HYMANS ROBERTSON

Current issues

May 2024

Articles this month:
DB annual funding statement, 2024
DB funding gets FIS-ical
Regulator settles with FSD targets
Ombudsman shaves overpayments claim
HMRC newsletters: April

DB annual funding statement, 2024

The Pensions Regulator has issued the 2024 edition of its Annual Funding Statement for private-sector defined benefit (DB) schemes. In recognition of other developments that are afoot—funding reforms and the Mansion House initiative—this year's Statement has been kept short, at around seven printed pages, and largely reiterates the points made in 2023. Where funding levels have improved trustees are urged to reconsider the strategies that they established in a period of low interest rates to ensure they remain in the best interests of members. Options include running-on to generate surplus, buy-out with an insurer or entering a consolidator. Meanwhile, the 'sizable minority' that are still in deficit on their scheme-specific funding basis are advised to plan to make up the shortfall as quickly as their sponsors can reasonably afford, with careful attention to covenant strength.

Schemes in scope

This year's Statement is aimed primarily at schemes with valuation dates in the range from 22 September 2023 to 21 September 2024—known as 'Tranche 19' in the Regulator's argot—which is expected to be the last group of valuations conducted before the introduction of requirements for funding and investment strategies. However, the Regulator says that the Statement is also relevant to schemes with valuations falling outside that range if the effect of recent market changes has been significant.

The state of the [DB funding] universe

Unsurprisingly, the Regulator notes the recent remarkable improvements in the funding fortunes of DB schemes. Although it acknowledges that the position for individual schemes will vary, it estimates that half of them have now exceeded buy-out level, and that less than a quarter are still in deficit relative to their 'technical provisions' (AKA scheme-specific funding basis).

That means that some trustees are in the happy position where they might consider running on to generate surpluses for members' benefit. However, the Regulator also recognizes that the same economic developments will be putting trustees under pressures from both sides, with employers requesting contribution reductions, and members asking for discretionary increases to pensions in payment. The improvement in funding positions may be especially notable for open schemes, whose employers may be hoping to use surpluses to offset their future-accrual costs. The Statement advises that trustees take a holistic view of their particular facts and circumstances (for example, whether the scheme has a history of awarding discretionary increases).

The Regulator warns trustees not to allow funding improvements to cause them to lose sight of the continued potential for economic and geopolitical uncertainty to affect investments and employer covenants. If reliance on the covenant remains substantial, trustees should be aware of re-financing risks, covenant leakage, and ensure that their schemes are treated fairly

alongside other stakeholders. The Regulator counsels trustees to consider the implications of climate change and other sustainability issues for their strategies and journey plans. It also encourages them to consider the steps that could be taken now to align with the requirements of the revised funding code, due for publication this summer, even though it will only come into force formally for valuations at dates from 22 September 2024 onward.

Scheme-specific guidance

As in 2023, the Regulator has structured its expectations according to which of three funding categories schemes currently occupy:

at-or-above buy out

The moral for trustees of schemes that are fully funded on a buy-out basis is to be clear about their strategy and why it is in members' best interests; they should document their conclusions. If they decide to run on (which the Regulator notes is likely to be more practical for larger schemes), there are potential benefits from surplus generation, but trustees should be aware of the possible risks and costs—especially of any innovative solutions. Surplus could act as a buffer to mitigate risks. They should obtain suitable advice. If they are targeting buy out, they should think about the best way to go about it in terms of protecting members and price. The Regulator also encourages consideration of sustainability issues, recommending the Sustainability Principles Charter for the Bulk Annuity Process produced under the auspices of Accounting for Sustainability, the Church of England Pensions Board and Railpen. It also draws trustees' attention to the implications for future discretionary increases to pensions in payment.

