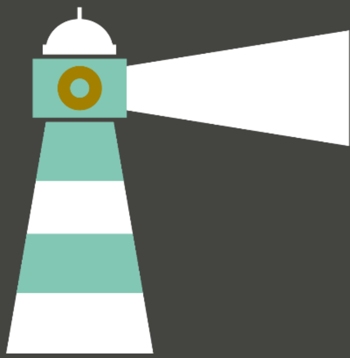
BRIEFING



What's Happening in Pensions

Issue 95 – May 2022

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Pension Schemes Act 2021 update: There is some updated information on the introduction of outstanding aspects of the Pension Schemes Act 2021.

TPR enforcement and prosecution policies: The Pensions Regulator has announced the finalisation of its policies on imposing high fines (up to £1 million) in respect of breaches of the anti-avoidance (moral hazard) and notifiable events/information gathering legislation. It is also consulting on new content for a consolidated and simplified "scheme management enforcement policy" and an updated general prosecution policy.

GMP equalisation: HMRC has published a new GMP equalisation newsletter including additional guidance in relation to the tax treatment of the corrective steps that trustees might take to address transfers paid on an unequalised basis. It also includes some guidance in relation to potential tax implications of GMP conversion. Various industry bodies have published to their members a statement relating to the income tax treatment of interest added to arrears payments. The GMP equalisation industry working group chaired by PASA has published answers to some initial administration FAQs.

GMP conversion legislation: The Pension Schemes (Conversion of Guaranteed Minimum Pensions) Bill has received Royal Assent. It aims to improve the GMP conversion legislation, to make it easier for schemes to use that facility as part of their GMP equalisation exercise, but much of the detail will follow later in Government regulations.

TPR transfer conditions guidance: The Pensions Regulator has made unpublicised corrections to its November 2021 guidance on "Dealing with Transfer Requests", which considers the transfer conditions regulations that took effect from 30 November 2021.

DC illiquid investments: The Government is consulting again on illiquid investment by DC schemes. The new consultation proposals include requiring DC schemes to "disclose and explain" in their statement of investment principles their policies on illiquid investment and for schemes with over £100 million in assets to disclose in the chair's statement their default asset allocation, split between seven main asset classes.

Solvency II review: HM Treasury has published its expected consultation on the review of the Solvency II regime as it applies to UK insurers.

PRA statement on capital arbitrage transactions: The Bank of England's Prudential Regulation Authority has issued a statement to its regulated firms on 'capital arbitrage transactions'.

Contribution notices: The Pensions Regulator has issued a £2 million contribution notice to a German parent company following the sale of a subsidiary group to a management buyout company "which had no realistic prospect of being able to support the business" and which was soon insolvent. The Regulator has also issued contribution notice warning notices to ITV and related entities in relation to unsatisfied financial support directions in respect of the Box Clever Group Pension Scheme.

PENSIONS RADAR: You may also be interested in the latest edition of Pensions Radar, our quarterly listing of expected future changes in the UK law affecting work-based pension schemes.

SUSTAINABILITY MATERIALS: Our Sustainable Business Hub includes a section on ESG and sustainable finance issues for pension schemes and their sponsors.

TPR annual funding statement

The Pensions Regulator has published its 2022 annual funding statement. It is consistent with the Regulator's approach to DB scheme funding in recent years but highlights recent developments and why schemes may need to have particular regard to them.

The statement is aimed at DB schemes with valuation dates between 22 September 2021 and 21 September 2022 ('Tranche 17') and any DB schemes undergoing significant changes that require a review of their funding and risk strategies. There are also messages for all DB schemes concerning potential issues around covenant. As previously, the statement includes tables for trustees to use to consider their scheme circumstances against the Regulator's expectations.

The statement notes that the funding position of Tranche 17 schemes has generally improved and that the average recovery plan length is now less than six years. There are currently, however, uncertainties as a result of the war in Ukraine, Covid-19 and Brexit, which are impacting scheme sponsors and investments to differing degrees. In the background are high inflation (including the direct and indirect effects of rising energy and fuel prices), rising interest rates, slower economic growth and greater market volatility.

