Current issues

May 2020

Articles this month:

Annual Funding Statement 2020: the one with COVID-19

The Pensions Regulator has published its annual funding statement for defined benefit (DB) schemes.[1] It is primarily for schemes with valuation dates in the period from 22 September 2019 to 21 September 2020, giving them guidance on how to conduct the valuation and set their recovery plans. Unsurprisingly, COVID-19 looms heavily over the guidance. The Regulator encourages close trustee – employer cooperation in the months to come in response to the pandemic, but reminds them not to neglect longer-term planning and risk management.

COVID-19's effect on funding levels

Funding positions are believed to have been better, generally, on 31 December 2019 than at 31 December 2016 (valuations usually being triennial), because of strong investment performance. Funding levels at 31 March 2020 were diverse, but may not have fallen as far as the markets given recent moves toward de-risking. Schemes that are well-hedged and with low equity exposures have fared better, and are encouraged to remain focused on the longer term. Those that have suffered sharp falls in funding levels should be implementing contingency plans (where they have them), or developing strategies to put them back on course.

As in its COVID-19 guidance, the Regulator says that the assumptions underlying valuations that are close to completion need not be revisited. The impacts (positive and negative) of post-valuation events on assets and liabilities and the employer covenant should, however, be considered when setting recovery plans. March and April valuations will be 'challenging', but it is reasonable to delay decisions on assumptions until more clarity on long-term investment prospects and the employer covenant is available; in the meantime, schemes should do as much of the preparatory work for their valuations as is possible. Trustees should consider the different possible rates and periods of economic recovery, as well as potential longer-term effects. The use of scenario planning, which many schemes already use as part of their integrated risk management (IRM), is encouraged.

The Statement sounds a warning note for any trustees thinking of pushing their valuation date back a few months to a time before the crisis. They should 'consider very carefully' why they believe that would be in members' interests, take legal and actuarial advice, consider taking post-valuation investment and covenant changes into account, and expect the Regulator to question their assessment.

[1] <www.thepensionsregulator.gov.uk/en/document-library/statements/annual-funding-statement-2020>.

Recovery plans

When setting recovery plans, trustees are expected (having carried out additional due diligence on the employer covenant) to focus on affordability, bearing in mind the need for fair treatment of the scheme and the employer's prospects for sustainable growth. Where possible, plans should make provision for incremental increases to contributions, linked to corporate health (using indicators such as free cash flow and payments to other creditors), especially where the trustees have shouldered additional funding risk to support the employer's recovery. If the investment return assumed in the recovery plan is more optimistic than the one used for the valuation, plans could incorporate additional contributions linked to investment performance, or involve contingent security.

Dividends, etc.

The Regulator anticipates that those employers that have suspended or reduced their dividend payments and other shareholder distributions will continue to do so until affordability and liquidity have been largely restored. It says that recovery plans should reflect that expectation. Any additional liquidity made available to companies through deferral of deficit-reduction contributions should not be use to support associated companies unless that is in the interests of the scheme. Cessation of shareholder distributions should be a legally enforceable condition of the trustees' agreement to defer DRCs, and trustees need to understand how the suspended contributions will eventually be paid.

The Statement also considers other sources of potential 'covenant leakage', such as cash pooling and inter-company lending, group trading arrangements, fees and royalties, transfers at undervalue and executive remuneration. These become matters for concern if the employer is seeking a long recovery plan because of limited affordability. In general, the advice is that trustees should understand the intentions behind the arrangements and the implications for the covenant, for which they might require specialist advice, and for them to seek suitable mitigation of adverse effects through contingent security or agreements whereby they receive increased contributions in the event of improved employer performance.

Covenant assessment & contingency planning

The Regulator suggests that trustees might need specialist employer-covenant advice, especially if they are highly reliant on the covenant, or if it is complex or deteriorating. They should only undertake the assessment themselves if they have sufficient expertise, and should be prepared to justify that conclusion. The potential for conflicts of interest should be considered. Detailed records of deliberations should be made and retained.

Frequency and intensity of monitoring should be elevated whilst uncertainty persists, and trustees and employers should have contingency plans in place for adverse changes. The Regulator may ask trustees for evidence that such discussions occurred.

The Statement encourages trustees and employers to agree contingency plans so that, for example, additional contributions are triggered if the funding level deteriorates by more than a specified amount.

