SLAUGHTER AND MAY

Pensions Bulletin

May 2020

Welcome to the May 2020 Pensions Bulletin from Slaughter and May. In this month's edition, we cover further updates from the Pensions Regulator (TPR) on COVID-19, with a focus on member communications and the transfers of benefits, DC investment and management, and automatic enrolment. We also review the delayed 2020 Annual Funding Statement from TPR. We summarise two recent cases where the High Court has refused to sanction switches from the use of the Retail Prices Index (RPI) to the Consumer Prices Index (CPI) as the relevant measure of inflation for pension increases. We also cover both the recent Supreme Court decision with implications for trustees' investment policies, and a determination from the Pensions Ombudsman that an employer had a duty to notify a member of a change in late retirement factors.

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I. COVID-19: Latest guidance from the Pensions Regulator

Guidance on communications

TPR has issued guidance for trustees (DB and DC) on communicating with members during the pandemic. To allay concerns that a member may make too hasty a decision to transfer benefits out of a DB scheme, TPR proposes practical steps for trustees to take, including a template letter to be sent to all members who request a cash equivalent transfer value (CETV).

TPR's 29 April 2020 guidance covers:

- **Requests for transfers, or to access benefits** - TPR says that trustees should be alert to risks arising from a transfer, and support members to make informed decisions, by:
  - Providing appropriate risk warnings, as set out in TPR's DC Code and amplified in its DC guidance on communicating and reporting. *A separate section on scams reiterates previous guidance for trustees on risk warnings and due diligence.*
  - Reading FCA guidance on DB transfers to help them outline the risks that members face. *Note that this FCA guidance is aimed at FCA-regulated IFAs specialising in DB to DC*

transfers, and should be used with caution by trustees so as not to be seen as providing regulated advice.

- Encouraging members to take independent financial advice and to ask questions of their IFA that will identify risks, as well as highlighting the guidance offered by PensionWise.

On DB to DC transfers, TPR, the FCA, and the Pension Advisory Service have jointly produced a template letter that TPR asks be sent to all members who request a CETV. In addition, trustees should "actively monitor" the number of requests for CETV quotes, and which advisers are involved, and if these reveal unusual or concerning patterns, they should contact the FCA.

Trustees may also find it helpful to refer members to a guide for pension savers: COVID-19 and your pension, recently produced by the Pension Protection Fund together with other regulatory bodies. The guide outlines the protections that are in place and directs savers to where they can seek free, impartial guidance.

- **Stopping contributions/ceasing membership** - TPR says trustees should make it clear to members that they will miss out on future employer contributions and may lose other benefits such as death in service or survivor benefits. TPR suggests that, once the pandemic is under control, trustees contact those who have ceased membership to remind them of their right to opt back in/re-join the scheme. (*Although, clearly, where members have opted out of DB schemes, future pension provision would only likely be available in a DC arrangement.*)

- **DC investments and market volatility** - To allay concerns about members switching investments and crystallising losses, or opting out/reducing contributions, TPR says that when sending out annual benefit statements and/or Statutory Money Purchase Illustrations over the next three months, trustees should highlight:

  - what current market volatility might mean to members retiring over different future time periods;
  - that they need to think carefully and consider getting independent advice before switching funds in the current market;
  - the danger of scams; and
  - the availability of the Pension Advisory Service guidance.

- **Keeping members informed about changes to member services** - Trustees should provide information on the types of member services impacted, whether there are any temporary changes to service levels for processing member requests, and a timescale of when annual publications (such as annual benefit statements) are expected to be published.

Guidance for DC trustees

On 13 May 2020, TPR amended its DC scheme management and investment: COVID-19 guidance for trustees. In contrast to transfers from DB schemes, TPR's expectation is for trustees and administrators to prioritise transfers out as core financial transactions. There is also a warning that *a temporary closure of investment funds (particularly property funds), and redirection of contributions, could lead to the creation of "default arrangements" for the purposes of the charges cap regulations.*

On 17 April 2020, in an update TPR trailed as a reminder of the dangers of pension scams, TPR set out their expectation that **transfers out to another DC arrangement** should be prioritised by trustees and administrators as a core financial transaction. Transfers need to be processed within a reasonable timeframe, after the necessary due diligence, to minimise the potential risk of a drop in CETV value caused by delay. Trustees of hybrid schemes need to consider how members will be affected in terms of their DC benefits, if a temporary transfer suspension is applied to DB benefits.