The Regulator stresses the importance of a robust and integrated approach to risk management and an open dialogue with employers, noting that covenant strength can change very quickly. It recommends conducting scenario planning to be prepared for what may come in different circumstances.

It also again urges schemes to prepare for the forthcoming, but delayed, changes to the funding regime, based around a long-term funding objective. We expect draft regulations very soon and the Regulator's consultation on a draft revised funding code of practice in late summer or early autumn (see below).

The Regulator is also working on revisions to its 2015 covenant guidance and other related guidance. In this regard, the statement says: *"We intend to provide more detail on how to treat guarantees for scheme funding purposes and more information regarding environmental, social and governance and how this can be factored into the covenant. We will also outline various examples to support trustees in understanding how to apply any updated guidance."*

Other points of note are as follows:

- **Shareholder distributions:** Dividends and other forms of shareholder distribution are on the increase. The Regulator continues to expect fair treatment of pension schemes. As a minimum:
  - Where distributions exceed deficit repair contributions (DRCs), the Regulator expects to see a strong funding target and a relatively short recovery plan period.
  - Where a scheme is rated as 'weak' or 'tending to weak', DRCs should exceed shareholder distributions unless the funding target is strong and the recovery plan period is short.
  - Where there is a weak covenant and the employer is unable to support the scheme, there should not be any shareholder distributions.

  Trustees should also be watchful for other forms of 'covenant leakage'. As previously, the Regulator encourages the use of dividend sharing mechanisms and negative pledges where appropriate.
- **Corporate activity:** This remains at a high level. Trustees should be alert to developments and seek mitigation where appropriate.
- **Mortality:** The long-term impact of Covid-19 is not clear. The Regulator expects that any reduction in valuation liabilities should not be greater than 2% unless there is strong evidence for a greater reduction.
- **Inflation:** As well as reflecting rising price inflation, schemes conducting valuations should (where relevant) discuss salary increase assumptions with employers.

- **Recovery plans:** The Regulator makes several points regarding new recovery plans:
  - There can be a 'business as usual' approach where the impact of recent developments on the employer's business is limited. Generally, however, DRCs should not be reduced and recovery plan periods should not be extended (and should be reduced if possible, especially where they are long and/or other stakeholders are benefiting from distributions).
  - Where there are short-term affordability issues and the trustees agree to temporarily lower DRCs, they should be higher in subsequent years and there should be no shareholder distributions.
  - Where DRCs are deferred or reduced, the Regulator expects trustees to secure mitigations against the increased risk.
  - The table in the statement categorising schemes and setting out expectations now takes a recovery plan period of six years, rather than seven, as the starting point.

Pension Schemes Act 2021 update

The latest information that we have on the introduction of outstanding aspects of the Pension Schemes Act 2021 is as follows:

- **Notifiable events:** The Government is still considering consultation responses. The previously indicated 6 April 2022 commencement date has slipped but no announcement has yet been made regarding a new date.

  There is no indication of when we might see the Pensions Regulator's proposed code of practice or updated guidance. We have heard that the Regulator is, as had been hoped, reviewing its direction which sets out circumstances when it does not need to be notified.

- **DB scheme funding:** The timetable has slipped again. The Government consultation on draft regulations is expected very soon and the best estimate for likely commencement is now October 2023.

  The Pensions Regulator is now expected to consult on a draft revised code of practice in late summer or early autumn 2022, with the code being finalised in mid-summer 2023 and taking effect alongside the legislation. There is expected to be consultation with industry and trade bodies before the public consultation, with the Regulator recently reported as saying that its thinking has "evolved a lot" since its initial consultation.

See our briefing on the Act and WHiP Issue 91 for detail of these forthcoming developments.