Segmentation

As with the 2019 Statement, the Regulator has set out over several tables its expectations for different schemes based on their funding, covenant and maturity characteristics. Pending a decision on the definition of maturity that is to be used for the revised funding Code, trustees should interpret the term in a convenient way, based on advice from their actuary. The Regulator suggests that trustees decide on the extent to which their covenant has been affected by COVID-19, and the possible implications of Brexit; how their funding position compares with their long-term funding target given the period over which they aim to reach it; and use their conclusions to identify the most appropriate table for their circumstances.

Next steps

The analysis behind the Statement will be published in the summer, and more guidance may be issued in the autumn. The Regulator also says that it is unlikely that a revised funding Code of Practice will come into force before late 2021.

This year's Statement balances the desirability of maintaining a long-term outlook with recognition of the immediate need to help employers weather the current crisis. We welcome the Regulator's realism and its avoidance of an overly prescriptive approach.

COVID-19: auto-enrolment in DC schemes

The Pensions Regulator has published guidance for employers on the implications of the COVID-19 pandemic for automatic enrolment (AE) via defined contribution (DC) schemes.[2] The headlines are that AE duties continue as normal, but that there is some flexibility already available within the system and the Coronavirus Job Retention Scheme (CJRS) allows employers to recover some of their pension costs. Worked examples illustrate some issues that arise for employers using salary sacrifice or the alternative AE quality requirements[3], and the Regulator announces a relaxation of the statutory consultation requirements in some circumstances.

Auto-enrolment—business as usual

The guidance confirms that employers' AE duties (including re-enrolment and declarations of compliance) still apply, regardless of whether employees are still working or have been 'furloughed' using the CJRS. Employers are, however, reminded that there is some flexibility in the timing of enrolment and re-enrolment. Assessment of new or newly eligible members of staff can be postponed for up to three months, and re-enrolment processes can take place up to three months after the third anniversary of an employer's staging or previous re-enrolment date.

Whilst AE has fixed the minimum levels of pensions provision that must be made for jobholders, the contributions basis for each particular scheme will be set out in its governing documentation. Contributions should continue to be made on that basis, unless members opt out of pensionable service. Employers must not encourage jobholders to opt out or (if the facility exists under the scheme rules) to reduce their contribution levels below the minimum required by the AE legislation.

AE implications of the CRJS

In March 2020 the Government announced the creation of the CJRS, which allows employers to apply for a grant to recover some of their costs associated with employees who are 'furloughed'—not working, but kept on the payroll. Claims are limited to 80 per cent of an employee's wages, capped at £2,500 per month, plus the employer National Insurance Contributions and *some of* the employer pension contributions due on those reduced wages.[4]

The pensions-related claim will be limited to three per cent of the claimed wages after deduction of the lower limit of the AE qualifying earnings band (£512 a month for periods before 6 April 2020, and £520 a month for periods after 5 April 2020); and they cannot claim back more than they actually contribute in respect of a member. The pensions claim limit corresponds to the basic minimum employer contribution due under the AE legislation to a DC scheme. If the employer's actual contribution is higher (for example, because that is what is required under scheme rules or employment contracts, or because scheme contributions are based on total rather than AE qualifying earnings—or because the employer has a defined benefit scheme) the excess cannot be claimed back from the CJRS. The

[2] *Automatic enrolment and DC pension contributions: COVID-19 guidance for employers* <www.thepensionsregulator.gov.uk/en/covid-19-coronavirus-what-you-need-to-consider/automatic-enrolment-and-pension-contributions-covid-19-guidance-for-employers>.
[3] *COVID-19 technical guidance for large employers* <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] <www.gov.uk/guidance/work-out-80-of-your-employees-wages-to-claim-through-the-coronavirus-job-retention-scheme#work-out-how-much-you-can-claim-for-employers-pension-contributions>.

Regulator notes that in such cases the employer will have to calculate the CJRS claim in addition to its normal payroll pension contributions.

DC employer consultation relaxations

It may be possible for employers to reduce their employer contributions to the statutory minimum, subject to contractual terms, any collective agreements that apply, and scheme rules.[5] The Regulator notes that if the scheme is a group person pension (GPP) it is likely that the employer and employee would need to enter into new contracts with the provider.

