SLAUGHTER AND MAY/

PENSIONS BULLETIN

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PENSIONS BULLETIN

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In this month's Pensions Bulletin, we cover:

1. Details of the new funding and investment strategy regime for defined benefit schemes now in consultation by the Department for Work and Pensions (DWP).
2. The joint statement from the DWP and the Pensions Regulator (TPR), on the new restrictions (from 1 November 2021) on individual statutory transfers out, addressing the problems for trustees where there are overseas investments or incentives to transfer.
3. TPR blog on its expectations of trustees and sponsoring employers when considering debt refinancing.
4. TPR's updated guidance on compulsory competitive tenders for new suppliers of fiduciary management services and setting objectives for investment consultants. TPR assumes compliance responsibilities, taking over from the Competition and Markets Authority, from 1 October 2022.
5. The High Court decided that a scheme rule on unclaimed benefits can be treated as a "forfeiture" provision, allowing the trustees of a defined benefit scheme to recover payments of arrears they had made following historic underpayments of benefits. However, the Court also found that if there is a dispute, trustees cannot apply set-off until the ability to recover has become enforceable under a court order. A determination from the Pensions Ombudsman is not sufficient.

We include our regular watch list of current and future developments.

DWP CONSULTATION ON FUNDING AND INVESTMENT REGULATIONS

The Department for Work and Pensions (DWP) has published consultation on proposed defined benefit (DB) funding regulations – closing 17 October - which are to be made under Part 3 of the Pensions Act 2004 (changed last year). The draft regulations will require DB schemes to have a long term funding target and set out DWP's proposed requirements for the funding and investment strategy (FIS) and statement of strategy (SoS). The legislation will be supplemented by a new Funding Code of Practice and guidance from the Pensions Regulator (TPR). This has not yet been published.

The Pension Schemes Act 2021 requires trustees of DB schemes to set out a FIS, with which, in the vast majority of cases, the employer must agree, for ensuring that pension benefits can be provided over the long term. The DWP has published a consultation on proposed draft regulations, providing further details about the matters that trustees will need to take into account in formulating the FIS and SoS. Consultation closes on 17 October 2022.

The draft regulations:

- set out the requirements for the FIS and the SoS that trustees will be required to produce; and
- make amendments to the existing funding regulations, including in relation to the calculation of Technical Provisions (the amount required on actuarial calculation to make provision for the scheme's liabilities), the new information on the FIS that is to be included in actuarial valuations, and, for the first time, detail as to what is "appropriate" in the context of a recovery plan.

It is not clear how the draft regulations fit within the Fast Track/Bespoke approaches that TPR put forward in its March 2020 consultation on the principles underlying its new Funding Code.

In its Corporate Plan issued earlier this year, TPR said it plans to launch its second consultation, on the Code itself, in Autumn 2022, with the Code operational from September 2023, but these timings "remain subject to change". Changes in the new Code will be "forward-looking", so that only schemes with valuation effective dates on or after its commencement date will be affected.

The FIS is intended to demonstrate that the scheme can provide pensions and other benefits over the long term with low dependency on the employer. The draft regulations require this to be demonstrated in two ways:

- by the scheme being funded on a "**low dependency funding basis**"; and
- by scheme assets being invested in "**low dependency asset allocation**".

"Low dependency" means that, under reasonably foreseeable circumstances, the scheme is not expected to need further employer contributions, although it recognises that there may be unexpected circumstances which require the employer to provide additional funds. "Low dependency asset allocation" means that schemes must "broadly match" cash flows with benefit payments and the value of assets relative to liabilities must be "highly resilient" to short-term adverse changes in market conditions. The draft regulations do not specify what happens if a scheme fails to reach low dependency or elaborate on the meaning of terms such as "highly resilient".

The intended funding basis and asset allocation must be specified at the date on which the scheme reaches "significant maturity" – likely to be measured as the point when the length of years that the "average" person will receive a pension until death is 12 (the number expected to be set by TPR in its Funding Code). When a scheme is projected to reach significant maturity is sensitive to actuarial assumptions. The projection of scheme maturity allows for the characteristics of open schemes to be taken into account – the DWP expects the Funding Code to give further guidance on how this can be done. By the time the scheme reaches significant maturity, the scheme's technical provisions must be consistent with the scheme's FIS. Trustees must have a strategy with the objective that the scheme is 100% funded on the low dependency basis by the "relevant date" (which is no later than the end of the scheme year in which scheme is estimated to/did reach "significant maturity").

