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Current issues

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Articles this month:

Freeing DB to do better

The Department for Work and Pensions (DWP) has launched a further consultation on Options for Defined Benefit Schemes. The consultation document ranges over various subjects, from amendment of the rules for surplus extraction, including the possibility of establishing a new Pension Protection Fund (PPF) compensation tier that would pay out members' full entitlements, through to confirmation of the Government's plans to put the authorization and supervision regime for DB superfunds on a statutory footing, and creation of a publicly operated consolidation vehicle. The consultation period runs from 23 February to 19 April 2024.

Surplus extraction

The Government is looking to remove barriers—both practical and behavioural—to the accumulation and extraction of surplus, by making it easier to share it with employers and scheme members. It believes that this will support its aim of enabling some schemes to run-on, investing the surplus in productive assets.

The Government plans to set clear rules for surplus extraction, with member protection at the forefront of its thinking. Responsibility for managing funding will continue to lie with trustees. Access to surplus will not be conditional on the use(s) to which the surplus is put. The Pensions Regulator will produce guidance for trustees, though the form that this will take (an addendum to the DB funding Code of Practice or something separate) has yet to be decided.

There are four proposed areas of change:

- *Statutory intervention* The DWP is considering options for statutory intervention to remove barriers in scheme rules. It could empower trustees to amend their rules if they currently have no power to make surplus payments, or the intervention could be more direct, in the form of a statutory override permitting surplus distributions.
- *Taxation* As announced in last year's Autumn Statement, the Government intends to reduce the authorised surplus payments charge from 35% to 25%, with effect from 6 April 2024. The consultation document says that it is also planning to change the tax rules so that it is easier to pay surplus to members, for example as one-off payments.

- *Safeguarding a minimum funding level for any surplus extraction* The Government is also considering changes to the buy-out-based funding condition that must currently be met before surplus payments can be made out of ongoing schemes. It may base it instead on a scheme's low-dependency funding basis, plus a fixed or variable margin; it may also introduce covenant-related considerations, though that '*is... not* [the DWP's] *preferred option*.'
- *Super-levy for super-compensation* The consultation document seeks views on the desirability of establishing a '100% PPF underpin', for schemes that choose to pay a higher levy. The idea is that this might give trustees (and their sponsors) the confidence to make more growth-seeking investments. The PPF estimates that the price would need to be high: perhaps more than 0.6% of a scheme's buy-out liabilities each year (or more if take-up is low). The Government is clear that the funds resulting from the super-levy would be held separately from those arising out of the ordinary pension protection levies, and there would be no cross-subsidy between the new 'underpin' and existing 'lifeboat'.

Public consolidator

The Government plans to give the PPF Board, by 2026, a new role as the operator of a public DB consolidation vehicle. It is anticipated to appeal mostly (though not necessarily exclusively) to the smaller and less-well-funded schemes that are unattractive to the commercial consolidation market. Entry would be voluntary.

The public consolidator would operate as a pooled fund, ring-fenced from the PPF proper, with the intention that it would run on rather than aspiring to buy out its liabilities. It would be subject to the same funding standards as commercial superfunds, which will influence the price of entry. To keep entry costs down, there would be some standardization of benefit structures on transfer into the new consolidator, on the basis of actuarial value.

The consultation document asks whether the Government should limit the growth or overall size of the public consolidator (to allay concerns about over-expansion), and about the eligibility criteria, including how to assess schemes' access to commercial consolidation. Trustees may need to show that they are unable to transfer into a commercial consolidator or buy out with an insurer.

Transfer into the public consolidator would sever the employer link, except when it is in the process of paying off a deficit. If a funding surplus exists at the time of transfer, it could be shared with the employer and (by way of higher benefits) the members. If the scheme enters the consolidator whilst in deficit, and the employer goes insolvent before that deficit is eliminated, members' benefits would be reduced, but not below PPF-compensation levels.

The PPF-run consolidator would be expected to provide a high level of security, so the Government anticipates that a form of 'underwriting' will be required (noting that commercial consolidators use third-party capital 'buffers'). The consolidator's investment strategy is likely to depend on how the need for underwriting is met. If liabilities are underwritten by the UK government, it would, in return, expect to have more say over investment policy. However, the consultation document says that the underwriting could come instead from the reserves that the PPF has accumulated in its existing 'lifeboat' role; if that route is taken, it would necessitate the PPF Board as operator of the public consolidator paying PPF levies to itself as the manager of the compensation fund.

