to do so soon, trustees should remained focused on managing risks through contingency planning. This should also help to address concerns from employers about trapped surplus.

On future plans, TPR says it expects to launch the second consultation on its draft code later in 2022, after the Department for Work and Pensions consultation on draft regulations. TPR plans to set out proposed changes to its various guidance notes (on Assessing and Monitoring the Employer Covenant, in particular), with more detail on how to treat guarantees for scheme funding purposes and on factoring ESG into the covenant.

**Next steps for trustees and employers:** Both sponsors and trustees should take advice on the Statement. The Statement provides a useful insight into TPR's expectations of behaviour. It covers important themes relating to risk management and covenant support, and sets out some of TPR's future plans.

## CONTRIBUTION NOTICE ISSUED TO GERMAN PARENT COMPANY AFTER MANAGEMENT BUY-OUT

*Whether the court of another country will enforce a Contribution Notice (CN) issued by TPR, is a question of the law of that other country. The Determinations Panel of TPR has issued a CN for £2.1m against a German parent company following a management buy-out (MBO) of a UK business. As a result of the MBO the pension scheme was severed from the sponsor. It will be interesting in due course to see if the German company makes payment or is forced by a German court order to do so.*

TPR issued a regulatory intervention report following a Determination Notice in relation to an MBO of the UK based business, Dosco Group (Dosco), from its German parent company, SMT Scharf AG (Scharf).

The background was:

- The Dosco DB pension scheme had 600 members, assets of £53m and a Section 75 deficit of £38.8m at the date of the MBO in 2013.
- Scharf had acquired Dosco from another company in 2010. The parties involved made an application to TPR for a clearance, acknowledging that the transaction could affect the employers' ability to support the scheme, as they were historically heavily reliant on formal support provided by Dosco's previous parent company.
- In 2012, Scharf decided to sell Dosco and end Scharf's connection to the scheme, as well as to defer the insolvency of one of the employers so as not to trigger a Section 75 debt. The CEO was incentivised by Scharf to find a buyer by a consultancy agreement, under which he would receive a minimum fee of EUR 250,000.

- Dosco was sold in 2013 for EUR 2m to a shell acquisition vehicle incorporated by Dosco's management team. The CEO received his consultancy fee. The purchase was funded by a loan from Scharf and loans were "extracted" on onerous terms from the scheme employers. No mitigation was provided and the scheme trustees were not notified until the day after the sale.
- Eight months later, the two scheme employers went into administration, triggering a Pension Protection Fund assessment. In 2015, the trustee secured a buy-out with reduced benefits for members.

TPR negotiated a settlement with the CEO for around £130,000, which TPR said reflected the benefit he received under the consulting agreement. TPR's Determinations Panel issued a CN against Scharf for over £2m, including an additional sum of approximately £670,000 for lost investment returns and interest, with daily interest added - the first such award by the Panel. The Panel rejected the TPR case team's argument that investment returns should be awarded from the date of the MBO and awarded the sum from the (later) date on which it estimated that the funds would have been available for investment in the scheme.

**Next steps for corporates:** Where there is an overseas dimension to a corporate transaction, careful consideration may need to be given to the enforceability of a CN extraterritorially. The fact that the TPR's Determinations Panel has issued a CN does not determine whether it is enforceable or not. Local law advice may therefore need to be obtained.

## GMP EQUALISATION: CONVERSION BILL RECEIVES ROYAL ASSENT

*A Private Members' Bill on conversion of Guaranteed Minimum Pensions (GMP) is set to become law. It addresses some technical issues identified with the conversion method of dealing with GMP equalisation.*

Conversion involves using statutory provisions to remove the GMP requirements for some or all scheme members, and providing such members with benefits at least actuarially equivalent to the GMP. Conversion can be used as a part of a method to equalise the GMP.

A number of issues have been identified with the conversion method. Some of these are addressed in a Private Members' Bill that passed through Parliament with Government support and received Royal Assent on 28 April 2022, including:

- clarification that conversion applies to survivors as well as members;
- regulation making powers to clarify employer consent requirements and simplify minimum survivor pension requirements; and
- removal of the requirement to notify HMRC of a conversion.

The Act comes into force immediately for the purposes of regulation making powers and will be brought into force fully on a date to be set by regulations. The Government has said it will update its 2019 statutory guidance on the use of GMP conversion legislation.

