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Current issues

July 2020

Articles this month:

Viral news—June 2020
Insolvency-law changes affect DB schemes
FCA action on DB transfers
PPF compensation cap unlawful
HMRC newsletters June 2020

Viral news—June 2020

The Pensions Regulator has updated several of its COVID-19-related guidance pages.[1] As with society in general, there are indications of a tentative return toward normality. Whilst the trustees of defined benefit (DB) schemes are advised to remain open to sponsor requests for contribution suspensions (subject to more scrutiny of the business case), from 1 July 2020, all trustees are advised to resume reporting of breaches. A new blog post explains why the information gathered in this way will be so important to the Regulator.[2]

DC schemes

The Regulator has updated its guidance on auto-enrolment and defined contribution (DC) benefits to reflect the Government's changes to the Coronavirus Job Retention Scheme (CJRS).[3] Readers of last month's *Viral News* may recall that furloughed staff members are now allowed to carry out part-time work for the employer, with effect from 1 July 2020. The Regulator's worked examples of employer contribution calculations now incorporate the added complication that this will bring. The guidance also notes that, whilst the CJRS is scheduled to run until the end of October, the ability to submit CJRS claims related to pensions or National Insurance contributions will be removed from the start of August.

DB schemes

The guidance for DB scheme trustees has had a '*Major rewrite*'.[4] The Regulator does not anticipate the need to issue any further updates.

Contributions

Deficit reduction contributions (DRCs) have been deferred for around ten per cent of schemes. Some of them may need to extend their suspensions, and the Regulator is aware of others that are in discussions to introduce postponements for the first time. It thinks that the latest round of employer-loan and banking-covenant tests may result in more requests to trustees. The Regulator warns trustees not to extend deferrals unquestioningly. It says

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[1] *Measures extended to help pension schemes tackle COVID-19 challenges* (16 June 2020) <www.thepensionsregulator.gov.uk/en/media-hub/press-releases/2020-press-releases/measures-extended-to-help-pension-schemes-tackle-covid-19-challenges>.

[2] *Why intelligence is key to combating COVID* (16 June 2020) <blog.thepensionsregulator.gov.uk/2020/06/16/why-intelligence-is-key-to-combating-covid>.

[3] *Automatic enrolment and DC pension contributions: COVID-19 guidance for employers* (15 June 2020) <www.thepensionsregulator.gov.uk/en/covid-19-coronavirus-what-you-need-to-consider/automatic-enrolment-and-pension-contributions-covid-19-guidance-for-employers>, and *DC pension contributions: COVID-19 technical guidance for large employers* (15 June 2020) <www.thepensionsregulator.gov.uk/en/covid-19-coronavirus-what-you-need-to-consider/automatic-enrolment-and-pension-contributions-covid-19-guidance-for-employers/covid-19-technical-guidance-for-large-employers>.

[4] *DB scheme funding and investment: COVID-19 guidance for trustees* (16 June 2020) <www.thepensionsregulator.gov.uk/en/covid-19-coronavirus-what-you-need-to-consider/db-scheme-funding-and-investment-covid-19-guidance-for-trustees>.

that employers' financial positions should now be clearer, enabling more-detailed reviews of the business cases for suspensions.

Covenant

Trustees should continue to be open to reasonable requests from the employer, but should assess them carefully even if they are part of a larger co-ordinated request to the business's stakeholders.

Protections and mitigations should be sought. Most notably, the Regulator says that this should include suspension of all shareholder distributions until the deferred DRCs have been paid, but also the establishment of triggers for the resumption of contributions, legally enforceable arrangements to ensure that other creditors are not inappropriately prioritized, and access to information about refinancing agreements (with the trustees seeking, where possible, similar terms for access to security or business assets, and the same protection for deferred contributions as for new loans).

Enhanced monitoring of trading and liquidity positions will be necessary in the short-to-medium term. Trustees should ensure that they receive sufficient information to identify changes affecting the employer and the position of its financiers.

