Sackers

Corporate briefing

July 2020

Highlighting the latest developments in pensions for employers and corporate investors

Welcome

The world has been facing unprecedented challenges in light of the COVID-19 pandemic. For defined benefit (DB) schemes, scheme funding (and employer covenant and cash flows) have fallen under a very bright spotlight, as has the possibility of suspending or reducing deficit repair contributions (DRCs). For defined contribution (DC) arrangements, increased regulation and costs are steering some employers towards master trusts.

In this briefing, we look at relevant guidance published to date by the Pensions Regulator (TPR) and industry trends relating to these key areas for employers. We also cover other changes of interest, including the pensions implications of the hotly debated Corporate Insolvency and Governance Act, as well as the current consultation on the future of RPI.

Finally, looking to the longer term, we consider new criminal and civil sanctions which will come into force under the Pension Schemes Bill, designed to bolster TPR's powers and to curb unscrupulous behaviour.

Scheme funding – what employers need to know

Published on 30 April 2020, TPR's annual funding statement acknowledges that these are very challenging times for many businesses. Employers will be relieved to see an emphasis on trustees and employers working together to manage the impact of COVID-19, with a focus on affordability for sponsors. However, this should not be at the expense of pension scheme security.

The statement is particularly relevant to employers whose DB scheme has a valuation date between 22 September 2019 and 21 September 2020 ("Tranche 15"), as well as those whose schemes are undergoing "significant changes that require a review of their funding and risk strategies".

COVID-19 impact on current valuations

Schemes close to completing their valuations are not required to revisit their assumptions, even though they will have been set under very different conditions. However, post-valuation experience should be considered in recovery plans, balancing the affordability and sustainable growth of the employer with fair treatment of the scheme.

As corporate health improves, employers are likely to see trustees requesting incremental increases in contributions, especially where a scheme has taken on additional funding risk while supporting the employer's recovery. TPR recommends that additional contributions should be based on appropriate triggers, such as free cash flow and payments to other creditors.

Scheme funding – what employers need to know cont.

Given the potential impact on member security, TPR has warned DB trustees to be mindful of the consequences of assuming overly optimistic returns in the recovery plan. Where appropriate, trustees are advised to consider seeking contingent arrangements (eg extra contributions or security) to take effect in the event that anticipated investment performance is not achieved.

Regarding the possibility of moving valuation dates to a point when conditions were more normal (eg moving the date back from 31 March 2020 to 31 December 2019), anyone going down this route can expect TPR "to question their reasons for the change".

A closer eye on covenant

Given both COVID-19 and Brexit, trustees will be scrutinising employers more closely, in particular covenant strength and the risks of covenant leakage. Employers should anticipate discussions around key risks and contingency plans, as TPR may ask trustees for evidence that these have taken place.

Trustees will be alive to potential covenant leakage. Echoing its specific COVID-19 guidance (on DB scheme funding and investment), TPR will expect DB schemes to be treated equitably compared with other stakeholders. As well as shareholder distributions, trustees are asked to be "vigilant" of other potential forms of covenant leakage, such as inter-company lending, group trading arrangements, or excessive executive remuneration.

With TPR steering trustees away from "DIY" covenant assessment, some employers may find themselves being asked to engage with independent covenant advisers for the first time.

Targeting the long-term

Paying promised benefits is the key goal for all DB schemes, requiring clear plans for how this objective will be delivered. Since its 2019 funding statement, TPR has expected all trustees and employers of DB schemes to adopt a long-term funding target.

The long-term funding target will be given a statutory footing under the Pension Schemes Bill, with DB trustees required to produce a funding and investment strategy. This strategy will need to specify the funding level which the trustees "intend the scheme to have achieved", and the investments the trustees intend to hold, as at a date to be determined in accordance with regulations. The scheme's technical provisions under the statutory funding regime will also need to be calculated "in a way that is consistent with" this strategy.