TPR updated this DC guidance again on 21 May 2020, this time adding a section on when the **temporary closure of investment funds creates a default arrangement**. This addresses the scenario where members of DC schemes have self-selected investment in funds, such as property funds, that have temporarily suspended contributions (or become "gated") until the market normalises. The guidance warns DC trustees that, if they are redirecting members' contributions to alternative funds until gated funds re-open, they need to consider whether they have created a default arrangement for the purposes of the charges legislation. If they have created a default arrangement, trustees should "*take immediate steps to ensure they meet legal requirements*". The funds would become subject to the charges cap (if the scheme is used for auto enrolment), as well as requiring a separate Statement of Investment Principles for the default arrangement.

Referring to the DC Code of Practice, TPR believes that a default arrangement would **not** be created if either:

- members were made aware before they selected the original fund that contributions could be diverted to another fund in certain situations; **or**

- the trustees contacted the members before diverting contributions and obtained their consent. (TPR says trustees should consider taking advice before doing this.)

The first point is a useful reminder that trustees should be careful to communicate with members about the possibility that contributions to self-selected options could be redirected in future where particular funds close to contributions.

On enforcement of the legal requirements on default arrangements, TPR will "*continue to take a pragmatic approach to decide whether it would be appropriate to take action in individual circumstances*".

Tagged on to this statement is a warning about **chair's statements** as follows: "*Please note that in the case of chair's statements we have no discretion in using our powers and will continue to impose fines for non-compliance*". This may be intended as a clarification of a comment on chair's statements in guidance on regulatory easements (see TPR's webpage on reporting and enforcement) that "*to ease the burden for schemes, we will not issue penalty notices before 30 June 2020*". This latest statement presumably means that TPR may issue penalty notices after 30 June in relation to breaches before then.

Guidance on auto-enrolment and the Coronavirus Job Retention Scheme

TPR's updated Guidance on Automatic enrolment and DC pension contributions: COVID-19 guidance for employers focuses on the continuing statutory obligations for employers on re-enrolment.

TPR notes that auto-enrolment duties apply as normal for furloughed employees, based on actual pay. Employers must still enrol (or postpone automatic enrolment requirements for) employees if they meet the eligibility requirements.

This means that where pay is reduced to the 80% available under the CJRS, employees need only be auto-enrolled for the first time if:

- they turn 22 during the furlough period and meet the earnings criteria, or
- the employer choses to apply a three-month postponement period and that period ends during furlough.

If an employee's pay increases after the furlough has ended, the employer must continue to assess them and enrol them if they are eligible.

TPR also notes that automatic re-enrolment applies as usual. If the third anniversary of the employer's staging date falls during furlough, it can choose a date up to three months after the anniversary on which to assess employees. The re-declaration deadline remains as five months after the anniversary. Employees must be re-enrolled whether or not they are furloughed. Employees whose pay is reduced such that they no longer meet the qualifying earnings thresholds need not be re-enrolled. Such employees will be reassessed at the next three-year anniversary (although they can ask to be reinstated before that). Furloughed employees can request (in writing) to be enrolled into the pension scheme at any time.

Applications to the Pensions Ombudsman

The Pensions Ombudsman has announced that it is now accepting complaints again. A temporary moratorium was put into effect from March 2020.

II. DB funding: The Pension Regulator's Annual Funding Statement

TPR's 2020 Annual Funding Statement contains important messages for trustees and employers to consider. Whilst it is largely consistent with recent COVID-19 guidance, and picks up on many themes from previous funding statements, there are some new specific warnings and changes of emphasis. For example, if trustees decide to change the valuation date they should obtain and consider legal and actuarial advice and can expect TPR to question their reasons. On covenant assessment, trustees should consider obtaining independent specialist advice and, where they do not do so, they should document their reasons. They should also consider the impact of Brexit on the covenant, where relevant given the employer's business. Trustees should ensure the employer's affordability is not constrained by covenant leakage to the wider group.

Meanwhile, TPR has suggested there may be further delay and amendments to its consultation on the DB Funding Code.

The delayed 2020 Annual Funding Statement, issued on 30 April 2020, is aimed at schemes with valuation dates between 22 September 2019 and 21 September 2020 (Tranche 15 valuations), as well as schemes undergoing significant changes that require a review of their funding and risk strategies. The supporting analysis will be published in the summer and TPR will consider issuing further guidance in the autumn.

Post-valuation experience - As previously stated in COVID-19 guidance, schemes close to completing their valuations are not required to take into account post-valuation experience in valuation assumptions. However, trustees should consider this in their recovery plans, with a focus on the affordability of the employer. Post-valuation experience must be applied consistently, taking account of positive and negative experience (particularly where trustees are also considering requests to take account of negative changes in the employer's affordability).

Changing valuation date - Some trustees of schemes with effective valuation dates on or around 31 March 2020 may be considering bringing forward the effective date of their valuation. If trustees decide to bring forward the valuation date they should obtain and consider legal and actuarial advice and can expect TPR to question their reasons. Trustees should consider carefully (and document) the impact on member security and why they believe this option is in the best interests of members.