During the scheme's "journey plan" (which is now a defined concept), the investment risk and risk in relation to calculation of liabilities are dependent on the strength of the employer covenant and on how near the scheme is to reaching significant maturity. For the first time, the regulations provide for new rules on measuring the "**strength of the**

employer covenant". Again, it is expected that guidance on this will form part of the Funding Code. The "strength of the employer covenant" is defined as:

- the financial ability of the employer to support the scheme (matters to be taken into account here include cash flow and the likelihood of an insolvency event); and
- the level of support from any legally enforceable contingent assets.

The FIS must be recorded in the SoS, which is signed by the trustee chair and submitted with the valuation documents in the form TPR prescribes in the new Code. Trustees must set out in the SoS:

- the extent to which, in their opinion, the FIS is being successfully implemented and, where it is not, remedial steps they propose (including timing details); and
- reflections on significant decisions taken by them in the past relevant to the FIS, including lessons learned that have affected other decisions or may do so in future.

Areas to be covered in the SoS include the main risks faced by the scheme; the actuary's estimate of scheme maturity and how this may change over time; the level of risk trustees intend to take in relation to investments and how the strength of the employer covenant has been taken into account; how trustees intend to achieve compliance with the principles of low dependency outlined above; and how the scheme assets are in investments with sufficient liquidity. The SoS must also include any comments that the employer has requested be included.

Where funding deficits emerge on the Technical Provisions basis, it is proposed that there will be a new legal requirement that **recovery plans** must be such that the deficit is recovered "as soon as the employer can reasonably afford". This is stronger than in the current Code. There is no further information on this, apart from that the DWP is considering whether this new factor should have primacy over the existing factors that trustees have to take account of when preparing or revising recovery plans (as set out in the current regulations) – such as asset and liability structure, risk profile, liquidity needs, and member age profile - and whether these existing factors remain relevant at all.

Next steps for trustees and employers: Whilst the details outlined above might be subject to change, the proposed changes to the funding regime are significant, and so trustees will want to take legal, actuarial and investment advice at an early opportunity. Although the new regime will not apply to valuations until late 2023, the impact may be immediate because the draft regulations prescribe how the transition must be made during the "journey plan" towards the significant maturity date. Trustees and employers will need to address with actuaries and advisers the likely duration of their scheme to significant maturity (which could be just a few years, or may in some cases already have been reached) and how the low dependency target might fit with their existing plans. A first step will be determining when scheme maturity arises. We will be running a further on-line Round Table for clients when the draft Code is published, which we have heard will be November.

DWP/TPR STATEMENT ON THE TRANSFER REGULATIONS

The Department for Work and Pensions (DWP) and the Pensions Regulator (TPR) have issued a Press Release about the Occupational and Personal Pension Schemes (Conditions for Transfers) Regulations 2021, which introduced new restrictions on individual statutory transfers out from 1 November 2021.

The joint statement is aimed at resolving two particular issues with the Regulations:

- A "red flag" (i.e. the trustees must refuse the transfer) is triggered where the member receives an incentive to transfer. Transferring schemes are interpreting this to include "refer a friend" schemes such as that operated by PensionBee.
- An "amber flag" (i.e. the member must be referred to guidance) is triggered by virtue of the receiving scheme having any overseas investments, even if this is part of an investment fund.

To address these issues, TPR has updated its guidance, Dealing with transfer requests. The guidance now says that where trustees believe that the Regulations mean there is no statutory right to transfer but they have concluded, following due diligence, that the transfer is in the member's interests and is at low risk of a scam, they can grant a discretionary (non-statutory) transfer where scheme rules allow. The DWP will consider the issue further in its review of the Regulations, due to be published by May 2023.

Most of the flags identified by trustees to date have been amber, triggered as a result of the receiving scheme having overseas investments. So long as the transferring member takes the appropriate MoneyHelper advice (and can demonstrate this to the transferring trustees), there is a statutory right to transfer. In these circumstances, there should be no need for trustees to go down the non-statutory route.

If they do take the non-statutory approach, trustees need to remember that this must be permitted under the trust deed and rules, and the statutory discharge in Section 99 of the Pension Schemes Act 1993 (which extends to contingent benefits that are extinguished on the transfer) will not apply: trustees will have to rely on any discharge in the scheme rules and/or the transfer-out documentation. A discharge under the scheme rules may extend to contingent benefits but this point, and the discharge wording generally, should be checked carefully.

Next steps for trustees and employers: Trustees should discuss with their administrators what approach is being taken to the two flags on incentives and overseas investments. Legal advice may be required before trustees choose to allow non-statutory transfers.