The consultation document includes a survey designed to gauge interest in the creation of the proposed public-sector consolidation vehicle.

We're pleased that the consultation starts the ball rolling on the package of pension reforms announced in November's Autumn Statement. It will be interesting to see how the looming General Election affects the next steps. Given the improvements in DB scheme funding levels, there is a significant opportunity for the next government—whoever forms it—to make some positive changes.

The consultation asks sensible questions. We're pleased to see the Government agreeing our call for surplus extraction to be conditional upon funding levels and the security of members' benefits. However, there are still a lot of options on the table and details to be worked through in both areas at this early stage.

We will be responding to the consultation, which closes on 19 April, and sharing more on our views and insights over the coming months.

[Amendment] powers and riches never want advocates

The first few weeks of 2024 brought two (or two-and-a-half) notable court judgments on a fertile source of pensions litigation: the interpretation and operation of scheme amendment powers.

Final salary to CARE—Partial validity

In the first case, the High Court issued a ruling on the extent of the invalidity of the changes introduced in a flawed amendment attempt.[1]

Briefly summarized, the trustees tried to close a final salary section of a scheme to new accrual, moving the members into a career-average revalued earnings (CARE) section, and breaking the final salary link for the accrued benefits of members who remained in service. The problem was that their scheme amendment power said that it could not be exercised '*in any way that affects prejudicially... benefits accrued... up to the date on which the amendment takes effect*'.

The judge was asked to assume that the amendment was '*prejudicial*', and therefore invalid, for those remaining in the employer's service for whom a break in final salary linkage will produce lower benefits. Nevertheless, it is expected that the amendment would work to the favour of some members, because statutory revaluation in deferment will exceed the post-amendment increases to their salaries; the true position for each person will only be fixed at the point of retirement.

The judge was prepared to allow the otherwise invalidly made alteration to have effect for any members who will profit from having their benefits revalued rather than linked to their final salaries. In effect, the amendment has been allowed, but with the addition of a final-salary underpin, so that members are entitled (but see the following paragraph) to the better of the two calculations.

A separate hearing was held to seek the Court's approval for a proposed compromise, which would determine how to give effect in practice to the underpin for those members and surviving beneficiaries who would be better off with the final-salary link. In very broad terms, the proposal was that those members should obtain 70% of the difference between the alternative member-benefit calculations. That reflected a 30% chance, agreed by the parties to the litigation, that the line of earlier cases supporting the need to continue the final-salary link would be overturned on appeal.

The judge noted that the proposal would avoid the need for costly litigation, resolve uncertainty, simplify the benefits to be paid, and speed up payments to members. He concluded that it was '*wholly appropriate*' for him to exercise his discretion in favour of the compromise, which conferred advantages on all involved.

It's not the first time that the courts have allowed partial validity, but the judge here seems to have steered a course between the somewhat divergent historical approaches to the matter. The consensus about the vulnerability to appeal of the case law on final-salary linkage (*re Courage* in particular), resulting in the 30% discount within the compromise, is also notable. There has long been a sizeable constituency within the legal profession that believes that it's bad law. The question is whether someone will come along with enough resources, and money at stake, to make it worth the gamble; it seems that the odds of success are perhaps not as good as a coin toss, but better than a roll of the die.

DB to DC—a value-based underpin

The second case, too, featured rule changes that seemed to exceed restrictive amendment powers, and a judge who was nevertheless willing to give some effect to them.[2] This one, though, had the extra frisson that comes with attempts to transmogrify defined benefits (DB) into a money purchase pot—with an accusation of unlawful discrimination thrown in for good measure.

The scheme originally provided only final salary benefits. In 1992, an interim deed purported to introduce a money purchase section. At the same time, members under the age of 40 had their defined benefits converted into money purchase funds within that new section, without their consent; members aged 40 to 44 were given a choice; and those aged 45 and over remained in the DB section.

[1] *Avon Cosmetics v Dalriada Trustees & others* [2024] EWHC 34 (Ch).
[2] *Newell Trustees v Newell Limited Rubbermaid UK Services Limited* [2024] EWHC 48 (Ch).

Later, when the trustees were exploring the possibility of buying out the scheme's liabilities with an insurance company, the validity of the conversion amendment was questioned. A representative beneficiary was chosen to argue that it was inoperative, and also that it had unlawfully discriminated against members under the age 40.