**Next steps for trustees:** The new Act will help trustees who are considering the conversion option, although some of the details are awaited in regulations. More broadly, as mentioned in our Pensions Bulletin March 2022, HMRC have recently issued their third newsletter on GMP equalisation, giving helpful guidance on how transfer top-ups fit with the tax regime, and an update and some limited guidance on conversion. For full analysis, please see our briefing: GMP equalisation: transfers, conversion and tax: an update.

## SUPREME COURT ALLOWS HMRC'S APPEAL IN OVERSEAS DIVIDENDS TEST CASE

*There will be some disappointed pension funds following the decision of the Supreme Court in HMRC v Coal Staff Superannuation Scheme Trustees Ltd on withholding tax on manufactured overseas dividends (MODs).*

Although this case is of mostly historic interest, because since 2014 there is no longer any UK withholding tax imposed on MODs, there are a number of UK pension funds (as well as life insurance companies, investment funds and charities) which made claims, arising from stock lending agreements they had entered into, and who will as a result of this decision be prevented from recovering tax previously withheld on MODs.

The issue in this case was whether the MOD tax regime (as it existed pre-January 2014) involved any restriction on the free movement of capital and so contravened EU law. The Supreme Court concluded that there was no such restriction

based on market economic analysis that the MOD regime did not have a dissuasive effect on the lending of overseas shares, as compared with lending of UK shares.

Even if there were such a restriction, the Supreme Court decided that the remedy sought by the trustees (tax credits in relation to MOD withholding tax attributable to stock lending by the trustees) was not proportionate to the wrong suffered as a result of the restriction.

**Next steps for trustees**: Trustees should note that this avenue of potential tax recovery has been closed.

## ADMINISTRATOR UNABLE TO RECOVER TRANSFER AMOUNT PAID IN ERROR BECAUSE OF UNIMPLEMENTED PENSION SHARING ORDER

*The case concerns the failure by an administrator to implement a Pension Sharing Order (PSO) before transferring the benefits. The Pensions Ombudsman rejected the administrator's claim for restitution from the member, despite finding that the member should have realised that the transfer had been paid in error.*

**Facts:** In the case of *Mr S*, the PSO was issued in 2011 and allocated 100% of Mr S's benefits in the scheme to his ex-wife (Ms S). However, the administrator did not implement the PSO at the time because it did not receive a response from Ms S to its request for a copy of the decree absolute. In 2014, Mr S decided to transfer his funds to a small self-administered scheme (SSAS) and was informed, incorrectly, that his pension was not subject to any earmarking order or PSO. The administrator transferred the full fund value (£52,309) to the SSAS. In 2015, Mr S used £50,000 from the SSAS as a loan to his business. The business went into administration in 2016 and the SSAS did not recover any of the loan. By 2018, the administrator realised its error and paid Ms S her share of Mr S's pension in accordance with the PSO, using its own funds. The administrator then requested the transferred funds back from Mr S, on the grounds of unjust enrichment. Mr S made a maladministration complaint to the Ombudsman.

**Determination:** The Ombudsman upheld Mr S's complaint, stating that the administrator's failure to inform the member about the unimplemented PSO, and its failure to prevent the transfer to the SSAS, was a clear case of maladministration. The Ombudsman also decided that the administrator's restitution claim failed.

To make out a case for restitution of the incorrectly transferred funds, for unjust enrichment, the administrator had to show:

- Mr S was enriched;
- the enrichment was at the administrator's expense;
- the enrichment was unjust; and
- Mr S had no defence on which he could rely to refuse to return the funds.

The fact that the transfer was made by mistake did not, on its own, satisfy the test. Mr S had not been enriched in a personal capacity, nor had he been enriched at the administrator's expense - the transfer to the SSAS occurred a significant time before the payment by the administrator to Ms S. The administrator had not established that the two payments were linked; what had happened was that the administrator had compensated Ms S for her loss and then sought to recover that amount from Mr S.

Although not necessary to its decision, the Ombudsman went on to consider whether Mr S had a "change of position" defence to the unjust enrichment claim. TPO concluded that he did not. He had "Nelsonian" knowledge (turning a blind eye) that he was not entitled to transfer the funds to the SSAS. The Ombudsman did not accept that Mr S was unaware that the PSO had allocated 100% of the benefits to Ms S and, in any event, it would have been reasonable for him to have checked its terms before proceeding to request a transfer.