Pensions legislation requires that employers with 50 or more employees consult with members before making certain '*listed changes*'. Reducing the level of employer contributions to a DC scheme is a listed change. The minimum statutory consultation period is 60 days; however,the Regulator has announced that it will not take action against failure to undertake a full consultation provided that all of the following conditions are met:

- the employer has furloughed staff, for whom it is making a CJRS claim;
- the employer is proposing to reduce its contributions in respect of furloughed staff only;
- the reduced contribution rate will only apply during the furlough period, after which it will revert to the usual rate; and
- the employer writes to affected employees and their representatives to describe the intended change and its effects.

The guidance encourages employers to carry out as much consultation as possible even though the above conditions are met. The easement will until 30 June 2020, subject to review.

Salary sacrifices, alternative AE quality requirements & the CJRS

The Regulator has produced some guidance on the implications of the CJRS for employers with salary sacrifice arrangements. It confirms that the reference wage for the CJRS will be based on post-sacrifice pay, and that no sacrifice-related deductions should be made from the CJRS grant. It stresses again that the CJRS does not override employment contracts or scheme rules, which will continue to determine the contributions that employers must actually pay. Notably, it suggests that employers need to base scheme contributions for workers whose wages are reduced to the CJRS grant on a *notional pre-sacrifice pay*, calculated by grossing up the furlough pay in accordance with the arranged sacrifice.

Whilst it may be possible to vary salary sacrifice arrangements, that would not by itself alter the pension scheme's contribution rules. If they need to be changed, consideration should be given to any relevant contractual terms and collective agreements. The Regulator notes that the statutory consultation requirement applies to any proposal to introduce or increase member contributions; it does not say whether its temporary concession regarding the usual 60-day consultation period is equally applicable in this case. Moreover, changes made now will have no effect on the CJRS reference wage, which in many cases will be the amount payable to the employee in the latest salary period ending on or before 19 March 2020.

There are alternative quality requirements that can be used if (as is often the case) a DC scheme's pensionable earnings definition is different from AE qualifying earnings. Crucially, qualifying earnings have a lower boundary, currently £6,240 per annum, whereas pensionable earnings often do not.[6] The Regulator's worked examples show that in such cases employers will be unable to recover all of their pension contributions via the CJRS. It may be possible to end the current certification period early and amend scheme rules to match the basic AE quality requirement, subject to contractual terms and collective agreements. Again, it is unclear if enforcement of the 60-day consultation requirement will be relaxed in such cases.

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[5] The Regulator has already outlined the possibilities for deferring contributions to DB schemes <www.thepensionsregulator.gov.uk/en/covid-19-coronavirus-what-you-need-to-consider/db-scheme-funding-and-investment-covid-19-guidance-for-trustees>.

[6] They have an upper boundary too, but it is irrelevant when furlough pay is capped at £2,500 per month.

The guidance confirms what employers will have realized already: that the support on offer through the Coronavirus Job Retention Scheme (although undoubtedly very welcome) is not a perfect match for their obligations under scheme rules, etc. The potential complications for payroll processes, for example when salary sacrifice is involved, need careful consideration (grossed-up furlough pay seems like a hyper-notional pre-sacrifice basis for contributions, when no sacrifice is actually permitted). The Regulator's general pragmatism and openness to emergency contribution-rule changes is to be applauded.

COVID-19: reporting duties

The Pensions Regulator has published guidance on reporting duties and enforcement activity during the COVID 19 pandemic.[7]

The Regulator has decided to adopt a '*more flexible approach*' to what it expects those involved in running an occupational pension scheme to report to it. In general, breaches resolved within three months, without negative consequences for members, need not be reported and will not provoke enforcement action, though records should be kept. The easements will remain in place until 30 June 2020, but will be kept under review to see whether more flexibility is required in specific areas over the following weeks, and whether the end date for the easements should be extended.

There is, however, a list of areas where the general policy does not apply, or applies with variations. For example, the Regulator has no discretion to waive Chair's statement fines (albeit it has undertaken not to issue any before the end of June); and breaches of the employer-related investment restrictions (being potentially criminal) should continue to be reported, as should notifiable events and charge-cap infractions.