The trust deed gave the principal employer and trustees wide power to change the terms of the scheme, so long as the alteration was not such that it '*would prejudice or impair the benefits accrued in respect of membership up to* [the time of the amendment].' The judge held that the proviso did not prevent the conversion from final salary to money purchase. A lot seemed to ride on the proviso's use of the word '*would*'. To the judge, saying something '*would*' happen was not the same as saying that it '*would probably*' happen. It had to be possible to make a judgement at the time of an amendment '*with some certainty*'.

The proviso did, however, mean that the amendment was subject to an underpin. The judge concluded, though, that it needed only to protect the *actuarial value* of the pre-amendment benefits. The proviso to the amendment rule acted to safeguard members' final-salary link, but the implication in the circumstances of this case was that the money-purchase funds resulting from the conversion calculation needed to be re-assessed to account for salary increases after the amendment date, and top-ups made as required.

That did not necessitate waiting until deferred members reached retirement age either. The uncertainty created by such a delay would have prevented the trustees from taking advantage of the favourable buy-out terms currently available. Instead, the judge allowed the re-calculation for the deferreds to proceed on the basis of actuarial assumptions.

The Court also concluded that the age-dependent outcomes for members did not amount to unlawful age-based discrimination, because the changes were decided upon before the relevant anti-discrimination rules were enacted.

The judge's concluding comments may provide some hope for those struggling to give a complete account of historical changes to their schemes:

> '*It is inevitable that after 30 years the evidence may simply not be available to establish that every 'i' was dotted and 't' crossed. But this does not mean that the [amendments] were invalid or that they should now be set aside.*'

As in the preceding case, the judge's pragmatism is encouraging. Some aspects of the judgment, such as the Court's willingness to countenance DB-to-DC conversion, may surprise, but the changes pre-dated the statutory restrictions on modification of accrued rights. A challenge to the ruling seems unlikely, given the potential costs to the representative beneficiary.

Auto-enrolment news

Thresholds unchanged for 2024/25

The Department for Work and Pensions (DWP) has published its annual review of the earnings trigger and qualifying earnings band used for automatic enrolment for the coming tax year. The trigger, above which jobholders must be automatically enrolled, is frozen at £10,000 as it has been since 2014/15. The earnings band, on which minimum contributions are based, will remain at last year's level (£6,250 to £50,270) in line with the Lower and Upper Earnings Limits for National Insurance purposes.

The *Pensions (Extension of Automatic Enrolment) 2023 Act*, which received Royal Assent in September 2023, gives the Government the power to widen the criteria for auto-enrolment by lowering the age at which jobholders become eligible for auto-enrolment and to reduce or remove the lower limit of the qualifying earnings band. The DWP has said that it intends to consult on the detailed implementation of these measures '*at the earliest opportunity*' and will report to Parliament before using these powers.

No change for DB alternative requirements

The Government has concluded, following a call for evidence, that no changes should be made to the alternative quality requirements that employers with defined benefit (DB) and hybrid schemes can use to demonstrate that they meet the minimum standard for auto-enrolment.

To be used for auto-enrolment, a DB scheme must either meet the 'test scheme standard' or satisfy one of two alternative quality requirements: a 'cost of accruals' test, or (much more rarely), for DB schemes that display money purchase characteristics, the money purchase quality requirements.

The DWP says that '*in broad terms, the alternative quality tests continue to provide a simplified option and are suitable for the majority of DB and hybrid schemes who use them*'; and that alternative test for collective defined contribution (CDC) schemes also remains sufficient.

England expects: fiduciary duty

FMLC report

The Financial Markets Law Committee (FMLC), a registered charity, published a report in early February on pension scheme trustees' fiduciary duties and decision-making in relation to sustainability and climate change. It gives a general explanation of the legal position and the difficulties and uncertainties that exist.

The report is notable for its advice that many ostensibly 'non-financial' factors will turn out to have financially material angles upon reconsideration, so that trustees should take them into account; and that narrative is as important as attempts at quantification. For more information about the report, and our views on the subject, please see the blog written by Sanjay Joshi (one of our responsible-investment experts).

The Government's spokesperson in the House of Lords said that it and the Regulator will consider what insights can be gleaned from the FMLC report, as they gather evidence on trustee investment approaches; and that the Government is organizing some roundtable events in the spring to solicit views on the need (if any) for further guidance.