THE PENSIONS REGULATOR’S EXPECTATIONS ON DEBT REFINANCING

The Pensions Regulator (TPR) has set out its views on debt refinancing and the risk to the employer covenant. Although there is no mention in the blog of regulatory action, one of TPR’s planned regulatory initiatives is on scheme management of risk and resulting covenant strength.

David Fairs of TPR has published a blog on the risks of refinancing, setting out matters TPR expects trustees and their sponsoring employers to consider when refinancing, as they could have a material impact on the employer covenant supporting the pension scheme:

- **Interest costs and fees**: trustees should understand the impact of changes in the cost of debt on cash flow and therefore the employer’s ability to make contributions.
- **Debt structure**: the impact of replacing one type of debt with another. For example, an asset-backed facility fluctuates over time and may allow a higher overall debt burden than a term loan.
- **Security and guarantees**: the implications of any changes to trustees’ ability to claim priority in the event of insolvency.
- **Financial covenants**: changes could represent a power shift between trustees and lenders in the event of financial stress.
- **Restrictive covenants**: clauses in lending documents that restrict the ability of the employer may in turn restrict trustees’ ability to agree appropriate funding plans or protections for the scheme.
- **Counterparty:** refinancing with the same or a new lender may result in changes to risk appetites and lender objectives.

Other general considerations for trustees (and employers) are mentioned:

- If new money is being introduced beyond that required to meet existing debt, trustees should ensure they have a clear understanding of the purpose of the additional debt and any associated risks to covenant.
- Trustees should be aware of the risks that could arise in the event debt is not refinanced (the need to sell assets to meet financial obligations is an obvious example).
- Where trustees become aware of a debt transaction, TPR expects them to work with the employer and new lender to assess any change in the circumstances of the employer or the lending strategy, and any consequent impact on the trustee’s assessment of covenant.

- Trustees should engage with management well ahead of any potential refinancing to ensure they have a strong understanding of the employer's current debt structure and consider debt covenants and refinancing within their monitoring, information sharing and contingency planning frameworks.
- TPR expects employers to provide trustees with meaningful and timely information on debt and refinancing proposals, including debt transactions. In addition to legal documents, this could include forecasts, scenario analysis and other information provided to the lender as part of the process.
- As set out in TPR guidance on corporate transactions and clearance guidance, it is critical that trustees and sponsoring employers assess the extent to which a corporate event is detrimental to covenant and agree adequate mitigation.

Next steps for trustees: Employers considering refinancing proposals, or trustees presented with such proposals, will want to take into account the factors set out by TPR.

UPDATED GUIDANCE ON TENDERING FOR FIDUCIARY MANAGERS AND SETTING OBJECTIVES FOR INVESTMENT CONSULTANTS

The Pensions Regulator (TPR) has updated its guidance on compulsory competitive tenders for new suppliers of fiduciary management services and setting objectives for investment consultants. This is to reflect the differences between the Competition and Markets Authority (CMA) regime and the Amendment Regulations which implement the CMA Order and come into force on 1 October 2022. Trustees have been required to comply with the Order since 10 December 2019; the main effect of the Amendment Regulations is to move compliance from the CMA to TPR.

TPR has published updated guidance for trustees on tendering for fiduciary management services and setting objectives for investment consultants. The guidance reflects the requirements of the *Occupational Pension Schemes (Governance and Registration) (Amendment) Regulations 2022* which come into force on 1 October 2022. (Please see our Pensions Bulletin June 2022 for the detail of the Regulations.) As with other TPR guidance, it uses "you must" to indicate legal duties and "you should" to indicate good practice approaches.

The **guidance on tendering** covers conflicts of interest, using independent third party evaluators, key principles of a competitive tender, invitations to tender and reviewing fiduciary manager submissions. TPR has added two new Appendices on how trustees can assess the performance of existing and potential providers of fiduciary management services, using the Global Investment Performance Standards developed by the Chartered Financial Analyst Institute and approved by the CMA. The other Appendices, which were in the previous version of the guidance, cover:

- Pros and cons of different third party evaluators (investment consultants, professional trustees and independent third-party selection firms).
- A defined benefit (DB) scheme example, applying the principles of tendering for fiduciary management.
- Topics to consider when deciding criteria for selecting a provider and designing an invitation to tender.