Generally, the Regulator expects that deferred contributions should be paid off within existing recovery-plan periods. Recovery plans should only be lengthened if the trustees are able to assess the employer's covenant sufficiently far into the future to be comfortable with the extension.

The Regulator expects trustees to distinguish between genuine, perhaps temporary uncertainty and a material deterioration in the employer covenant. In the latter case it advises that it may be in members' interests to commission a fresh valuation. Trustees can agree to short-term extension of deferrals if there is genuine uncertainty about the employer covenant caused by paucity of available information, but must be confident in their ability to justify the suspension in light of their fiduciary obligations. They should expect other creditors to join with them in making concessions to support the employer. In the absence of good covenant information deferrals should be short—and the lower the trustees' confidence in obtaining relevant information, the shorter they ought to be.

Challenges recognized

The Regulator acknowledges that trustees are being confronted with difficult decisions to which there may be no right answers and no guarantees. It says that these are judgement calls, and that they are asked to do their best, having considered the relevant (and no irrelevant) information, taking appropriate advice, acting in accordance with scheme rules, making decisions in good faith—and keeping comprehensive records.

Advice

Advice is not needed for every decision, but sometimes (in cases of difficulty or when there is a lot at stake, for example) it is sensible and can protect the trustees. The Regulator also says that it can help to illuminate negotiating options when the scheme is one of a number of competing creditors.

The Regulator advises the trustees to focus their resources on important issues and essential projects. It suggests that trust documents are examined to see whether the trustees are allowed to meet their expenses out of scheme funds, even if the employer usually covers those costs; and that trustees consider amending the rules if they do not currently have such powers.

Transfers

With effect from 1 July, trustees should report breaches of transfer deadlines; a pragmatic response is promised. They should consider their ability to use the flexibility existing in the transfer legislation. Transfer quotations should be accompanied by the cautionary letter composed by the Regulator, Money and Pensions Service, and Financial Conduct Authority.

Regulatory approach

Trustees should comply with reporting requirements from 1 July 2020. In particular, the Regulator expects to be informed about deferred contributions either by receiving revised recovery plans and schedules of contributions, with the changes explained, or from late-contribution reports that detail how the breach is to be resolved. It would also like trustees to provide details of the advice they obtained, whether the employer has been sharing information responsibly, when the deferred contributions will be paid, any mitigation obtained by the trustees, and how equitable treatment of the scheme has been ensured. Trustees should not be surprised to receive follow-up questions.

The Regulator promises pragmatic and sympathetic regulation, with a reasonable response to late reporting as long as it is informed within three months of the breach in question.

Advice for sponsors

The Regulator's guidance for DB scheme employers remains brief, but has been updated to make it consistent with the guidance to trustees.[5]

Reporting obligations resuming

In most cases, there is to be a resumption of normal reporting rules.[6] One notable exception is that, during the COVID-19 crisis, late payments should be assumed to become 'material' (that is, important enough to be reported) to the Regulator once contributions have been outstanding for 150 days, rather than using the pre-pandemic, 90-day measure. The Regulator is not going to review (or even read!) any DC annual governance ('Chair's') statements that it receives before 1 October 2020; however, fines are compulsory when Chair's statements are late. It is unlikely to take enforcement action over missed deadlines for the preparation of audited accounts or review of statements of investment principles, provided they are not delayed beyond 30 September 2020.

Scheme administration

Trustees are advised to ensure that their members—especially the vulnerable—are able to contact the scheme administrator, noting that some are reliant on postal and telephone communications services.[7] In a separate blog the Regulator's Executive Director of Regulatory Policy, Analysis and Advice (David Fairs) highlights the '*pivotal*' importance of scheme administrators, as demonstrated during the pandemic lockdown.[8]

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[5] *DB scheme funding: COVID-19 guidance for employers* (16 June 2020) <www.thepensionsregulator.gov.uk/en/covid-19-coronavirus-what-you-need-to-consider/db-scheme-funding-covid-19-guidance-for-employers>.