In Parliament

The House of Commons Work and Pensions Committee held an oral evidence session on fiduciary duty on 21 February 2024. The hearing was broken into two sessions: the first involving ShareAction, Make My Money Matter, Pensions For Purpose, and the UK Sustainable Investment & Finance Association; later, we heard from the Pension and Lifetime Savings Association, the Universities Superannuation Scheme, the Institute and Faculty of Actuaries and the Association of Professional Pensions Trustees.

There was, in very broad terms, a divide between the two groups on the need for further action on fiduciary duty. The participants in the second session agreed that the law is already sufficiently clear, and voiced concerns about the unintended consequences of legislative intervention; they were, however, in favour of translating the FMLC report into Pensions Regulator guidance for trustees. Even amongst participants in the first session, ShareAction appeared to be out on its own in thinking that legal change is already necessary; the other speakers seemed more willing to give extra guidance on interpretation of the law a chance.

The Regulator

In a recent blog, the Pensions Regulator has urged trustees to 'take stock and plan for wider ESG risks and opportunities', now that many have become accustomed to climate-change reporting.

The Regulator's Climate and Sustainability Lead, Mark Hill, asks that trustees continue to improve their understanding of wider environmental, social and governance (ESG) considerations, such as nature and social factors, and their interplay with climate change. It is suggested that, despite there being no obligation to adopt the recommendations of the UK Transition Plan Taskforce, Taskforce for Nature-related Financial Disclosures or Taskforce for Social Factors, trustees '*would do well to familiarise themselves with them*.'

Like the FMLC, the Regulator recognises the challenge of finding good qualitative data, and endorses use of qualitative, narrative approaches in addition. It suggests that trustees take the initiative in considering wider ESG risks and opportunities, building on their experience of Task Force on Climate-Related Financial Disclosures reporting, and increase their collaboration and knowledge sharing with others.

More expected from professional trustee

The Pensions Ombudsman directed the independent corporate trustee of a small self-administered scheme (SSAS) to meet 80% of the loss arising from an injudicious investment, which its fellow trustee (and sole scheme member) wanted to make.

The independent trustee's due diligence had been limited to confirming that the investment (part-ownership of an unfinished hotel suite in the Republic of Cabo Verde) was permitted by His Majesty's Revenue and Customs. The Ombudsman found that the independent trustee had failed to discharge various statutory and common-law investment duties on pension trustees: for example, the need to obtain proper advice before making investment decisions, and considering the need for diversification (the Cabo Verde investment accounted for 85% of the scheme's total assets).

Exoneration and indemnity clauses in the trust deed and relevant contracts were rendered ineffectual by the statutory rule against attempts to exclude or restrict trustees' duty of care over their investment functions. The Ombudsman's loss apportionment was intended to reflect the greater weight of expectations on professional versus lay trustees. The independent trustee was also directed to pay £1,000 to the member in compensation for '*materially* significant' distress and inconvenience.

HMRC newsletters: February 2024

Lifetime allowance abolition guidance

His Majesty's Revenue and Customs (HMRC) published a February edition of its Lifetime Allowance Guidance Newsletter. It responds to frequently asked questions on lump sums, reporting requirements, the overseas transfer allowance, and transitional matters. There is also some clarification of points about transitional tax-free amount certificates, member statements, and pension commencement excess lump sums (PCELSs).

In that last section, the Newsletter says that changes are to be made to the legislation via statutory instrument, so that PCELSs are payable only when members have used up their lump sum or lump sum and death benefit allowances, but that they will not otherwise be tested against members' remaining lump sum and death benefit allowances. This is in response to concerns that the PCELS rules in the Finance Bill 2023/24 (now *Finance Act 2024*) are more restrictive than the lifetime allowance excess lump sum rules that they will replace.

HMRC subsequently amended* the February Newsletter to clarify its advice about the circumstances in which lump sums will have to be reported through the new 'event 24'.

*It has been in a newsletter-editing frenzy: Pension Schemes Newsletter 155 was recently altered to remove a misleading statement about transitional tax-free amount certificates (the expurgated version says that 'guidance will confirm that we expect applications to be made to the scheme from which the first lump sum is being paid post after 6 April 2024'); whilst December's Lifetime Allowance Guidance Newsletter is on its third revision, now saying that members who have had benefit crystallization events without entitlement to ongoing pension payments will need to be provided with 'relevant benefit crystallisation event' statements by 5 April 2025.