Points to note from the guidance:

- Trustees must invite and use reasonable endeavours to obtain bids from at least three unconnected fiduciary management (FM) providers and to evaluate the bids received. The guidance says, "It is likely to be prudent to approach more than three providers to ensure that you obtain the best value for your scheme and to increase the likelihood of obtaining at least three bids".
- Trustees "should" document the tender process followed and the decisions made, with reasons. This might include criteria for selection, details of the process followed to reach a shortlist of providers, key decisions made and reasons. Even if trustees are unsuccessful in receiving three independent bids, they should still document the process to demonstrate that they used reasonable endeavours.
- Trustees must retain ownership of certain decisions, although a FM provider may offer advice. In relation to a DB scheme, this includes strategic decisions on asset allocation and liability management, decisions on the extent to

which ESG considerations should be reflected in the investment strategy, and a decision to replace the scheme's FM provider.

In the guidance on **setting objectives**, as well as a section explaining the technical differences between the Amendment Regulations and the CMA Order, there are lists of typical investment consultancy services for schemes and case studies for investment consultant objectives and performance measurement. The guidance notes that the range of services provided by investment consultants is broader than those subject to the legal requirements, and encourages trustees, as a matter of good governance, to set objectives even where the legal requirement may not apply. (The previous version of the guidance went further, saying that failure to consider whether it might be appropriate to set objectives could be evidence that the trustees had failed to ensure there was an effective system of governance or that the trustees did not have the required level of trustee knowledge and understanding. This wording no longer appears in the guidance.)

Although the guidance does not mention scheme returns, the working assumption is that the need to make annual compliance reports to the CMA in January each year will cease, as the Amendment Regulations amend the Register of Occupational and Personal Pension Schemes Regulations 2005 (from 1 October 2022) to require trustees to report compliance in the annual scheme return. However, there has been no confirmation that the need to report to the CMA has ceased and the CMA has not yet updated its webpage.

Next steps for trustees: Trustees will already have been complying with the oversight duties since December 2019. They will want to check that their arrangements are in line with the updated TPR guidance. From 1 October 2022, trustee reporting of compliance will be via the annual scheme return, but there has not yet been confirmation that the need to make annual compliance reports to the CMA will cease.

SCHEME RULE ON UNCLAIMED BENEFITS ALLOWED TRUSTEES TO FORFEIT ARREARS

The High Court in CMG Pension Trustees Ltd v CGI IT UK Ltd decided that a scheme rule on unclaimed benefits should be interpreted as meaning that any benefit which had not been claimed within six years was forfeited. This allowed the trustees of a defined benefit scheme to recoup payments they had made to members to compensate for historic underpayments of benefits.

Rule 5.11 of the scheme provided "*if a benefit or instalment of benefits is not claimed by or on behalf of the person entitled to the benefit or instalment in accordance with these Rules within 6 years of its date of payment it shall be retained by the Trustees for the purposes of the Scheme*".

From 2009 onwards, the trustee had begun to identify problems relating to the way in which benefit changes had been implemented and the scheme had then been administered. Errors had resulted in benefits being underpaid to members. The trustee had taken steps to address the issues and then to pay off the arrears to members. In 2019, the question arose whether the trustee should pay arrears to members which fell due for payment more than six years earlier. This issue turned on the construction of Rule 5.11 and provoked a difference of view. The employer contended that Rule 5.11 was a forfeiture provision and that its effect was to forfeit all sums which fell due for payment more than six years before. The trustee argued that it was intended to have the more limited effect of freeing up orphaned benefits and dealing with missing beneficiaries, and that it did not extinguish the benefits of identifiable members or shortfalls in the payment of benefits.

The Court decided in favour of the employer's construction, meaning that any benefit or instalment of a benefit which had not been claimed within six years of the date on which it fell due for payment was forfeited. The Court also found that Rule 5.11 was not limited to missing beneficiaries but applied to all unclaimed benefits once the six-year period had expired. The parties had agreed that affected members were deemed to have made a claim for their unpaid benefits on 1 October 2019. All arrears accruing prior to 1 October 2013 were therefore forfeit. (It is reported that this has resulted in a saving to the scheme of approximately £2 million in additional liabilities.)

The Court commented that there is no stigma attached to a forfeiture clause in a pension scheme; it serves the same function as a contractual limitation clause. Although Rule 5.11 did not use the word "forfeit", the words "shall be retained by the Trustee for the purposes of the Fund" had the same effect. Rule 5.11 made no distinction between benefits unclaimed because the beneficiary was missing and those unclaimed because the beneficiary was unaware of the entitlement. On the trustee's interpretation, it was difficult to see what practical benefit Rule 5.11 was intended to serve. It would not have freed up "orphaned" benefits because the trustee would never know whether the beneficiary was missing or aware of the entitlement. In addition, the previous versions of the Rules all supported the conclusion that Rule 5.11 was intended to be a forfeiture rule.

