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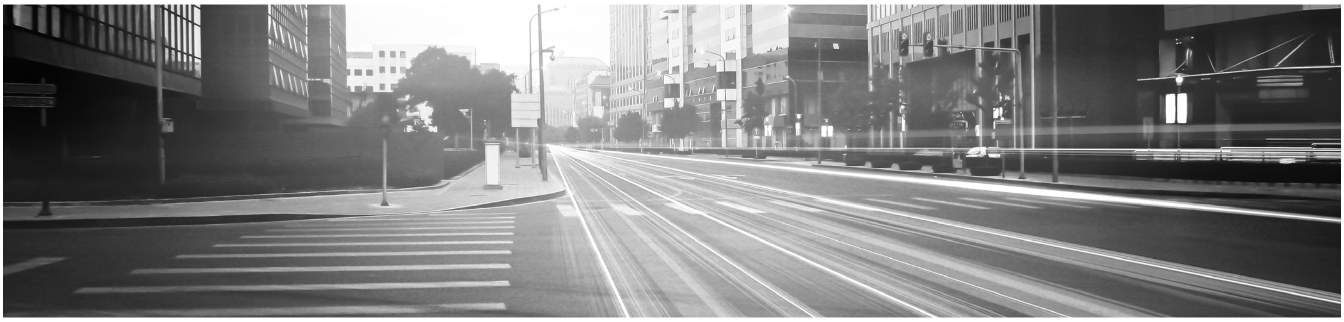

Essential Pensions News

Updater

June 2019

Introduction

Essential Pensions News covers the latest pensions developments each month.

Pensions Regulator publishes annual funding statement analysis

As a follow-up to its annual funding statement published in March 2019, the Pensions Regulator has produced an analysis of the expected positions of DB schemes with valuation dates between September 22, 2018 and September 21, 2019 (known as tranche 14 schemes).

The analysis examines market conditions and the impact of scheme funding, development in employers' profit, shareholder funds and dividend payments and the implications for recovery plans and affordability. The Regulator reaches the following conclusions

- Funding levels and deficits of schemes undertaking valuations as at March 31, 2019 have marginally improved over three years, but not to the extent expected. Recovery plans are therefore unlikely to be on track to remove deficits. If trustees want to retain the same recovery plan end date, deficit reduction contributions (DRCs) will need to be increased.

- The ratio of dividends to DRCs for FTSE 350 companies that sponsor DB schemes has increased on a median level from 9.2:1 to 14.2:1 since 2012, mainly as a result of the significant increase in dividends over the period without a similar increase in DRCs.

- The Regulator's modelling shows that the median required increase in DRCs for schemes in tranche 14 would be around 25–50 per cent over the current level if they were to retain their existing recovery plan end date (or, for schemes reaching the end of their recovery plan, increase its length by less than three years).

- Trends in employers' profits before tax and shareholder funds indicate that affordability might have increased for some employers, giving them a greater range of deficit management strategies.

View the Regulator's analysis.

View our briefing on the annual funding statement 2019.

Comment
The analysis is aimed primarily at a more technical audience than the main 2019 annual funding statement. It models the impacts of market conditions on schemes, and makes a number of approximations based on the high-level and limited data held by the Regulator, meaning that it cannot take account of all scheme-specific characteristics.

The position of individual schemes will therefore vary, depending on a number of individual factors not considered in the analysis. Similarly, the Regulator's analysis of trends in potential employer affordability is based on high-level publicly available data and is not offered as a substitute for scheme-specific assessments.

Pensions Regulator announces crackdown on reviews of DC default arrangements

On June 11, 2019, the Regulator announced a new drive to ensure that DC trustees are meeting their legal obligations and properly governing default arrangements. The move is part of the Regulator's ongoing work to protect savers and to that end, hundreds of DC and hybrid scheme trustees have been contacted and asked to confirm that they have reviewed their default arrangements.

It is a legal requirement for schemes to review both their default strategy and the performance of the default arrangement every three years, or when there is a significant change in a scheme's investment policy or demographic of its membership. Trustees should check the default arrangement is performing as expected and that the default strategy ensures investments are made in savers' best interests. More than 95 per cent of members of trust-based DC schemes are saving in a default arrangement.

David Fairs, Executive Director of Regulatory Policy, Analysis and Advice at the Regulator, said: "*Regularly reviewing a pension scheme's default arrangement, which the majority of savers contribute into, is vital for trustees to ensure they are investing in the best interests of members. We are working to wake up those trustees who … do not engage with the Regulator or sometimes do not realise they are not meeting standards of governance or administration that we expect.*

This pilot is among some of the things we are doing as part of a new approach to contact trustees about their legal duties, support them to become compliant where we can and inform them about the alternatives – including winding up their scheme – if they do not or cannot meet the standards which we expect."