A "statement of strategy" will capture the detail in writing. Employer agreement to the scheme's funding and investment strategy, as set out in the scheme's statement of strategy, must be obtained. Trustees will also have to consult the employer on certain elements of the statement, including the extent to which the strategy is being successfully implemented.

New DB funding code on the horizon

Earlier this year, TPR consulted on the first stage towards introducing a new DB funding code. Under the proposals, trustees will be able to choose either a "Fast Track" or "Bespoke" approach to completing and submitting their scheme valuation. As the more straightforward (and prescriptive) approach, the Fast Track will only be available to schemes whose valuation meets certain guidelines.

The consultation was due to close on 2 June, but the period for responding has now been extended until 2 September, with the possibility of a further extension. The second stage in the consultation process (on the draft code itself) is now not expected until next year, with the new code likely to come into force "late 2021 at the earliest".

Employers under strain – pensions options

Reducing or suspending DRCs

Many businesses have been considering ways to ease cash flow as a result of the pandemic, with some exploring the possibility of temporarily reducing or suspending DRCs to their DB pension schemes. TPR believes that a number of schemes have already agreed a short-term suspension or reduction of DRCs, with more trustees and employers understood to be in discussions.

TPR has been sympathetic towards companies looking to use such options, and its recently updated funding and investment guidance makes clear that trustees should "be open to reasonable requests". However, TPR also expects trustees "to make an informed assessment of whether it is in members' best interests to agree".

Whilst it may have been necessary at the beginning of the crisis to agree stop-gap arrangements quickly and with limited information, TPR does not want this to become the new norm. Employers seeking either to extend existing arrangements, or to put new ones in place, can therefore expect more rigorous due diligence (including enhanced covenant monitoring).

Trustees and TPR will want to see that other stakeholders are sharing the pain and that the pension scheme is being treated fairly (expect payments to shareholders and other forms of value leaving the company to stop). Employers will also be expected to keep trustees informed of discussions with other stakeholders, such as banks and other lenders, which may impact on the scheme's position.

TPR's guidance for employers notes that it will be "reasonable in scenarios where trustees are being asked to agree to a previously unforeseen arrangement" (such as DRC suspensions or reductions), provided that:

- the need can be justified
- a plan is made for deferred scheme payments to be caught up (eg beyond the short term)
- if possible, a plan is agreed for mitigating any detriment caused to the scheme, and
- the scheme is being treated equitably.

Tips for employers

- **Be ready to provide timely and relevant information to trustees** – eg details of the business case, financial projections (including future liquidity), and discussions with other stakeholders
- **Review your other cash flow options** – eg suspending dividends and renegotiating credit arrangements
- **Be prepared for trustee questions** – TPR's guidance lists questions to help trustees monitor covenant and understand risks
- **Consider offering contingent assets or security** – as TPR expects some form of mitigation
- **Consider potential conflicts** – eg where employees are also trustees
- **Create a paper trail** – document your considerations, discussions and advice received, to help with any conversations with TPR or potential challenges.

Liability management

There has been unprecedented activity in the liability management (or derisking) market in recent years, with buy-ins, buy-outs and longevity transactions all being used to help manage DB costs. So-called "superfunds" (or DB consolidators) are a relatively new kid on the block, with TPR recently introducing a new interim regulatory regime to help ensure that both savers and the Pension Protection Fund (the pensions lifeboat) are adequately protected.

Employers looking to take advantage of potential opportunities to derisk need to get trustees on board early. Different options offer differing degrees of protection, ranging from coverage of specific liabilities through to the complete transfer of risk. Each option comes with its own price tag, but well-prepared schemes will be best placed to move quickly to take advantage of market conditions. Steps that can be taken in advance include:

- benefit specification and data – ensuring quality and accuracy, as their reliability will affect the ultimate price paid
- equalisation – ensuring that any issues relating to possible inequality (eg sex or age) have been ironed out.