On covenant assessment, for businesses where uncertainty is heightened by Brexit, trustees should review the employer covenant to understand the potential impact of the different outcomes of the trade agreement negotiations, including the possibility of leaving the current trading agreement in December 2020 on WTO terms.

Trustees that do not currently obtain independent specialist advice on covenant assessment are under more pressure to do so. They should only undertake their own assessment where they have sufficient expertise and objectivity. If they do not use covenant advisers they must record their reasons in writing.

Trustees should ensure the employer’s affordability is not constrained by covenant leakage and, if it is not justified, they should seek compensatory protections. The Statement draws attention to five specific ways in which the covenant can be diluted, in addition to dividend payments:

- cash pooling and inter-company lending arrangements;
- group trading arrangements;
- charges such as management fees and royalties;
- transfers of business or assets at undervalue; and
- excessive executive remuneration.

In the light of current conditions, the frequency and intensity of covenant monitoring should be significantly increased. Where the monitoring identifies adverse changes in the covenant, trustees should have contingency plans in place, drawn up in conjunction with the employer. Trustees should be able to demonstrate that interactions with the employer have taken place.

Noting the pending introduction, in the Pension Schemes Bill, of a requirement for a specific **long-term strategy**, schemes that have not yet done so are encouraged to set a Long Term Funding Target (and be prepared to evidence that their shorter-term investment and funding strategies are aligned with it).

The Statement repeats the table of **key risks**, divided according to the five levels of covenant strength and sub-divided according to whether the scheme is immature or mature. This table was included for the first time in the 2019 Statement. It includes TPR's expectations as to covenant, investment and funding in relation to each type of scheme. Trustees need to decide where in the maturity spectrum their scheme fits.

Meanwhile, in a blog on 18 May, David Fairs, Executive Director of Regulatory Policy at TPR, suggested that there may be a further extension to the current **DB Funding Code consultation** (due to close on 2 September). TPR is reviewing the position. The second consultation, on the detail of "Fast Track" compliance benchmark, will not now take place until next year, and will take account of "prevailing market conditions". In addition, as part of that second consultation, TPR will be reviewing the parameters set out in the first consultation for the low dependency funding basis, and the timing for reaching it, in the light of the changed market conditions since the first consultation was issued. (For details of the draft Code, please see our Pensions Bulletin March 2020.)

III. Latest court cases preventing switches to CPI-linked increases

In two recent cases, the High Court has again construed pension increase rules in such a way as to prevent a change from RPI-linked to CPI-linked increases. However, in the second case discussed below, the Court found that, in theory, the (unusual) wording of the rule did allow a limited change to be made, although it would not have been a reasonable change to make in accordance with the requirements of the rule.

In *Carr v Thales Pension Trustees* (22 April 2020), the High Court confirmed a determination of the Pensions Ombudsman, who had upheld a complaint by a member about the trustee's decision to change the index used to calculate annual increases on his scheme benefits.

The rules provided that the rate of increase to be applied to annual pension benefits was the percentage increase in the RPI subject to a maximum of 5% (the Court called this "limb 1") "*as specified by order under Section 2 of Schedule 3 of the Pension Schemes Act*" (limb 2).

In 2015/16, the trustee decided to freeze pension increases for future years until the amount of the pension in payment had become equal to what it would have been had increases been based on CPI from 2011. The Pensions Ombudsman upheld a member's complaint and directed the trustee to increase his pension in line with RPI.

The High Court rejected the employer's appeal. The natural reading of the rule meant that limb 1 applied; the rate of increase was to be calculated in line with RPI capped at 5%. This was the case even though the legislation in limb 2 required CPI-linked increases.

In *Ove Arup and Partners International Ltd v Trustees of Arup UK Pension Scheme* (5 May 2020), the 2013 Rules defined the "Index" for pension increase purposes as RPI but went on to provide that

"*If the composition of the Index changes or the Index is replaced by another similar index, the Trustees, after obtaining the Actuary's advice, may make such adjustments to any calculations using the Index (or any replacement index) as they consider to be fair and reasonable*".

The employer argued that RPI had been "functionally" replaced since CPI and CPIH had come to be regarded as the main measure of inflation for use by pension schemes. However, the Court held that the Index had not been "replaced" in its fullest sense. It would be replaced only if it was discontinued and another similar index introduced or declared by the responsible body to be in its place. The definition of "Index" did not contemplate a "functional" replacement.