More than 500 DC schemes with between two and 999 members have been contacted as part of the pilot. Trustees have been asked to review guidance which outlines the Regulator's expectations. They are then asked to confirm if the strategy and performance of their scheme's default arrangement have recently been reviewed and remain suitable, by completing a simple online declaration form. Initial indicators show positive trustee engagement with the pilot.

If a scheme's default strategy has not been recently reviewed, trustees are being taken through simple steps to comply with the law including reviewing the current strategy, taking members' needs into account as well as the performance of the default arrangement. Trustees struggling to meet the expected standards should consider whether value for savers would be improved by transferring them into an alternative and better run scheme.

View the Regulator's announcement.

CMA publishes Order implementing remedies following investment consultancy market investigation

Following its consultation on a draft of the Investment Consultancy and Fiduciary Management Market Investigation 2019, the Competition and Markets Authority published the final Order on *June 10, 2019*. The Order aims to implement the remedies to address the adverse effects on competition identified in the final report on the market investigation into the supply and acquisition of investment consultancy services and fiduciary management services to and by institutional investors and employers in the UK.

There are a number of actions arising from the Order but the two specifically relating to trustees are set out below and come into force on *December 10*, 2019.

Part 3 – Mandatory tendering for fiduciary management

This part contains a prohibition on pension scheme trustees entering into or continuing a contract for FM services involving more than 20 per cent of assets without carrying out a competitive tender process. Scheme trustees must use their best endeavours to obtain bids for the provision of FM services from three or more unrelated FM providers and have evaluated the bids received. It is for the trustees to decide whether an open or closed tender process best suits the needs of their scheme and to invite as many more providers to tender as they see fit. The process may be conducted by the trustee or a third party on their behalf.

Where a FM has previously been appointed without a competitive tender process, such a tender must be run within five years of the original appointment. Schemes which have already passed the five year mark (or which will do so before *June 10, 2021*) have a grace period until *June 10, 2021* to undertake the process.

Guidance is expected from the Regulator on the competitive tender process during Summer 2019.

Part 7 – Investment consultancy services - objective setting and performance reporting requirements

The aim of this part is that pension scheme trustees better monitor the performance of their IC by setting and measuring them against an appropriate set of strategic objectives. It prohibits pension scheme trustees from entering into a contract for the provision of IC services or continuing to obtain IC services unless the trustees have set strategic objectives for the IC provider.

Strategic objectives for the IC provider's investment advice will be closely linked to the scheme's investment objectives where possible. They should be reviewed at least every three years, as well as after any significant change to the scheme's investment strategy. Trustees should ask their IC to report periodically on their performance in meeting the objectives.

Again, guidance will be provided by the Regulator.

View the Order.

View the explanatory note.

Comment

The CMA's investigation was launched in September 2017 and discovered adverse effects on competition where investment advisers were selling their own products to trustees who might have achieved a better deal elsewhere. Power has now been placed in the hands of trustees to ensure a competitive tender process is put into operation, and to seek comparative information on fiduciary management services which have previously been sold to them by firms already supplying investment consultancy services to their scheme. The new requirements should result in an improved standard of service for both schemes and their members.

The Financial Conduct Authority (FCA) has finalised its proposed rules implementing the revised requirements of SDR II applicable to FCA-regulated financial services firms, again from *June 10, 2019*. The Conduct of Business Sourcebook is being amended so that where an asset manager or insurer regulated by the FCA invests in shares in a regulated market on behalf of a pension scheme, the asset manager has various disclosure obligations.

New shareholder engagement obligations for trustees: the Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019

On *June 6, 2019*, the DWP laid before Parliament the Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019, which implement aspects of the revised Shareholder Rights Directive (SDR II) applying to workplace pension schemes. Under the Amending Regulations, trustees of occupational schemes will need to comply with new obligations on shareholder-engagement. There was no public consultation, as the Amending Regulations have been implemented as a result of the extension of the Article 50 period past the SDR II deadline of *June 10, 2019*.

The SRD II aims to encourage long-term shareholder engagement, effective stewardship and transparency between traded companies and investors.

The Amending Regulations change current requirements regarding pension schemes' statements of investment principles and the disclosure of information. Both DC and DB schemes will be required to explain their policies in relation to various investment matters, including

- The details of their arrangements with asset managers, including the disclosure of the duration of the arrangement and how the arrangement incentivises the asset manager to align its investment strategies and decisions with the trustees' wider investment policy. There must also be clarity on how the trustees monitor portfolio turnover costs incurred by the asset manager.