TPR enforcement and prosecution policies

The Pensions Regulator has announced the finalisation of its policies on imposing high fines (up to £1 million) in respect of breaches of the anti-avoidance (moral hazard) and notifiable events/information gathering legislation. It is also consulting on new content for a consolidated and simplified "scheme management enforcement policy" and an updated general prosecution policy.

The high fines policy for anti-avoidance covers failure to comply with a contribution notice and the new civil offences where a person was party to an act or deliberate failure to act which had a main purpose of avoiding an employer debt or had a materially detrimental effect on the likelihood of accrued scheme benefits being received. It sets out the levels of penalties the Regulator would normally expect to impose. For failure to comply with a contribution notice, the level is 20% of the contribution notice value, capped at £1 million, or 10% capped at £0.5 million if paid before the Determination Panels hearing. For the other offences there is a sliding scale of three bands based on levels of culpability and harm, with amounts within those bands to be determined after taking account of any aggravating and mitigating factors.

The high fines policy regarding information requirements covers breaches of the notifiable events requirements (some of which are not yet in force), providing false or misleading information to the Pensions Regulator, and providing (in some circumstances) false or misleading information to scheme trustees. The policy notes that, in respect of notifiable events under the forthcoming expanded regime, there can be more than one fine under different sections of the Pensions Act 2004 (sections 69 and 69A) in respect of the same notifiable event. Here there is a sliding scale of four bands, again based on levels of culpability and harm and with amounts within those bands to be determined after taking account of any aggravating and mitigating factors.

There are also two draft policies which are out for consultation until 24 June 2022.

The draft scheme management enforcement policy combines and simplifies existing enforcement policies in relation to DB funding, DC compliance and public service pension scheme compliance. It does not include automatic enrolment and master trust authorisation, to which separate policies apply.

The draft updated prosecution policy outlines the Regulator's general approach to the prosecution of criminal offences and provides more detail than the existing policy. An expanded section on the proceeds of crime says that *"Where appropriate, we may ask the court to make an order to compensate the victims of the crime when the confiscation sum is paid, or through a separate compensation order."*. Note that there is a separate prosecution policy already in place for the new criminal offences introduced by the Pension Schemes Act 2021 (see WHiP Issue 92).

A consultation response outlines changes to these two draft policies and the high fines policies in relation to the Regulator's overlapping powers and its approach to information gathering (see WHiP Issue 92 for details of the consultation on these). Those aspects of the draft policies are now finalised and so are not included in the consultation. Some points of interest on these are as follows.

- The scheme management enforcement policy content on overlapping powers has been expanded and includes the following, as well as case examples on employer-related investment, contribution notices, and information gathering:

  > *"To protect the security of scheme members, our primary objective when considering avoidance behaviour is to obtain funds for the scheme and/or protection of the PPF. It is therefore likely that we will prioritise regulatory proceedings seeking a CN. However, there may also be grounds to pursue criminal proceedings or a financial penalty in parallel or sequentially, or as an alternative to regulatory action for a CN. This might be the case, for example, where we identify evidence of serious intentional or reckless conduct that has caused harm to the scheme.*
  >
  > *…*
  >
  > *Where the conduct is serious but not so serious as to justify prosecution, we may consider issuing a financial penalty for avoidance of employer debt or conduct risking accrued scheme benefits under s58C and D of the Pensions Act 2004 for which the Determinations Panel can impose a fine of up to £1 million. The seriousness of the behaviour and its impact on the scheme, as well as any aggravating or mitigating features, determines the amount sought, as set out in the high fines policies.*
  >
  > *We may pursue a criminal prosecution without pursuing a CN. For example, we may choose not to pursue a CN against a potential target if there is no prospect of any meaningful recovery, and we are not able to impose a CN if a person was not associated or connected to the scheme employer at the relevant time. However, in either case, prosecution would be reserved for only the most serious types of behaviour."*

- The Regulator may carry out "dual track" investigations where it has overlapping powers. Where someone is being interviewed, the Regulator will make clear the basis on which it is being conducted, which will be under caution for a criminal investigation.
- There is more detail on "protected items" under section 311 Pensions Act 2004 (i.e. certain types of communication with a legal adviser and related documents, which a person cannot be required to disclose to the Regulator).