As to whether the "composition" of the Index had changed, the Court held that a substantial change had to have occurred and that any such change could not be at a date earlier than the adoption of the latest set of rules. Therefore, the 2010 change in the way in which price data for clothing and footwear was collected and analysed for RPI was capable of being a change in composition, but it was too late for the trustees to act on it because it predated the adoption of the 2013 Rules.

The Court did hold that the change in 2017 in the way housing cost data was incorporated in the RPI was a change in composition and that therefore, in principle, the trustees had power to make adjustments and that it was not too late for them to do so. Nonetheless, the trustees could not switch from the RPI to another index as a result of the 2017 composition change, because it failed the "fair and reasonable" test under the wording of the Rule.

A number of cases have addressed whether RPI could be replaced by CPI as the relevant index to measure pension increases. In many of those cases the courts have held that replacing the relevant index was not possible. However, there is a wide range of pension increase rules, and the position will depend on the particular wording of the rules.

IV. Supreme Court decision on non-financial investment considerations

The Supreme Court's decision in Palestine Solidarity Campaign Ltd v Secretary of State for Housing, Communities and Local Government (29 April 2020) examines the use of non-financial considerations by public sector pension schemes in making investment decisions. However, it has relevance too in the private sector, as it endorses the Law Commission's findings on trustees' investment for non-financial considerations, where doing so would not involve significant risk of financial detriment.

The Supreme Court ruled that a Government policy, which stopped pension funds from making investment decisions that differed from its foreign or defence policy, was unlawful. Although the Government had power to direct how administrators should approach investment decisions by reference to non-financial considerations, this did not include power to direct what investments they should not make.

The significance of this decision for trustees of private sector schemes lies in the Supreme Court's comments on non-financial considerations (in other words, members' views, including their ethical views and opinions on social and environmental impact).

The Government's guidance provided that schemes could take purely non-financial considerations into account provided that doing so "*would not involve significant risk of financial detriment to the scheme and where they have good reason to think that scheme members would support their* *decision*". The Court pointed out that this was an almost word for word adoption of the tests identified by the Law Commission for trustees' investment by reference to non-financial considerations. The Court commented that the Law Commission's report had settled a long-running debate as to the extent to which pension scheme trustees could take account of non-financial factors.

Previous case law suggested that non-financially material factors can only be taken into account if they do not result in any financial detriment. The Supreme Court's ruling appears to change this to allow these factors to be taken into account provided they do not involve significant risk of financial detriment to the scheme and the trustees have good reason to think that members would support their decision. The Pension Regulator's guidance (for both DB and DC trustees) on investment governance also adopts this test, so the Court's decision may help trustees in formulating their ESG policy in the Statement of Investment Principles and the implementation report that DC schemes need to draw up (from 1 October 2020).

V. Duty to notify member of changes to late retirement factors

The Pensions Ombudsman, in Mr N (PO-922730, 29 January 2020), upheld a complaint brought by a member that his employer had failed to alert him about changes to late retirement factors. Whilst recognising there is no duty on employers to advise members on what to do with their benefits, this case demonstrates the importance of ensuring members are notified of changes to factors in a timely fashion.

Mr N was a member who had passed his normal retirement age in the Local Government Pension Scheme (Scotland). In March 2018, he discovered that a circular had been sent, in February 2017, by administrators to employers in the scheme, about new actuarial guidance on late retirement factors that were to come into effect on 24 June 2017. The circular contained instructions that late retirement members should be notified about the changes as soon as possible, to allow them the opportunity to retire before the new factors took effect. Mr N was not notified of the changes to late retirement factors.

Mr N's employer, Police Scotland, argued that it was not obliged to notify members of administration changes. The case law established that there is no general implied duty on employers to give advice to employees about pensions.

However, the Ombudsman upheld Mr N's complaint. He viewed the failure to pass on the administrators' warning about factors as a breach of the duty to provide information about the impact on the member's benefits, rather than the duty to advise. The employer had a duty of care to notify the member of the implications of the changes to his retirement benefits. The Ombudsman directed the employer to calculate the member's late retirement benefits as if he had elected to take his pension on 23 June 2017. The Ombudsman also awarded the member £2,000 for distress and inconvenience.

This determination is very short, with no reference to *Outram v Academy Plastics*, where the Court of Appeal held that there is no general implied duty on employers to give advice to employees about pensions, nor to other cases that show the narrow circumstances in which a duty to take reasonable steps to draw an employee's attention to pension entitlements (under the principle in *Scally v Southern Health and Social Services Board*) would be implied. The Ombudsman (who expressed his annoyance at the employer's failure to engage with TPO processes) viewed the failure to pass on the administrators' warning about factors as a breach of the duty to provide information, rather than to advise. However, even that duty has been applied only rarely in recent cases and determinations.

Dated May 2020

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