in between scheme-specific and buy-out funding

Where schemes are fully funded on their technical-provisions basis, but do not yet have sufficient assets to buy out, trustees should review their long-term objective, as well as the associated timings and investment-strategy transitions (which they might be able to accelerate if there have been marked improvements in funding). They ought to prioritize setting a long-term funding objective (LTFO) if they do not already have one. They should consider members' best interests and the potential benefits of running on *versus* buying out *versus* emerging options such as those offered by commercial consolidators, the planned public-sector consolidator, and capital-backed journey plans. If they decide to wait and see how those emerging options develop, they should set dates for reconsideration and have appropriate funding and investment strategies in the meantime (the Statement obliquely points trustees to its guidance on Private Markets Investment for one potential payoff from some consolidation options). The Regulator expects that they consider when different consolidation options might become accessible to them; guidance on alternative arrangements for consolidation is coming '*later this year*'.

below technical provisions

Like X-Wing pilots assaulting the Death Star, the trustees of schemes that remain in deficit on their scheme-specific funding basis are admonished to stay on target. The Statement says that they should focus on eliminating the deficit as quickly as reasonably affordable. They should also make sure that their technical provisions are congruent with their LTFO, and that the risks they are running are sufficiently covered by the employer covenant and will taper off appropriately with funding improvements and scheme maturity.

With funding holding strong and a new code of practice imminent, the paring back of this year's statement is no surprise. Fewer schemes remain in the regulatory crosshairs, so it's mostly about encouraging trustees to develop their endgame strategies, echoing the shift to a world beyond solvency funding. The Regulator goes further in acknowledging the full (and growing) range of available options. It's good to see it directing trustees and sponsors not just to 'accept the status quo' but to explore their own scheme circumstances, objectives and beliefs, and to consider how the different options might affect member outcomes. Careful consideration is key to navigating this diverse landscape—to learn more, visit our Excellence in Endgames hub.

DB funding gets FIS-ical

Two sets of Regulations, made on 2 April 2024, have brought the *Pensions Act 2021*'s defined benefit (DB) funding reforms into force, with effect from 6 April 2024.[1] The changes will manifest themselves in actuarial valuations with effective dates on or after 22 September 2024.

Recap

As a result of the reforms, trustees of private-sector defined benefit schemes will need to formulate a funding and investment strategy (FIS), intended to ensure the long-term provision of the promised benefits. The FIS will specify the funding level that the trustees intend to have achieved by the time the scheme reaches significant maturity, and the investments that they intend to be holding by then.

When preparing their FIS, trustees will need to follow certain principles, namely that:

- the scheme will be fully funded, as a minimum, by the point of significant maturity
- at any stage in its journey plan toward that point, the level of risk that can be taken is dependent upon the strength of the employer covenant, and proximity to significant maturity
- the scheme's investments are liquid enough to meet expected cash-flow needs, and make reasonable accommodation for the unexpected.

By the time the scheme is significantly mature, scheme liabilities will need to be calculated on the assumption that its assets (those backing the minimum funding level, at least) are in a 'low-dependency investment allocation', and that no further employer contributions will be required (the legislation dubs the latter a 'low-dependency funding basis'). A low-dependency investment allocation means that the assets are invested so that their value relative to that of the scheme liabilities is highly resilient to short-term adverse changes in market conditions.

Details of the FIS will need to be set out in a statement of strategy, together with the trustees' assessment of their progress toward implementation and the risks to success, and reflections upon their decision-making. When carrying out actuarial valuations, a scheme's technical provisions will have to be calculated consistently with the FIS.

Regulations

The Department for Work and Pensions made several alterations to the original draft Regulations, published in July 2022, to address concerns that the new rules would be too constraining. Examples include a change to the method for determining scheme maturity, to make it less volatile; allowing trustees of open schemes to take account of future joiners and accrual when determining maturity; a shift of emphasis, to preserve trustees' primacy in investment decision-making (albeit the employer must still agree the FIS and be consulted about aspects of the statement of strategy); and reducing the level of detail required for statements of strategy. A requirement to eliminate deficits as quickly as sponsors can reasonably afford has been leavened with a new consideration, about the effect of a recovery plan on the employer's sustainable growth.[2]

Final milestones

It is expected that the Pensions Regulator's DB funding Code of Practice will be laid before Parliament in the summer, allowing it to be in place by 22 September 2024, when the legislation takes effect. The Code will fill in important remaining details, such as how the Regulator will define the point of significant maturity, and its approach to regulating valuations, including the final parameters for its 'Fast Track' filter. A consultation exercise on the Regulator's proposed approach to statements of strategy closed on 16 April 2024; it is expected to consult on new employer-covenant guidance later in the summer.