The Court rejected the trustee's argument that Rule 5.11 did not apply where the trustee did not inform the member of the entitlement to the shortfall. It was not necessary to imply such a term, either to give Rule 5.11 business efficacy or to satisfy the "officious bystander" test. The Court also decided that a claim was made if the trustee could identify from the member's communication an intention to assert the entitlement; it was not necessary for the member to make a separate claim. Completion of retirement option forms would not be sufficient, however.

The Court went on to consider what would happen if a member had been overpaid after their entitlement had been extinguished by Rule 5.11 and the trustee sought to recoup from future payments of pension, but the member disputed either the total amount of recoupment or the amount of each proposed reduction. Under Section 91(6) of the Pensions Act 1995, trustees cannot exercise the right of recoupment unless the obligation to repay has become enforceable under an order of a "competent court". Here the Court agreed with comments made by Mr Justice Arnold in the 2018 High Court decision in *Burgess v BIC UK Ltd* - that the Pensions Ombudsman is not a "competent court" for the purposes of Section 91(6). (At the time, the Ombudsman disagreed with the judge's comments and issued a factsheet in April 2019 setting out its reasons; the factsheet is currently being reviewed in light of the *CMG* decision.) The Court added that a declaration from a court, rather than an order to pay, would be sufficient because recoupment did not require the member to repay anything.

Next steps for trustees and employers: The decision is an example of what appears to be a growing trend of the courts being prepared to interpret scheme rules in a way that limits liability for previous errors. More generally, trustees wishing to recover overpaid benefits by offsetting them against future benefit payments should note that, if there is a dispute, they will need an order from the county court; a direction by the Pensions Ombudsman will not be sufficient.

PENSION LEGISLATION AND REGULATION WATCH LIST

No	Topic	Expected effective date	Further information/action
1	DB superfunds	Regulatory regime was expected Winter 2021.	Interim regulatory regime in place from October 2020.

No	Topic	Expected effective date	Further information/action
2	Changes to DC scheme governance and disclosure, including the annual Chair's Statement and the charge cap	First scheme year ending after 31 December 2021 - detailed "value for members" assessments for schemes with assets below £100m. (First scheme year ending after 1 October 2021 - return on investments from default and self-select funds included in Chair's Statement; and 5 October 2021 - total value of assets reported in annual scheme return.) For charging years ending after 6 April 2022: £100 *de minimis* pot size below which flat fees cannot be charged.	DC schemes only. Consultation on requirements to include explanation of illiquid investment policies in SIPs and (for large schemes) asset allocation data in Chair's Statement closed 11 May 2022; further consultation on removal of performance-based fees from charges cap.
3	New notification requirements for DB schemes in relation to corporate and financing activity and change to the notification process	Draft Notifiable Events (Amendment) Regulations were expected to commence in April 2022. Response to consultation was expected Summer 2022.	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.
4	Refer members to guidance before processing application to access or transfer flexible benefits	1 June 2022.	For DC schemes only.
5	Draft DB Funding Code of Practice	Part 2 of TPR consultation and draft Code expected Autumn 2022 and Code to be operational from September 2023.	DWP regulations issued for consultation July 2022. Once in force, the Code will apply to triennial valuations submitted thereafter.
6	TPR Single Code of Practice	Revised Code to be issued "during 2022".	All schemes.

No	Topic	Expected effective date	Further information/action
7	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).
8	Trustee oversight of fiduciary managers and investment consultants	1 October 2022.	All DB and DC schemes (with minor exceptions). Draft regulations largely replicate existing regime under the Competition and Markets Authority Order 2019. TPR guidance issued August 2022.
9	Climate risk governance and reporting requirements	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. (1 October 2022 also the implementation date for the new fourth metric on portfolio alignment.)
10	Stewardship and voting reporting in Implementation Statements: statutory guidance	Implementation Statements for scheme years ending on or after 1 October 2022.	All schemes that are required to prepare Implementation Statements. Guidance on Statements of Investment Principles is non-statutory.
11	Simpler annual benefit statements	1 October 2022.	DC schemes used for auto-enrolment.
12	Changes to the scheme asset information collected through scheme returns	Scheme returns from 2023.	DB schemes.

No	Topic	Expected effective date	Further information/action
13.	Pensions dashboards	Compulsory connection deadlines from August 2023.	All registerable UK-based schemes with active and/or deferred members. TPR initial guidance for trustees published in June 2022. Further consultation on two aspects issued June 2022. Pensions Dashboards Programme consultation on mandatory standards published July 2022.

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