[6] *COVID-19: an update on reporting duties and enforcement activity* (16 June 2020) <www.thepensionsregulator.gov.uk/en/covid-19-coronavirus-what-you-need-to-consider/covid-19-an-update-on-reporting-duties-and-enforcement-activity>.

[7] *Scheme administration: COVID-19 guidance for trustees and public service* (16 June 2020) <www.thepensionsregulator.gov.uk/en/covid-19-coronavirus-what-you-need-to-consider/scheme-administration-covid-19-guidance-for-trustees-and-public-service>.

[8] https://blog.thepensionsregulator.gov.uk/2020/06/23/paying-benefits-is-not-just-admin>.

Insolvency-law changes affect DB schemes

The *Corporate Insolvency and Governance Act 2020* gained Royal Assent on 25 June 2020.[9] It is intended to help businesses in financial difficulty avoid insolvency. Most of its provisions came into force on 26 June 2020, but with retrospective effect in some cases. Although sometimes portrayed as a response to the current economic uncertainty, some of its reforms are permanent, and were under discussion long before the SARS-CoV-2 outbreak. Some—particularly a moratorium during which creditor activities are restricted, and a new type of court-sanctioned restructuring arrangement capable of overriding the objections of company stakeholders—gave rise to concerns about potential adverse implications for DB pension schemes; however, eleventh-hour Government amendments appear to have alleviated (but not entirely eliminated) the ill effects.

Moratorium on enforcement activities

The Act makes provision for a moratorium (initially lasting for twenty business days, but extendable), which is intended to provide financially distressed companies with the breathing space in which to attempt to rescue the business. During the moratorium there are restrictions on the enforcement or payment of certain debts that become due before or during the moratorium, giving the company a '*payment holiday*'. Where this applies the company's creditors are unable to enforce those debts, crystallize charges, or instigate corporate wind-up proceedings. The company itself will be subject to restrictions on its ability to obtain credit, grant security, enter into certain market contracts, settle debts or dispose of property. These matters will be subject to supervision by a '*monitor*' (an insolvency professional) and, in some circumstances, the courts.

The payment holiday does not apply to some categories of debts, which therefore remain payable during the moratorium. Moreover, if insolvency proceedings are commenced within twelve weeks of the end of a moratorium, some debts become payable out of the company's assets in preference to other claims. One example covers contributions to occupational pension schemes, although it seems unclear precisely what sorts of contributions the drafters had in mind (it is doubtful whether it includes those intended to eliminate past-service deficits, for instance). Financial-services debts that fell due before or during the moratorium are also prioritized. This gave rise to concern that banks and other financiers would be able to engineer 'super priority' for the debts that they are owed by activating clauses in their contracts, thereby leaving less available in insolvencies for other creditors, such as pension scheme trustees; and that that would apply regardless of any agreement that the trustees might have reached with the employer to put the pension scheme on an equal footing with lenders. Meanwhile, any security over employer assets that the trustees have negotiated as part of their funding and risk-management activities might be unenforceable at the time when it is most needed.

The Government has responded to those concerns by specifying that financial services debts falling due during the moratorium via the operation of acceleration or early termination clauses are *not* to be given special preference in a subsequent winding up of the company.

New restructuring option (AKA '*cross-class cram down*')

The Act also establishes a new sort of court-sanctioned restructuring mechanism that is capable of overriding the objections of dissenting creditors. In a House of Lords debate on the issue Lord Callanan, the Government's spokesperson, sought to reassure concerned peers about the strength of the protections that have been put in place. He noted in particular that a request to 'cram down' (disregard) dissenting votes cannot be granted if they would obtain a better result in insolvency proceedings, and that, even if all of the statutory requirements are met, the courts can refuse to sanction restructuring plans if that is '*fair and equitable*'.

The role of the Regulator & PPF

Another worry is that neither the moratorium nor the new restructuring mechanism counts as an 'insolvency event' for pensions-law purposes. That means that they will not trigger the calculation of 'section 75' employer debts or assessment of the scheme for entry into the Pension Protection Fund (PPF). During an assessment period, the

[9] <www.legislation.gov.uk/ukpga/2020/12/pdfs/ukpga_20200012_en.pdf>.