Employers contemplating a liability management exercise should seek specialist advice at an early stage. For more information about possible options, and Sackers considerable expertise in this area, see our website.

In other news

Moving to a DC master trust

Many employers are finding it increasingly expensive and time-consuming to meet the regulatory expectations placed on their occupational DC scheme, or DC section of a hybrid scheme. There has been a sharp increase in employers looking to move DC pension provision into a master trust, both for future contributions and employees' built up benefits. For employers, the goal is generally to find an appropriate vehicle for existing employees, as well as to reduce the costs and management time of their occupational DC scheme.

Transferring DC assets into a master trust can be a long process, and is one that should be planned in detail. There are many legal issues to consider and quite a few potential pitfalls to avoid. It is usual for employers and trustees to work together on such projects and to take advice on important decisions.

Key issues to consider:

- ✓ **type of master trust** – what type is best suited to the employer's needs? A standard auto-enrolment vehicle or a tailored offering.
- ✓ **choice** – what investment and retirement options does the master trust offer members?
- ✓ **costs** – will all expenses fall on members, or will the employer subsidise certain costs?
- ✓ **transferring trustees** – who has the power to transfer out existing funds into the master trust and at what stage will they be involved?
- ✓ **oversight** – who will check whether the master trust is meeting expectations and who will they report to?
- ✓ **exit** – how difficult will it be for the employer to switch provider in the future?

RPI/CPI

Over the last few years, several cases have looked at whether trustees can use CPI (as opposed to RPI) as the index for assessing increases to DB pensions in payment, as well as for calculating increases on an early leaver's pension between the date of leaving and taking that pension. Each court decision has tended to turn on the specific drafting of the scheme rules in question, and whether the trustees have sufficient latitude to make a switch. This has led to a scheme rule lottery.

Alongside this year's Budget, the Government and the UK Statistics Authority published a consultation on the possible reform of RPI to address its perceived "shortcomings" as a measure of inflation. Broadly, the consultation proposes aligning RPI with CPIH (CPI including housing costs), but seeks information on the impact of this on gilt-holders (such as DB pension schemes) and the wider gilts market. Government consent is required to make such changes before 2030, so the consultation looks at the possibility of implementing the proposal between 2025 and 2030.

For many DB sponsoring employers, moving from RPI to CPI could produce significant cost savings. With the consultation due to end on 21 August 2020, this is clearly one to watch.

Corporate Insolvency and Governance Act

Expedited as a result of the COVID-19 pandemic, the Corporate Insolvency and Governance Act 2020 received Royal Assent on 25 June 2020. The Act is intended to provide businesses in financial difficulties with the flexibility and breathing space needed to explore their options – a free-standing moratorium (similar to the one afforded employers in administration) or a restructuring plan.

Provided certain conditions are met, a business can obtain a moratorium lasting for an initial 20 business days. This can be extended for a further 20 business days without creditor consent (provided the first 15 business days of the initial period have lapsed), with the possibility of a moratorium lasting up to a year with either creditor consent or court approval.

The moratorium provides a payment holiday from debts falling due before the moratorium commenced and during the moratorium. However, there are exceptions to the general payment holiday rule, which include contributions to an occupational pension scheme arising under a contract of employment. The precise meaning of this exemption is currently unclear, although DRCs to a DB scheme would seemingly fall out of scope (and would therefore be covered by the payment holiday). Puzzlingly, the Act also overlooks contributions to personal pension arrangements, although we assume this is an oversight which will be remedied in due course.

New powers for TPR

DB schemes are never far from the headlines, but a string of reports over the last few years (including a Government White Paper in March 2018) have focused on improving the way in which the current legislative and regulatory system works, the ultimate aim being better protection for members.

Originally published in October 2019, following the December General Election, the Pension Schemes Bill was reintroduced into Parliament in January in substantially the same form. But the Bill's progress has been hampered by a shortage of Parliamentary time during the pandemic, raising questions about how soon it will receive Royal Assent.