PSN 156

Pension Schemes Newsletter (PSN) 156 confirmed that the Finance Bill 2023/24 had completed its passage through Parliament (it subsequently received Royal Assent), and that the (many) necessary amendments to its lifetime-allowance-abolition provisions will be achieved by secondary legislation (regulations). Another Lifetime Allowance Guidance Newsletter was expected within the next fortnight.

PSN 156 also announced Guidance for Pension Scheme Administrators—preparing for the new 2024 to 2025 Pension Scheme Return. It advises scheme administrators how to prepare for the submission of pension scheme tax returns (which are only required if notice to complete a return is issued) via the online Managing Pension Schemes service; the facility to submit the returns is not yet available, having been delayed. The returns will ask for more details than in previous years.

The rest of the PSN 156 explains the tax treatment of interest payments arising from implementation of the remedy for 'McCloud' discrimination in the public sector schemes. In short, it depends on whether the interest is on compensation, on authorised pensions, on authorised top-up lump sums, or on unauthorised payments.

It's now clear that the final details of lifetime allowance abolition will be revised right up to (and quite possibly beyond) the wire. This is deeply unsatisfactory for all concerned.

Small pots delivery group

The Department for Work and Pensions (DWP) has established a small pots delivery group consisting of pension industry, consumer group, and government representatives. The group will provide recommendations on the design and implementation of the 'multiple default consolidators' approach for small, deferred, defined contribution (DC) pension pots.

The multiple default consolidator approach is the government's preferred model for addressing the issue of savers having increasingly many small DC pension pots, because of automatic enrolment and the tendency for people to move jobs. It would enable a few authorised schemes to act as automatic consolidators for inactive DC pension pots under £1,000. A central clearing house would tell schemes where to transfer a member's fund: this would be either the consolidator chosen by the member, or one of the authorised consolidators, allocated by the clearing house.

The DWP indicated in November 2023 that it intended the group to provide an interim update on the specific elements of the consolidation framework by the spring or summer of 2024, with proposals following in late 2024 for ministerial consideration and decisions.

Thar she blows—the PPF levy ceiling

The Pension Protection Fund and Occupational Pension Schemes (Levy Ceiling) Order 2024 (SI 2024 No. 101) set the ceiling on the amount that the PPF can try to raise via the levies for the year commencing 01/04/2024 at—drumroll, please—a shade under £1.35 billion. The levy ceiling rises each year in line with earnings inflation, even though a separate cap on year-on-year increases has long been far more relevant, and the PPF has set the 2024/25 levy estimate at £100 million (more than it needs—just to protect its ability to raise something meaningful in future if economic conditions take a turn for the worse. The Department for Work and Pensions '*has agreed to revisit the legislation as soon as parliamentary time allows.*'

Dashboard operators require authorization

Regulations that come into force on 11 March 2024 will make operating a pensions dashboard a regulated activity[3]. Providing pensions dashboard services without authorization from the Financial Conduct Authority (FCA) will be an offence.

The Regulations will also allow the FCA to finalise the regulatory framework that will govern dashboard services, which it consulted on in December 2022.

[3] The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2024, SI 2024 No. 169.

And Finally…

The following House of Commons exchange appears in *Hansard* for 5 February 2024:

> *Jonathan Gullis (Stoke-on-Trent North) (Con*):*
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> *I wish to place on record my thanks to the Secretary of State for helping to guide my private Member's Bill through Parliament. It lowers the pension auto-enrolment age from 22 to 18, and abolishes the lower earnings threshold. Briefly, has the Secretary of State received reassurances from the Chancellor that the necessary forms* [sic] *will be implemented in the spring Budget?*
>
> *Mel Stride (Secretary of State for Work and Pensions):*
>
> *I thank my hon. Friend for that question. Those matters are under active consideration.*

*[Indicates party-political affiliation, not past criminal convictions.]

The Secretary of State's response reminded *AF* of the brush-off line from *Raiders of the Lost Ark* about how '*Top. Men.*' would study the mysteries of the Ark of the Covenant. We like to imagine that Gullis's *Pensions (Extension of Automatic Enrolment) Act 2023* is now in a crate on a shelf in a massive underground storage facility.