PPF is able to exercise any rights and powers that the trustees have as creditors of the employer. The concern was that the PPF in particular would have no role in the event of a moratorium or restructuring proposal.

The Government came back with amendments to the Bill, as a result of which:

- monitors will be required to inform the Regulator and the PPF about moratoria and any proposed compromises or similar arrangements;
- the PPF will be given the same rights to challenge monitors and directors as trustees have; and
- regulations can be made to allow the PPF to exercise trustees' rights.

This is a highly specialized area and DB trustees will need specialist legal and covenant advice about the potential repercussions for their schemes. They may find that protections that they have agreed have, in certain scenarios, been weakened by advent of the Act. On the other hand, it might facilitate the survival of sponsors that would be doomed to fail otherwise, leaving them better able to manage their pension scheme funding obligations.

FCA action on DB transfers

The Financial Conduct Authority (FCA) has decided to proceed with a ban on 'contingent charging' for advice on transfers from defined benefit (DB) to defined contribution (DC) pension schemes.[10] The prohibition is one of several measures intended to improve the suitability of financial advice about such transfers. Most of the changes will come into effect on 1 October 2020.

Advice audit

The FCA has also published the results of its investigations into the quality of the DB transfer advice that scheme members have received since the DC 'Freedom and Choice' reforms were introduced in in 2015. It found evidence of improvements in advice suitability over time, but says that the proportion of advice recipients who are advised to transfer is still '*unacceptably high*', and that there were still too many cases in which advice was unsuitable.

Contingent charging

Contingent charging is a practice whereby scheme members pay a fee to the financial adviser only if a transfer goes ahead. The FCA has agreed that it creates a clear conflict of interest for advisers. The ban will be accompanied by anti-avoidance measures to prevent firms gaining competitive advantage by cross-subsidizing transfer advice using investment or implementation charges, for example offering low upfront advice costs but charging significantly more for implementing the advice where the recommendation is to transfer.

There will be exceptions to the ban for those who are otherwise unable to pay for advice. There will be two such 'carve-outs': one that applies when, for medical reasons, a DB scheme member can reasonably expect to die before reaching age 75; and the other when early access to pension funds could help alleviate '*serious financial difficulty*', evidenced by, for example, missed bills and credit-card payments. However, the charges paid by people in those circumstances should not exceed the charges for advice paid for on a non-contingent basis.

Abridged advice

To mitigate the effects of the ban on access to advice, financial advisers will be allowed to offer their clients a less-costly form of 'abridged advice'. However, the new advice process comes with the limitation that it cannot result in a recommendation to transfer: the adviser must either counsel against a transfer or say that full advice is necessary to reach a conclusion.

[10] For an overview of the package of measures, please go to <www.fca.org.uk/news/press-releases/fca-sets-out-next-steps-improve-defined-benefit-pension-transfer-market>. The changes to the advice rules are detailed in *Policy Statement PS20/6: Pension transfer advice: feedback on CP19/25 and our final rules and guidance* <www.fca.org.uk/publications/policy-statements/ps20-6-pension-transfer-advice-feedback-cp-19-25-final-rules>.

Improving advice quality

The FCA's latest package of measures contains other changes that are intended to raise the quality of DB-to-DC transfer advice:

- Pension transfer specialists will have to undertake at least 15 hours' continuing professional development (on top of their other CPD commitments) every year.
- Advisers will have to present their clients with tailored information about the charges that they would pay from the outset.
- During the advice process, the adviser must log evidence of the client's understanding of the risks involved in transferring out of their DB scheme. If the transferring client has a workplace DC scheme to which he or she could transfer the DB rights, the adviser will have to explain why any other proposed destination for the transferred funds is more suitable than that workplace scheme. This requirement is intended to confront the incentive for advisers to recommend complex, costly products for which they stand to receive high, ongoing advice fees.

Advisers will have to give one-page summaries at the start of their transfer suitability reports, detailing all expected charges, the advisers' recommendations, risks and information about any ongoing services.