- How they monitor the capital structure of companies in which they have invested, and the management of actual or potential conflicts of interest on the part of such companies.

In addition, trustees must include in their scheme's annual report (and make publicly available free of charge) information about their shareholder engagement policies, including how they have cast their votes in the general meetings of companies in which they hold shares and whether they have used proxy voter services. The requirement on occupational DC schemes to publish their SIP and shareholder engagement implementation statement free of charge, which is due to come into force on *October 1, 2019* under separate ESG and stewardship changes, is being extended to include DB schemes too.

While most aspects of the Amending Regulations come into force on *October 1, 2019*, the new disclosure obligations on trustees will not apply immediately.

The overall position is that, by *October 1, 2020*, trustees of Occupational Pension Schemes must

- Prepare their first policies for inclusion in the SIP in relation to their arrangements with asset managers.

- Prepare the first policies for inclusion in the SIP in relation to the capital structure of investee companies, and the management of actual or potential conflicts of interest.

- Publish the SIP on a website (this requirement applies only to DB schemes).

By *October 1, 2021*, trustees of Occupational Pension Schemes must publish on a website the first year's information for inclusion in the annual report relating to

- Their voting behaviour.

- The capital structure of investee companies, and the management of actual or potential conflicts of interest on their part.

Comment

These regulations appear to have taken the industry by surprise, and had the UK left the EU in March 2019 the SRD II may not have needed to be transposed into UK law. At any rate, while they do not demand substantive investment changes, they do impose a reporting burden. It is therefore timely that in the same week as the regulations were issued, the CMA published its remedies Order enacting measures aimed at improving standards in the investment consultancy market, including compulsory competitive tendering in the case of schemes that delegate investment decisions for more than 20 per cent of their assets (see CMA-related item above).

HMRC drops its appeal against taxpayer who accidentally exceeded his lifetime allowance and had fixed protection revoked: *Hymanson v HMRC* [2018]

Fixed protection 2012 was introduced when the lifetime allowance was reduced from £1.8 million to £1.5 million with effect from the start of the 2012/13 tax year. It had to be claimed before April 6, 2012.

An individual who has fixed protection 2012 benefits from a protected lifetime allowance of the greater of

- £1.8 million.
- The standard lifetime allowance (£1.055 million in 2019/20).

However, an individual only retains the benefit of fixed protection 2012 after April 6, 2012 if he or she does not lose it in one of the ways specified in legislation, including accruing further benefits by way of continuing to make additional contributions.

In *Hymanson*, the member failed to appreciate that he was required to stop making contributions and continued making monthly payments under standing Order. When HMRC discovered this, it revoked the member's fixed protection and levied a tax charge.

Allowing the taxpayer's appeal, the tribunal held that where an individual who had been granted a certificate of fixed protection was mistaken as to the tax consequences of continuing to make pension scheme payments - namely the loss of fixed protection - he would be granted the remedy of rescission of those payments. The tribunal then applied the equitable maxim to treat *"that which ought to have been done as having been done"* and proceeded on the basis that the additional payments should be ignored for the purposes of the fixed protection legislation.

In *Hymanson*, the member had mistakenly paid in £7,000 of extra contributions and had incurred a tax charge of £50,000, and this seems to have convinced the tribunal of the injustice of not permitting them to treat the erroneous scheme payments as if they had never been made.

HMRC has now withdrawn its appeal in this case.

Comment

We understand that the case was the first tribunal decision concerning a purported revocation of a transitional protection certificate, as most previous decisions have arisen from claims for late notification of a taxpayer's intention to rely on transitional protection. Further benefit accrual is also a trigger for the loss of several other forms of protection from the lifetime allowance charge, and individuals should take care to understand the implications of further pension saving.

In *Hymanson*, the tribunal seems to have reached their decision by considering the potential injustice of a situation in which the taxpayer was faced with an additional £50,000 tax liability on account of having made relatively small pension contributions.

It appears that anyone who accidentally breaches their fixed protection and has a tax charge applied now has a strong case to go back to HMRC. The numbers could be substantial as a Freedom of Information request has revealed that over 12,000 individuals have notified HMRC of the loss of one of the forms of protection since the Finance Act 2004 reforms were implemented in 2006.

Court of Appeal finds tax due after DB to DC transfer and failure to take pension before death – *Commissioners of HMRC v Parry and Others* [2018]

In our November 2018 update, we reported on the case of *HMRC v Parry* (also known as the *Staveley* case) in the application of inheritance tax (IHT) to pension benefits which were transferred out of a scheme shortly before a terminally ill member died.