GMP equalisation

HMRC newsletter

HMRC has published a new GMP equalisation newsletter including additional guidance in relation to the tax treatment of the corrective steps that trustees might take to address transfers paid on an unequalised basis. It also includes some guidance in relation to potential tax implications of GMP conversion.

- **Corrective action for transfers paid on unequalised basis**

  The third judgment in the *Lloyds Banking Group* case confirmed that, in relation to statutory transfer values, former members had a right to have the transfer value calculated by reference to equalised benefits, with an ongoing right to claim the "correct" transfer payment (by way of a top-up transfer payment) where the transfer had been calculated on an unequalised basis (see our briefing "GMP equalisation – where are we now?"). The HMRC guidance helpfully confirms that the right to such a top-up transfer payment is an "accrued right" for tax purposes (even though it is not an accrued right under general pensions legislation), meaning that a cash payment made directly to former member directly to extinguish that right can, in many cases, be payable as an authorised lump sum, provided the relevant conditions for making that particular type of lump sum are met.

Where the original transfer occurred after 6 April 2006, and the payment is less than £10,000, then it is likely that a cash sum can be made as a "payment following a relevant accretion". The HMRC newsletter contains some helpful guidance on when the "6-month clock" starts running for these purposes, which should cover most of the timing delays schemes may incur in locating former members and obtaining any consents needed to make a cash payment. If a scheme is winding-up, then the payment may be possible as a winding-up lump sum, with the higher threshold of £18,000. The "small lump sum" payment provisions may also be applicable; these might be needed to provide a lump sum option for former members who transferred-out before 6 April 2006. Outside of a winding-up, however, these authorised lump sum payments will only be applicable for payments which are £10,000 or less.

- **Conversion**

  The newsletter also contains some guidance from HMRC on some of the key tax issues that arise in a GMP conversion exercise.

  HMRC confirm some key principles which will be helpful for those navigating a conversion solution. In particular, HMRC confirm that members who left pensionable service before 6 April 2006 will fall outside of the annual allowance regime and that annual allowance issues are not created by a conversion exercise which is carried out after retirement for any post-6 April 2006 leavers (including for exercises carried out in the same tax year of retirement). Similarly, conversion after retirement will not trigger any loss of lifetime allowance fixed protection for these members.

  HMRC do, however, acknowledge that there can be tax issues for a conversion exercise carried out before retirement. In particular:

  - In the year of conversion, the conditions for the annual allowance "deferred member carve out" (DMCO) to apply are very unlikely to be met. In order for the DMCO to apply, non-GMP benefits (known as "relevant rights") must not increase by more than a prescribed level. In the year of conversion, there will be a one-off increase in relevant rights – as former GMP benefits are converted into 'excess'. This increase is likely to exceed the prescribed level, meaning that the DMCO will not apply; and, additionally,

  - Post-conversion, if the reshaped benefits increase in deferment by more than permitted rates, the DMCO will not apply and fixed protection could be lost. The issue here is that the GMP revaluation rates applicable before conversion are, if continued, likely to fall outside of what is permitted for either the DMCO to apply or fixed protection to be retained.

  There may be a glimmer of hope for some of these issues being resolved in the future, with HMRC noting in the newsletter that they are continuing to undertake further work in this area, including determining "the potential for any legislative change".

Interest on arrears

Various industry bodies have published to their members a statement relating to the income tax treatment of interest added to arrears payments, which we understand follows industry discussions with HMRC about this topic. Although the statement is in relation to GMP equalisation, the principle would seem to apply to interest on arrears generally.