The FCA is also consulting on guidance intended to help advisers identify weaknesses in their existing processes.[11]

Support for transferring (and transferred) members

The FCA has created a new web-page for DB scheme members who are considering transfers.[12] It restates the Authority's belief that it is in most members' interests to keep their defined benefits, and outlines the characteristics of those for whom transfers are least and most likely to be appropriate. The main factor is the level of reliance on the income from the DB scheme (transfers being most likely to be beneficial for those with other sources of income).

A new 'advice checker' resource is intended to help members identify historically poor advice—and educate them on how to complain about it.[13]

The ban on contingent charging has polarized the industry, especially given that the FCA's ongoing market review has failed to find compelling evidence that poor advice outcomes are correlated with contingent charging models. However, the FCA is hoping that, by removing this conflict of interest, overall advice standards and outcomes will improve. Only time will tell if this objective is achieved.

The ban should help provide a much-needed increase in confidence and transparency to the market and, importantly, to consumers. However, it remains to be seen how those members most in need of advice, but not meeting the FCA's strict criteria for use of contingent charging, will be able to pay material upfront costs once the ban is in force. Abridged advice may be helpful but it is highly uncertain what appetite advisers will have to offer it and at what price. Where members do pay for advice upfront, they may be more determined to go ahead with the transfer, regardless of the adviser's recommendation and whether transferring is in their best interests. Education and communication about the value of quality advice, regardless of its recommendation, will be key.

The ban on contingent charging is likely to lead to even greater numbers of advisory firms leaving the market and the supply of advice reducing further. Unfortunately, the effects of COVID-19 on jobs, finances, sponsor covenants and health are likely to be far-reaching and lasting, and over the coming months and years we expect that the need for quality DB transfer advice will only increase.

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[11] <www.fca.org.uk/publications/guidance-consultations/gc20-1-advising-pension-transfers>.
[12] <www.fca.org.uk/consumers/pension-transfer-defined-benefit>.
[13] <www.fca.org.uk/consumers/defined-benefit-pension-transfers/advice-checker>.

We remain strong advocates of trustees and sponsors facilitating quality financial advice for their members. A ban on contingent charging coupled with an increase in demand makes the business case here even more compelling. By facilitating financial advice, trustees and sponsors can ensure that members have access to a high-quality service which is priced transparently and delivered affordably through economies of scale. This approach can ultimately help deliver better member outcomes for all. Please speak to your usual Hymans Robertson consultant to find out how we can help.

PPF compensation cap unlawful

In a 22 June 2020 judgment the Pension Protection Fund (PPF) was told that the compensation cap in its governing legislation is an example of unlawful discrimination on grounds of age.[14] The ruling contains a qualified endorsement of the method that the PPF has adopted to ensure that its compensation is adequate under EU law, but may nevertheless complicate the task of compliance (even though few scheme members are affected by the cap). Trustees of schemes that are under assessment for entry into the PPF will need to take the judgment into account when paying benefits.

Background

The PPF was established by statute in 2004 to provide compensation to members of defined benefit (DB) pension schemes that are left unable to pay promised benefits when the sponsoring employer becomes insolvent. The compensation basis is broadly speaking 90 per cent of the expected scheme pension for those who are under normal pension age (NPA) at the point when the PPF steps in, and 100 per cent for those over NPA at that time; the PPF is also typically less generous than the original pension scheme when it comes to making inflation-linked increases to benefits. Lastly—crucially, for this story—PPF compensation is subject to a cap, the standard amount of which stands at £41,461.07 for a 65-year-old with effect from 1 April 2020 (the cap varies with age, and is applied before compensation is restricted to 90 per cent, making the maximum annual compensation around £37, 315 currently for someone 65 years old; it is higher for those with periods of pensionable service of twenty-one years or longer).

In its judgment in the *Hampshire* case, delivered in 2018, the European Court of Justice (ECJ) said that EU law on the protection of employees in the event of employer insolvency meant that scheme members must receive benefits worth at least 50 per cent of the value of their accrued entitlements.[15] The PPF was forced to revisit the calculations for those affected by its compensation limits.