[1] The *Pension Schemes Act 2021 (Commencement No. 8 and Transitional Provisions) Regulations 2024* (SI 2024 No. 451), and the *Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2024* (SI 2024 No. 462).
[2] For a longer description of the changes, see our January 2024 Sixty Second Summary, *Plink, plink, FIS: funding & investment remedies administered*.

Regulator settles with FSD targets

The Pensions Regulator has published a Regulatory Intervention Report setting out how it reached a settlement after restructuring activity and debt write-offs put assets outside the reach of a small defined benefit (DB) pension scheme when its sponsoring employer went into administration.

The Newburgh Engineering Co Ltd Pension and Assurance Scheme was a small DB scheme with around 100 members and an estimated section 75 debt of £8.84 million. Its employer went into administration in October 2018 and later entered creditors' voluntary liquidation.

The Regulator's investigation found that assets had been transferred out of the scheme employer to its wider corporate group, placing them out of the reach of the sponsor's creditors, such as the pension scheme. Had the funds been available to the scheme, the Regulator states, it is possible that the liabilities could have been bought out with an insurer. Instead, the scheme entered a Pension Protection Fund (PPF) assessment period in 2018.

The Regulator issued warning notices that it was proposing to use its financial support direction powers against six target companies. The case was settled with a payment of £3.52 million into the scheme. The settlement sum was less than the section 75 debt to the scheme, but it represented all of the targets' cash assets and around 80% of their available assets.

This case shows that the Regulator will investigate corporate transactions and restructurings affecting schemes of all sizes if proper mitigation is not considered and will consider reasonable settlement offers.

Ombudsman shaves overpayments claim

The Pensions Ombudsman recently published a mammoth (72-page) determination, exploring defences to 'equitable recoupment', in which trustees offset overpayments against pension instalments, rather than asking the member to pay the money back.[3] He whittled down more than £90,000 of claimed overpayments, made over the course of 24 years to one, now-elderly gentleman, to about £6,500.

The case arose out of the BIC UK v Burgess litigation, which was about an invalid attempt to introduce non-statutory pension increases that resulted in pensioners receiving money to which they were not legally entitled.[4] The Ombudsman's decision to limit the overpayments that could be recouped was based on considerations of change-of-position, estoppel by representation (the idea that a person—in this case, pension trustees—should not be allowed to assert something inconsistent with that person's own statements or actions), and laches (in which a person is deemed to have delayed unreasonably in asserting his or her legal claim). He devotes considerable space in the determination to discussions of court judgments developing those concepts.

In this case, one of the deciding facts concerned a poorly phrased announcement that failed adequately to warn members that their pension payments might continue to include sums that they could in future be asked to reimburse.

Decisions on whether members have valid defences to claims involving overpayments, and how they apply when scheme trustees or managers seek to recoup the excess from future pension instalments, can be complicated—at least to non-lawyers like us—and heavily fact-dependent. The Ombudsman's determination may (subject to appeal) be valuable in outlining his approach to the subject.

[3] Mr E (CAS-55100-G3W9).
[4] [2019] EWCA Civ 806.

Pension Schemes Newsletters

PSN 158

His Majesty's Revenue and Customs (HMRC) published Pension Schemes Newsletter 158 on 4 April. It contains a lengthy list of areas where HMRC knows that additional regulations are required, in connection with the abolition of the lifetime allowance on 6 April 2024, and suggests that certain benefit crystallization events (BCEs) might or should be delayed until the necessary changes to legislation (which will be backdated to 6 April 2024) are made. For example, it says that:

- members with enhanced protection may wish to consider delaying transfers to new providers to avoid losing their protection;
- members with enhanced and primary protection lump sum rights of more than £375,000 should delay payment of their benefits if they wish to take a tax-free lump sum of more than £375,000; and
- those wanting to take a pension commencement lump sum (PCLS) under scheme-specific lump sum protection should also consider delaying it.