COVID-19: communicating with members

The Pensions Regulator has published guidance on communicating to pension scheme members during the pandemic.[8] The intention is to help members avoid making rash decisions as a result of the current crisis. In particular, the Regulator is asking trustees to send a template letter to defined benefit (DB) members who request a cash equivalent transfer value (CETV) quotation.[9]

The Regulator wants trustees to keep members informed of any changes, delays or disruptions and what action is being taken to resume normal services and timescales.

The template letter to be sent to DB members urges them to consider their decisions carefully, as well as directing them to sources of impartial guidance. Trustees are asked to monitor the number of transfer inquiries they receive and the advisers involved. Unusual or suspicious activity should be reported to the Financial Conduct Authority (FCA).

To help members make informed decisions about transfers or accessing benefits, the guidance advises trustees to:

- provide appropriate risk warnings;
- encourage members to take regulated independent advice and ask the adviser about the risks associated with the proposed use of their funds; and
- highlight the guidance available from Pensions Wise.

If a member asks to stop making contributions and cease pensionable membership, they should be made aware that they will lose the right to employer contributions and, potentially, death benefits. The Regulator suggests that,

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[7] <www.thepensionsregulator.gov.uk/en/covid-19-coronavirus-what-you-need-to-consider/covid-19-an-update-on-reporting-duties-and-enforcement-activity>.
[8] <www.thepensionsregulator.gov.uk/en/covid-19-coronavirus-what-you-need-to-consider/communicating-to-members-during-covid-19>.
[9] <www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/cetv-members-letter.ashx>.

once the current crisis is over, trustees should consider contacting those who have opted out and remind them of any rights they may have to re-join.

The Regulator notes that falls in the investment market and individual fund values may cause some members to switch funds, discourage them from saving, and make them more susceptible to scams that appear to promise better results. If trustees intend to contact members over the coming months (for example, when sending annual benefit statements) they should highlight:

- what current market volatility might mean for members with different retirement horizons;
- the need to think carefully and consider investment advice before switching funds; and
- the danger of falling foul of a scam.

To help protect members from swindles, trustees should carry out appropriate due diligence when a member requests a transfer (using the Regulator's transfer checklist and following the Pension Scams Industry Group's Code of Good Practice) and direct them to the FCA's 'Scamsmart' website and Pensions Advisory Service guidance on the effects of COVID-19.

There is, at the moment, very little evidence that TV requests are increasing in general; however, the Regulator has said that it is aware that it is aware of spikes in requests in some schemes.

PPF insolvency scoring 2021/22

The Pension Protection Fund (PPF) has issued a policy statement on *Insolvency Scoring from 2021/22*, confirming that '*the basis for scoring will be substantially unchanged from that consulted on*' in December 2019.[10]

The December consultation set out proposed changes to the scoring methodology and a move from Experian to Dun and Bradstreet (D&B) for calculating the risk of an employer becoming insolvent.[11] The PPF's policy statement reports that respondents were largely supportive of its proposals and that they will be adopted. The 2021/22 levies will be based on the insolvency scores for the 12-month period to 31 March 2021, with live scores being provided by D&B from April 2020.

The PPF says that it considered changes suggested by some respondents but concluded that they were typically on issues specific to individual or small groups of employers. The statement sets out the PPF's detailed analysis of the points raised.

In the statement's foreword, the Executive Director and General Counsel to the PPF, David Taylor, notes the uncertainty caused by the COVID-19 outbreak and states that the PPF does not plan to publish its final rules for the 2021/2022 levy year until December 2020. The PPF '*will monitor developments carefully and consider what, if any changes to* [its] *rules are necessary in view of these exceptional circumstances*'. A separate announcement on updated processes for submission of certain documentation has also been published.[12]

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[10] <ppf.co.uk/sites/default/files/file-2020-03/insolvency_risk_scoring_2021-22_march2020.pdf>.
[11] For more details of the consultation, see our 60 Second News Summary, *PPF insolvency risk from 2021/22*, <www.hymans.co.uk/media/uploads/PPF_levies-_DnB_60SS_Jan_2020.pdf>.
[12] <ppf.co.uk/news/our-coronavirus-covid-19-preparation>.