The various bodies' statements are slightly different from each other, though not in any material respect. The one issued by the Association of Pension Lawyers says:

> "***GMP Equalisation projects: interest on arrears payment of pension - income tax treatment***
>
> *HMRC have given guidance (in particular https://www.gov.uk/government/publications/guaranteed-minimum-pension-gmp-equalisation-newsletter-february-2020/guaranteed-minimum-pension-gmp-equalisation-newsletter-february-2020) on various pensions tax considerations when equalising benefits for the effects of inequalities in Guaranteed Minimum Pension in light of the Lloyds case.*

Many schemes are duly proceeding in particular with equalising benefits for members in receipt of pension and identifying the arrears of pensions due, with interest for late payment.

There has been some inconsistency in practice on the tax treatment of the interest element, in terms of tax due and the responsibilities (if any) of schemes to deduct that at source. (This message is NOT about tax treatment of the arrears themselves which is covered explicitly in the HMRC guidance note referred to above.)

This matter has been the subject of discussion with HMRC on the GMPe Industry Working Group and HMRC has authorised that the following be confirmed to the industry in advance of clarifying the issue in a future newsletter.

For the purpose of GMP equalisation

- *For pensions tax purposes the interest payment should be treated as interest payment made in respect of a late payment of pension instalments.*
- *The interest is likely to be "yearly interest" for tax purposes, and an obligation to withhold income tax is unlikely to arise under section 874 of Income Tax Act 2007, unless of course the payment falls under s874(1)(d) i.e. to a person whose usual place of abode is outside the UK.*
- *In terms of the Personal Savings Allowance (PSA): the interest element should be covered by the PSA, although this is primarily a point for individuals and their particular circumstances.*

Catherine McAllister comments "Therefore schemes should not be deducting tax at source on the interest payment relating to correction payments in most instances. Instead, members should be advised that they are responsible for accounting to HMRC for any tax due.""

Working group FAQs

The GMP equalisation industry working group chaired by PASA has published answers to some initial FAQs. This guidance from the administration sub-group looks at:

- Whether the 'look-back' approach in assessing crossover points is appropriate
- PAYE tax considerations on the payment of arrears and interest (see also above)
- The practicalities of equalising death benefits
- Checking whether underpaid members receiving arrears or increases exceed the lifetime allowance
- The impact of GMP equalisation on commutation

GMP conversion legislation

The Pension Schemes (Conversion of Guaranteed Minimum Pensions) Act 2022 has received Royal Assent. It aims to improve the GMP conversion legislation in the Pension Schemes Act 1993, to make it easier for schemes to use that facility as part of their GMP equalisation exercise.

This was a private member's bill that had Government and Opposition support. It will amend the GMP conversion legislation to provide more flexibility in relation to (a) who has to consent to a conversion exercise and (b) the amount of the survivor pension that has to be provided post-conversion, allowing these matters to be prescribed by Government regulations.

No timetable for commencement or for any consultation on the regulations has been announced.

TPR transfer conditions guidance

The Pensions Regulator has made unpublicised corrections to its November 2021 guidance on "Dealing with Transfer Requests", which considers the transfer conditions regulations that took effect from 30 November 2021 (see our briefing "Pension scams: new statutory transfer right restrictions").

The material changes are as follows (removed text struck through; added text underlined):

- **Second condition checks:** "If you believe that the member has failed to provide a substantive response to a request for evidence, you should send a reminder at least one month after the initial request ~~and a second reminder after a further period of a month~~. If there is still insufficient evidence after one month from the reminder being sent, this may be treated as a red flag."
- **Overseas transfers:** "In these cases, you must check that the member is ~~tax~~ resident in the same country that the receiving scheme is based by obtaining a copy of the member's formal residency documentation and at least two other items of evidence that demonstrate they ~~have been tax resident for a continuous period of at least six months ending~~ are resident on the date you received the transfer application."

DC illiquid investments

The Government is consulting again on matters around illiquid investment by DC schemes. The new consultation proposals include requiring DC schemes to "disclose and explain" in their statement of investment principles their policies on illiquid investment and for schemes with over £100 million in assets to disclose in the chair's statement their default asset allocation, split between seven main asset classes.