TPR's current powers

TPR already has a broad range of powers to help it regulate occupational pension schemes, including the ability to gather information and to inspect premises. Trustees and employers are also required to notify TPR of certain events about the scheme on the one hand and the employer on the other (known as "notifiable events"). Examples of existing employer events include a breach of a banking covenant or a decision to cease trading.

Crucially, TPR also has the following anti-avoidance powers enabling it to act against a sponsoring employer (and those associated or connected with it):

- contribution notices – under which TPR can require payment to be made into a scheme, and
- financial support directions – requiring financial support to be put in place for a scheme.

TPR's proposed new powers

Criminal offences:

- failure to comply with a contribution notice – punishable by an unlimited fine
- avoidance of a statutory employer debt – punishable by an unlimited fine and/or up to seven years in prison
- conduct risking accrued DB scheme benefits – punishable by an unlimited fine and/or up to seven years in prison.

Civil penalty of up to £1 million:

- as an alternative to the criminal sanctions outlined above
- where a person knowingly or recklessly provides TPR with information which is false or misleading in a material particular (such conduct can already be subject to a criminal sanction, punishable by an unlimited fine and/or up to two years in prison)
- where a person knowingly or recklessly provides the trustees with information which is false or misleading in a material particular (this will capture existing information requirements applicable to employers and their advisers), or
- for breach of the new notifiable events.

What will a clearer, quicker, tougher TPR look like?

As well as introducing new criminal and civil sanctions for certain breaches (see above), the Bill lays the groundwork for:

- introducing new notifiable events – further detail will be set out in regulations. However, the new events are expected to include a requirement to notify TPR on the sale of a material proportion of a scheme employer's business or assets (where that employer has funding responsibility for at least 20% of the scheme's liabilities), or where security on a debt is granted giving it priority over the scheme
- broadening the circumstances in which contribution notices can be imposed – including introducing a snapshot test focusing on the potential weakening of a sponsoring employer's resources resulting from an act or course of conduct (including a failure to act)
- extending TPR's information gathering powers.

What next?

There is concern that the proposed criminal sanctions (specifically, those relating to avoidance of an employer debt and conduct risking accrued DB benefits) could potentially capture ordinary business activity. Unlike TPR's other anti-avoidance powers, there is also a broad range of possible targets. Whilst the Bill is unlikely to change significantly between now and Royal Assent, TPR guidance is expected which will hopefully go some way to allaying industry fears surrounding the potential use of its new powers.

Sackers

Contact

Sackers is the leading law firm for pension scheme employers, trustees and providers. Over 60 lawyers advise employers on all aspects of their pension arrangements. This includes getting automatic enrolment right, moving to a master trust, advising on corporate pensions strategy, advice relating to DB schemes such as DB risk and funding solutions, and advising on the pensions aspects of M&A activity and corporate group restructuring. For more information, please get in touch with David Saunders, Philippa Connaughton, Faith Dickson, or Tom Jackman, or your usual Sackers contact.

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Stay up to date with all the latest legal and regulatory developments affecting pensions and retirement savings by signing up to our free publications on www.sackers.com/knowledge/publications.

These include our weekly round up 7 Days, Alerts where topical issues are covered in depth and Briefings which give practical commentary and perspectives on essential issues.

Our latest Hot Topic on key DC issues for employers to consider can be found here.

All publications are being sent electronically until further notice. Hard copies will be available once we are back in the office, should you need them.

Upcoming events

6/10/20
ESG, climate change and stewardship update (12.30pm -1.15pm)
This webinar will highlight the new requirements coming into force in October 2020, with a particular focus on implementation statements.

12/11/20
Quarterly legal update (12.30pm -1.15pm)
This webinar will provide an essential overview of significant developments affecting occupational pension provision in the UK for employers and trustees.

In the current climate, our regular seminars are going ahead as webinars and we are also offering smaller virtual roundtables on specific topics. You are advised to check our website for all the latest information on www.sackers.com/events

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