Pensions dashboards update

The Money and Pensions Service (MaPS) has published a report from the Pensions Dashboards Programme (PDP) on the progress made so far, and the work that still needs to be undertaken before dashboards can be made available to the public.[13]

The PDP (formerly known as the Pensions Dashboards Industry Delivery Group) is responsible for delivering the digital architecture and governance framework that is needed to support the development and operation of the dashboards. The report explains that this will involve three areas:

- The Pension Finder Service (which will send out an instruction to all data providers to search for a user's pension);
- The Identity Service (which will allow users to prove that they are who they say they are); and
- a governance framework (which will specify the data, technical, security and performance standards that dashboards need to meet to be connected to the digital architecture).

The report also sets out the challenges facing the PDP (ensuring that a person's identify can be verified, matching individuals to pension records and ensuring a consistent set of data standards) and how it intends to overcome them.

Development of the data standards for pension schemes and providers will be a priority for the PDP over the next six months. It has published two additional papers setting out its thoughts on the scope of dashboards and the data elements required from pension providers.[14] Although there is no formal consultation exercise, feedback on the documents will be welcomed.

The executive summary of the report notes the uncertainty caused by the COVID-19 pandemic but says that the PDP hopes to have a more-detailed programme timeline available before the end of the 2020.

HMRC updates

Pension Schemes Newsletter 119

In its latest Newsletter[15], Her Majesty's Revenue and Customs (HMRC) sets out further temporary changes to pension processes to help scheme administrators during the COVID-19 pandemic:

- Notices to file pension schemes returns for the 2019/20 tax year will not be issued in recognition of the difficulties that scheme administrators may be encountering in obtaining the valuations necessary to complete the returns.
- Flexibility is available in valuing sums and assets for 'benefit crystallization event 1' (funds designated for drawdown) and other tax purposes.

Attention is drawn to a written ministerial statement[16] in which the Economic Secretary to the Treasury says that temporary changes are to be made to public-service pension abatement rules[17] and the conditions for early retirement at protected pension ages[18] so that recently retired public sector workers can be re-employed during the COVID-19 crisis without adverse effects on their pensions.

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[13] <maps.org.uk/wp-content/uploads/2020/04/pdp-progress-update-report.pdf>.

[14] <maps.org.uk/wp-content/uploads/2020/04/pdp-data-scope-working-paper.pdf> and <https://maps.org.uk/wp-content/uploads/2020/04/pdp-data-definitions-working-paper.pdf>.

[15] <www.gov.uk/government/publications/pension-schemes-newsletter-119-april-2020/pension-schemes-newsletter-119-april-2020>.

[16] .<www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2020-04-22/HCWS196>.

[17] Abatement is the practice of cutting back the pensions of re-employed public-sector retirees so that their pension plus their new salary does not exceed pre-retirement earnings.

[18] The protected pension age conditions also create a bar to retirement with immediate (or near-immediate) re-employment with the same (or a connected) scheme employer.

The Newsletter also announces that the annual allowance calculator for the 2020/21 tax year is now available.

Managing Pension Schemes Service Newsletter—April 2020

A new *Managing Pension Schemes Service Newsletter* is available.[19] Accounting for Tax returns can now be submitted via the service, and HMRC has revised the timetable for various developments during Phase 2 of delivery.

Countdown Bulletin 52

Countdown Bulletin 52 says that HMRC now hopes to publish its timetable for the issue of final GMP data cuts by the end of April 2020.[20]

[19] <www.gov.uk/government/publications/managing-pension-schemes-service-newsletter-april-2020/managing-pension-schemes-service-newsletter-april-2020>.

[20] <www.gov.uk/government/publications/countdown-bulletin-52-april-2020/countdown-bulletin-52-april-2020>.

And Finally…

The Pensions Regulator is to be given powers to obtain communications data, via a draft amendment to the *Investigatory Powers Act 2016*.[21]

How you feel about that will probably be pretty well correlated with your past usage of phrases like '*Snoopers' Charter*' or (toward the other end of the spectrum) '*If you've nothing to hide, you've nothing to fear*'. For *AF*, it makes the announcement of the Regulator's move to 'the cloud' seem vaguely ominous.[22] Watch the skies, people!

On the plus side, lots of people are searching for ways to keep their kids busy, and what could be better than a wee crafting project making tin-foil hats…?

[21] <www.legislation.gov.uk/ukdsi/2020/9780111195499>.

[22] <www.gov.uk/government/case-studies/the-pensions-regulator-moves-email-and-web-portal-to-the-cloud>.