The document also responds to two consultations: the December 2021 charge cap consultation, which sought views on proposals to remove performance fees from the 0.75% limit on charges in default arrangements (see WHiP Issue 93), and last summer's call for evidence on the future of the DC market (see WHiP Issue 90). Following a 'mixed response' to the charge cap proposals, the Government plans to engage further with industry and other stakeholders. Again following a mixed response, there will be no further proposals on encouraging consolidation in 2022.

The Government is also proposing to bring forward legislation this year to modify the employer-related investment restrictions in relation to large authorised master trusts (broadly, those with more than 500 participating employers), as the restrictions can otherwise cause them issues. A draft of the regulations is included in the consultation document.

Solvency II review

HM Treasury has published its expected consultation on the review of the Solvency II regime as it applies to UK insurers.

Brexit allows the Government to make changes in this regard, which it wishes to do at least in part in order to free up insurers' assets for investment in long-term productive investments such as infrastructure, venture capital and growth equity. The Government says that policyholder protection is a top priority and will be safeguarded.

Our website article considers how such reforms might affect DB pensions de-risking.

PRA statement on capital arbitrage transactions

The Bank of England's Prudential Regulation Authority (PRA) has issued the following statement to firms that it regulates:

> *"We are aware that some PRA-regulated firms have conducted, or may be considering conducting, deficit reduction transactions with their defined benefit pension schemes that are structured to limit the regulatory capital impact that would otherwise result.*
>
> *In line with the Basel Committee on Banking Standards statement of 2 June 2016, firms should not engage in transactions that have the aim of offsetting regulatory adjustments. As that statement makes clear, these types of transactions pose a number of risks. They can be complex, artificial, and opaque. They can include legal risk and be untested in their ability to fully address the underlying rationale for the regulatory adjustment. Furthermore, they can have the effect of overestimating eligible capital or reducing capital requirements, without commensurately reducing the risk in the financial system, thus undermining the calibration of minimum regulatory capital requirements.*
>
> *Entering into such transactions may not be compatible with a firm's obligations under the PRA's Fundamental Rules. We also draw firms' attention to the PRA's approach to banking supervision, which states that 'we expect all capital to be capable of absorbing losses in the manner indicated by its place in the capital structure' and that*

our policies should be followed 'in line with their spirit and intended outcome, not managing the business only to the letter, or gaming the rules'.

We will carefully scrutinise transactions in light of the principles, rules and expectations summarised above, including any transactions that would allow firms to avoid regulatory capital deductions under Article 36(1) Capital Requirements Regulation (as transposed into PRA rules). Where any existing transactions are to be unwound, we will look to agree with firms a reasonable timeline to achieve this."

Contribution notices

Scharf – Dosco Overseas Engineering Limited (1973) Pension & Assurance Scheme

The Pensions Regulator has issued a £2 million contribution notice to a German parent company, SMT Scharf AG, following its sale of the Dosco Group to a management buyout company "which had no realistic prospect of being able to support the business" and which was soon insolvent.

The Determinations Panel also awarded, for the first time, additional sums for the scheme's lost investment returns and interest (i.e. because sums were not contributed when they might have been) but from a date later than the Pensions Regulator had sought.

A settlement for £130,000 was reached with a senior Dosco Group executive, part of the management buy-out team, who had been incentivised to find a buyer.

The above amounts are small in relation to the scheme's deficit. The events of course occurred before the Regulator's strengthened powers and criminal offences came into force.

ITV – Box Clever Group Pension Scheme

The Pensions Regulator has reportedly issued warning notices for contribution notices to ITV and four related entities. These relate to unsatisfied financial support directions (FSDs) imposed in March 2020 in relation to the Box Clever Group Pension Scheme (see WHiP Issue 81).

This scheme related to a failed joint venture with Thorn. Cash contribution offers made by ITV to satisfy the FSDs were rejected by the Regulator as inadequate. The Regulator's contribution notice warning notices reportedly claim £133 million. It is understood that ITV does not believe it should be held responsible for the whole of the joint venture scheme's deficit and that its offers were significantly lower.

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