The 22 June 2020 High Court ruling that is the subject of this article is a response to legal challenges to the PPF's method of implementing the *Hampshire* judgment.

Decision

The judge concluded, in summary, that—

- the PPF's compensation cap constitutes unlawful discrimination on grounds of age, contrary to EU law, and must be dis-applied;
- the PPF is not necessarily obliged to carry out the 50-per-cent test annually—it can make a one-off calculation with the intention of ensuring that total compensation paid out during retirement (or the lifetime of a survivor) will be at least half of the total of the expected benefits;
- however, '*the obligation is to provide 50% of the actual value, over time, of the benefits not 50% of the actuarially predicted value*', so that if the PPF makes an actuarial calculation it will have to establish some way of identifying and dealing with any shortfall that arises in practice;
- claims for arrears of compensation resulting from underpayments due to the application of the compensation cap are limited to six years; and

[14] *Hughes & Others v Board of the Pension Protection Fund* [2020] EWHC 1598 (Admin).
[15] *Hampshire v Board of the Pension Protection Fund* (Case C 17/17).

- trustees will have to heed the striking down of the cap when restricting benefits during an assessment period.

The Court was not asked to rule on the validity of the 90 per cent compensation level for members below NPA at the time of assessment. However, the judge commented (*obiter dicta*, as a lawyer would say) that it was open to Parliament to impose the 90 per cent limit as an appropriate and necessary means of achieving legitimate aims about moral hazard and cost.

Official response

The PPF says that it is studying the detail of the judgment and will work closely with the Department for Work and Pensions to understand how the Government will respond (the compensation limits being set in legislation).[16] In the meantime it is continuing to pay people their current level of compensation.

The PPF put on a brave face, saying that its Hampshire-implementation methodology had been ruled 'permissible'; but the qualifications that the judge has imposed over the legitimacy of a one-off, actuarial approach promise to make the necessary adjustments onerous to administer. The Government, ultimately Parliament, will need to decide whether to further complicate the compensation rules to make them compliant with the growing number of critical judgments, or do something more radical. The ruling affects a very small number of pensioners, so the overall effect on PPF levies is likely to be immaterial; however, the impact of the ruling will vary from scheme to scheme.

HMRC update June 2020

Her Majesty's Revenue and Customs (HMRC) has published *Pension Schemes Newsletter 121*.[17]

This edition:

- provides an update on various temporary changes to processes as a result of COVID-19, including the relaxation of penalties of penalties connected with missed deadlines for Accounting For Tax (AFT) returns and an extension of other changes until 31 October 2020;
- announces that trustees and managers will not be able to submit their AFT returns using the Managing Pension Schemes Service (HMRC's online portal) until 21 July 2020 (and not from 1 July 2020 as HMRC had originally intended);
- requests that scheme administrators check that the correspondence addresses held by the Service are correct; and
- reminds them of the need to ensure that their IT systems can accommodate forthcoming changes to the Real-Time Information (RTI) system as amendments to RTI submissions from April 2021 will be done through the Full Payment Submission facility rather than as an Earlier Year Update.

[16] <www.ppf.co.uk/news/court-confirms-hampshire-methodology-permissible>.
[17] <www.gov.uk/government/publications/pension-schemes-newsletter-121-june-2020/pension-schemes-newsletter-121-june-2020>.

And Finally…

As a bit of an afterthought (much like this month's column, if we're honest) it struck *AF* that it is almost inevitable that the *Corporate Insolvency and Governance Act 2020*, discussed in this edition, will become known by its acronym as the 'CIGA Act'. That would be of little consequence where *AF* comes from (we is speaking proper-like), but taking into account regional differences in pronunciation it might have the regrettable effect of perpetuating a cliched and hopefully outdated (if only for respiratory-health reasons) image of smoked-filled board rooms and company chiefs with a fondness for rolled-tobacco products—all lit from a burning bank-note, naturally…

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