Following a divorce, Mrs Staveley transferred a portion of a pension she had set up with her ex-husband into a new scheme, and then named her children as beneficiaries. Following the member's death a few weeks later, HMRC applied IHT to the transfer on the basis that it conferred a gratuitous benefit on the children.

The First-Tier Tribunal and the Upper Tribunal found against HMRC, but the Court of Appeal allowed HMRC's appeal. The latest decision is now to be appealed in the Supreme Court.

Comment

This case highlighted the risk for dying members of making DB to DC transfers where the transferring scheme has a binding nomination rule for death benefits (here this was a "section 32 policy"), but the receiving scheme makes such decisions under discretionary trust. However, discretionary trusts provisions apply in the vast majority of workplace pension schemes.

Members in serious ill-health should beware of potential IHT implications where they transfer their benefits, or delay taking a pension, and do not survive for two more years. Where a member is terminally ill and is considering making a transfer, tax advice should be sought so that the beneficiaries do not eventually receive an unexpected demand for IHT on an inheritance they may have presumed was tax free

If the Supreme Court were to find for the appellants, this would be much welcomed by members seeking to transfer from contract-based schemes to those awarding death benefits under discretionary trusts. Such a ruling would negate the risk that HMRC may seek to levy an IHT charge where such a transferring member, who is in ill-health at the time of the transfer, fails to survive for a further two years.

GMP equalisation: cross-industry working group aims to publish initial guidance “by the end of June”

In our January update, we reported the announcement of the formation of a cross-industry GMP Equalisation Working Group to assist schemes following the High Court’s ruling in the *Lloyds Bank* case on the equalisation of guaranteed minimum pensions. The aim of the working group is to help develop and promote best practice on issues arising from the ruling, from how to address missing data to dealing with transfer requests and rectifying underpayments.

On June 17, 2019, the working group published an open letter setting out its current progress, intended focus and anticipated timeframe for publication of its promised best practice guidelines. It has recognised that this work will be significant and has created five sub-groups focusing on specific areas such as methodology, data and reconciliation and rectification.

The letter states that the working group is aiming to publish its initial guidance by the end of June 2019.

View the open letter.

HMRC publishes countdown bulletin no. 45 and pension schemes newsletter no. 110

Published on *May 16, 2019*, the latest edition of the bulletin for formerly contracted-out schemes deals principally with administrative exercises which are to be re-run for an extended period, following concerns raised in connection with the Phase 7 Automation and Scheme Financial Reconciliation plan relating to Contribution Equivalent Premiums.

View the bulletin.

Published on *May 29, 2019*, the most recent edition of the Newsletter details various issues for scheme administrators related to relief at source. It also notes that there was a short consultation on the Government’s proposals to meet the UK’s expected obligation to transpose the Fifth Money Laundering Directive into national law, which closed on June 10, 2019.

View the newsletter.

Issues in the pensions pipeline

October 31, 2019 – the UK withdraws from the EU, although it is (currently) unclear exactly what form Brexit will take.

October 1, 2019 – new SIP requirements in force relating to environmental, social and governance (ESG) factors.

GMP Equalisation – DWP conversion guidance has now been published. *Guidance expected from the cross-industry working group by the end of June 2019.*

Revised Funding Regime – consultation on a revised Code of Practice is expected "in the summer" with technical provisions expected to remain broadly as they are, with the main change being the addition of a secondary LTFT.

New Pensions Bill is now unlikely before the Autumn 2019, as the Queen's Speech has been postponed. It is expected to include provisions covering the Pensions Dashboard, the Regulator's powers, the revised Funding Regime, DB Consolidators and the Money and Pensions Service.

EMIR – new requirements to the exchange variation margin relating to derivatives applied from March 1, 2017. A further EMIR temporary exemption extension for pension scheme arrangements applied to August 16, 2018 and has now expired. On *May 28, 2019*, the EMIR amending regulation was published and was implemented on *June 17, 2019*. Under the amendments, the clearing requirement is not activated for the first two years, and the exemption may also be extended twice more, each time by a further year if "*... no viable technical solution has been developed and that the adverse effect of centrally clearing derivative contracts on the retirement benefits of future pensioners remains unchanged.*" The UK Government has confirmed that, as far as possible, the regime set out in the EMIR legislation will not change after the UK has left the EU.

October 1, 2020 – new disclosure obligations apply for trustees in relation to scheme's Statement of Investment Principles under the Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019 following the transposition into UK law of the revised Shareholder Rights Directive (SDR II).

October 1, 2021 – new requirements apply for trustees to publish information on a publicly available, free website relating to voting and capital structure of investment companies under the Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019 following the transposition into UK law of the revised Shareholder Rights Directive (SDR II).

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