The Newsletter also announced that HMRC was winding down the recent fortnightly publication of lifetime-allowance-abolition FAQs, and would compile all of its answers in another newsletter, later in the month (see below).

Other sections of the Newsletter cover the implications of lifetime allowance abolition in the public sector, and the tax treatment of Members of Parliament and of the devolved parliaments in connection with the *McCloud* discrimination remedy.

PSN 159

Pension Schemes Newsletter 159 was published on 25 April. It contains more information on the abolition of the lifetime allowance, including responses to questions about entitlements arising pre-abolition where payment is made afterward, pension commencement excess lump sums (PCELS), scheme-specific lump sum protection, the statutory override, and transitional calculations.

With PSN 159, the Revenue also published the promised compendium of lifetime allowance abolition FAQs and says that it is looking for people to help develop the necessary changes to the Pay As You Earn and Real Time Information legislation.

The Newsletter also contains

- Q1 2024 pension flexibility payment statistics;
- updates to the scheme registration statistics for 2023/24;
- some advice for administrators of relief-at-source schemes;
- reminders about the online Managing Pension Schemes service; and

for the public sector, an announcement about the unavailability of the calculation tool that it had created for members affected by the *McCloud* remedy, and an update to PSN 156's guidance on the tax treatment of any associated interest awards.

And Finally…

AF encountered the following line recently, and was struck (metaphorically, although colleagues *have* been known to throw wadded-up paper in his direction) by its relevance to current debates:

> '*Pension funds in Britain have enormous assets. If all, or nearly all, of these assets were invested in Britain, and none, or few, were invested overseas, this would do much to revive this country's economy and so benefit all workers, especially if the investments were in the form not of purchasing established stocks and shares but of "real" investment in physical assets and new ventures.*'

It almost sounds like it could have been part of the Government's marketing puff for the Mansion House initiative, doesn't it? The next sentence gives the game away, though, because it's about the prosperity of the UK coal industry. At this point, younger readers may have to look up concepts like 'UK coal industry', and indeed 'coal' and 'mining'.

The quotation comes in fact from the judgment of Sir Robert Megarry, then Vice-Chancellor of the Chancery Division of the High Court, in the 1984 case of *Cowan v Scargill*.[5] The 'Cowan' of the case title is Mr J R Cowan, who was the chairman of the trustees of the Mineworkers' Pension Scheme. 'Scargill' is of course Mr Arthur Scargill, a fellow trustee, and (not coincidentally) President of the National Union of Mineworkers. Part of the entertainment value to be gleaned from the court report (yes, such a thing is possible) is in reading between the lines of the judge's game attempt to give a balanced account of Scargill's contributions to the hearing. The firebrand trade unionist chose to dispense with the services of his barrister and instead represent himself in court, evidently scorning the hoary adage that the man who is his own lawyer has a fool for his client (in Arthur's defence, the person most likely to advise against such a course of action is probably a lawyer, who could be considered to have some conflict of interest in the matter).

In more youthful days, *AF* associated Scargill with sports commentator Archie MacPherson, entirely on the grounds that they appeared to share the same barber. Older Scottish readers will remember Macpherson as the 'Voice of Football'—or possibly '*the voice of a football*', if they are fans of the *Only An Excuse* radio show, which also cruelly deployed the word '*candyfloss*' to describe Macpherson's tonsorial style.

Cowan v Scargill was about the extent to which trustees might legitimately take account of non-financial factors when investing the assets of a pension fund. Scargill wanted the Scheme to eschew investment in any energy-sector competitors of the coal industry, and to invest in British assets. *Plus ça change, plus c'est la même chose*, as the French (or in *AF*'s case, Google Translate) would say.

AF wondered how Chancellor of the Exchequer Jeremy Hunt would feel about being so sympatico with the architect of the 1984 – 1985 miners' strike…

[5] [1984] 2 All ER 750.