**Next steps for trustees:** As this case illustrates, there are hurdles for trustees or administrators to overcome in trying to recover overpayments. In cases of overpayments to members, recoupment - under which trustees recover overpayments from recipients by making deductions from future payments made to them - is often an attractive option as avoids some of the practical and technical problems of litigation to recover the overpayment. That remedy was not available here.

## PENSION LEGISLATION AND REGULATION WATCH LIST

| No | Topic | Expected effective date | Further information/action |
|---|---|---|---|
| 1 | Changes to DC scheme governance and disclosure, including the annual Chair's Statement and charge cap | First scheme year ending after 1 October 2021 - return on investments from default and self-select funds included in Chair's Statement; 5 October 2021- total value of assets reported in annual scheme return; first scheme year ending after 31 December 2021 - detailed "value for members" assessments for schemes with assets below £100m<br><br>Fee charging years ending after April 2022: £100 de minimis pot size below which flat fees cannot be charged | DC schemes only.<br><br>DWP to review whether fines for non-compliance with Chair's Statement requirements should be mandatory.<br><br>DWP proposals on universal charging structure to follow.<br><br>Consultation to 11 May 2022 on requirements to include explanation of illiquid investment policies in SIPs and (for large schemes) asset allocation data in Chair's Statement; further consultation to follow on removal of performance-based fees from charges cap. |
| 2 | Restrictions on transfers of member's cash equivalent transfer value by trustees/managers of occupational or personal pension schemes unless prescribed conditions are met | Transfers where the date of the member's application for a statement of entitlement (DB schemes) or transfer request (DC schemes) occurs on or after 30 November 2021 | |
| 3 | Trustee oversight of fiduciary managers and investment consultants | | Consultation response and new DWP regulations have been delayed until June 2022. |
| 4 | DB superfunds | Regulatory regime was expected Winter 2021 | Interim regulatory regime in place from October 2020. |
| 5 | New notification requirements for DB schemes in relation to corporate and financing activity and change to the notification process | Draft Notifiable Events (Amendment) Regulations, published for consultation September 2021. Expected commencement date uncertain | Consultation closed 27 October 2021. TPR will consult on update to Code of Practice 2 (Notifiable Events) and accompanying guidance once DWP have published their finalised regulations and consultation response. |

| No | Topic | Expected effective date | Further information/action |
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| 6 | Refer members to guidance before processing application to access or transfer flexible benefits | 1 June 2022 | For DC schemes only. |
| 7 | Draft DB Funding Code of Practice | DWP regulations expected for consultation "Spring 2022". Part 2 of TPR consultation and draft Code expected "late Summer 2022". New Code expected to be operational in December 2022 | Once in force, the Code will apply to triennial valuations submitted thereafter. |
| 8 | TPR Single Code of Practice | Revised Code to be issued before Summer Recess (expected to be 21 July 2022), to come into force early Autumn 2022 | TPR consultation issued 17 March 2021 and interim response issued August 2021. |
| 9 | Register certain trusts with the Trust Registration Service | Registration by 1 September 2022 | Applies to some trusts relating to pension and life assurance benefits where no exemption applies (e.g. bare trusts set up on distribution of a lump sum). |
| 10 | Climate risk governance and reporting requirements | 1 October 2022 | 1 October 2022 for schemes with £1 billion or more in net assets, governance to be in place for the scheme year underway, and the first annual report to be published within seven months of the end of the scheme year.<br>(1 October 2021 deadline applied for all authorised master trusts and collective DC schemes and schemes with £5 billion or more in net assets.) |
| 11 | Simpler annual benefit statements | 1 October 2022 | DC schemes used for auto-enrolment. |

| No | Topic | Expected effective date | Further information/action |
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| 12 | Changes to the scheme asset information collected through scheme returns | Scheme returns from 2023 | DB schemes. |
| 13 | Pensions dashboards | TPR guidance for trustees expected to be published May 2022. DWP response to consultation on draft regulations expected Summer 2022, followed by laying of regulations "as soon as Parliamentary time allows". Consultation on standards expected Summer 2022. Staging deadlines from 30 June 2023 | All registerable UK-based schemes with active and/or deferred members. |

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