HERBERT SMITH FREEHILLS

PENSIONS PLANNER

YOUR GUIDE TO FUTURE DEVELOPMENTS

AUTUMN 2024

Contents

02 Contents

03 Introduction

04 Quarter in review

- 04 Pension Schemes Bill to "drive better outcomes and growth"
- 04 Government launches landmark pensions review
- 04 DB Funding Code finally published
- 05 Value for money: major changes proposed
- 07 Court of Appeal rules on BBC amendment power
- 08 Appeal dismissed in Virgin Media case
- 08 BHS directors ordered to pay £150m for misfeasance and wrongful trading
- 09 Ombudsman makes changes to address backlog

10 Timeline

12 Next 3 months

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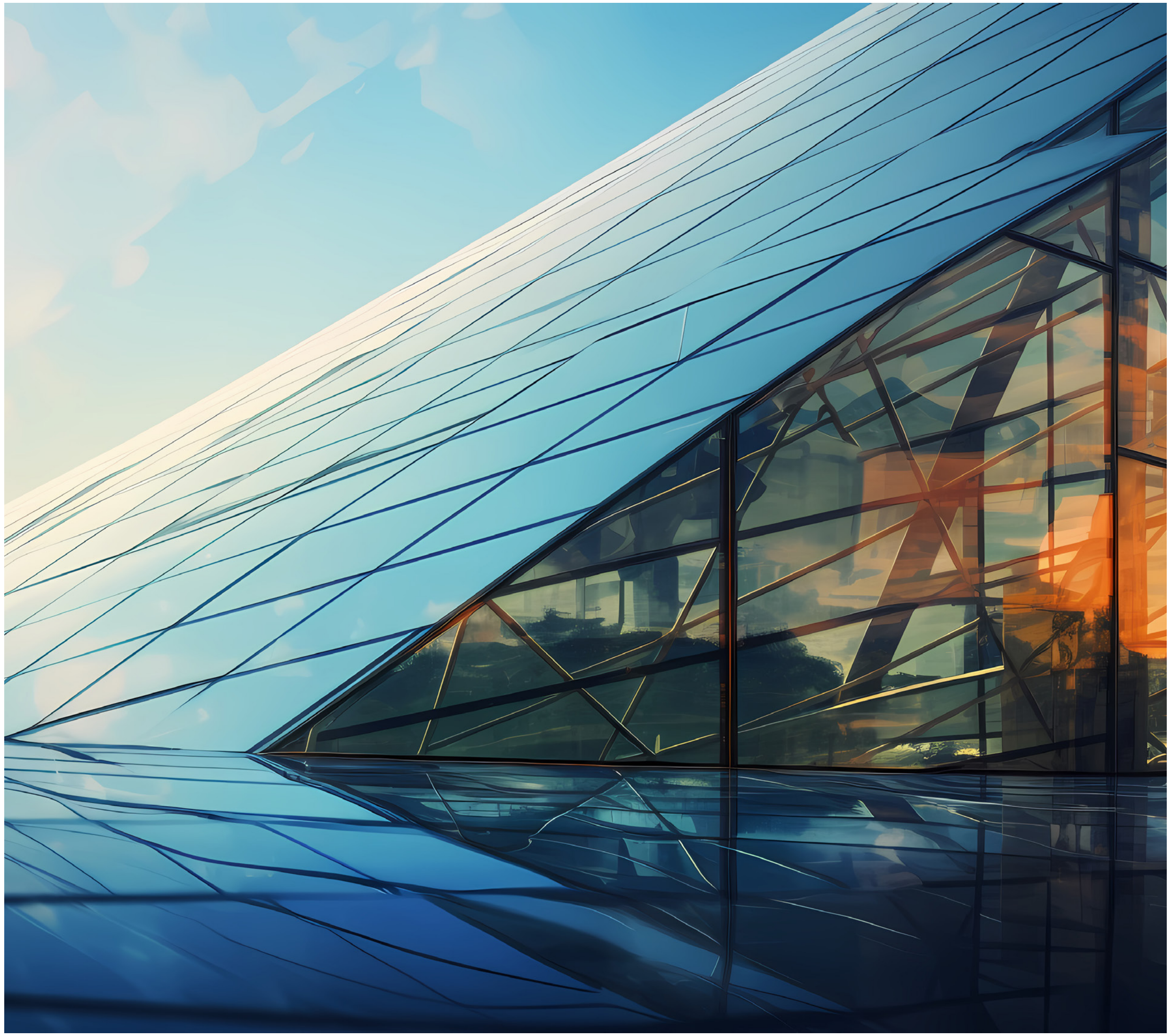
Introduction

This autumn edition has a suitably back-to-school feel, with the new Government taking office, a major pensions review underway, and a Pension Schemes Bill in the pipeline.

Separately but in keeping with the Government's push for value and consolidation, the Financial Conduct Authority has launched a consultation about a new "VFM" framework for DC default arrangements. Once finalised, the framework will be rolled out across all workplace schemes. The FCA is open to suggestions about some elements of the framework, but the direction of travel is clear. Trustees and governance committees will in due course have to assemble and publish a raft of information, not only as to investment performance but also as to service standards. Value will have to be assessed relative to comparator schemes, including some of the UK's biggest. Where value cannot be shown, specific action, including potentially wind-up, will be required. The new framework will surely accelerate the long-term decline in the number of occupational schemes, with The Pensions Regulator reporting that there are now about 1,000 small DC arrangements (5,000 or members or less); back in 2012, there were 3,600.

Meanwhile the industry has two important judgments to digest: the Court of Appeal firmly upheld the High Court's decisions in the *BBC* and *Virgin Media* cases. Both related to restrictions on changes to benefits, and in each case the Court started from the same principle: its task was to identify the meaning of the words in question in their particular context. Thereafter the approaches of the respective judges diverged. In the *BBC* case, the focus was very much on the words themselves; it was "appropriate to give weight to textual analysis, by concentrating on the words which the drafter has chosen to use and by attaching less weight to the background factual matrix than might be appropriate in certain commercial contracts". By contrast, in *Virgin Media*, context was front and centre. The Court began by looking at the "scheme and purpose" of the relevant legislation. That scheme and purpose informed substantially the interpretation of the words used. Whereas in *BBC* the end result was a literal reading of the restriction, the judges in *Virgin Media* arrived at a reading which, they acknowledged, was "unusual… but not impossible". The two cases illustrate the challenges of interpretation in the pensions arena: much will turn on the particular words used; but the words in themselves are not necessarily the end of the story.



Quarter in review

Pension Schemes Bill to "drive better outcomes and growth"

The new Government hit the ground running, with the **King's Speech** promising a total of 40 Bills. To the surprise of many, a Pension Schemes Bill was among them.

Based on a **background memorandum**, the Bill will cover the following:

- **Small pot consolidation**: Measures will be introduced to enable an individual's small deferred DC pots to be brought together automatically in one place.
- **Value for money**: The Bill will introduce a new VFM regime for trust-based DC schemes. The Government expects that the new regime will lead to consolidation, and so improve member outcomes and boost productive investment. The Financial Conduct Authority will ensure that the new regime applies also to contract-based schemes (see below).
- **DC decumulation**: Trustees of DC occupational pension schemes will be required to offer members a retirement income solution, including default investment options. The Government wants to ensure that members can have "a pension, not just a savings pot" when they stop work.
- **Commercial superfunds**: It is expected that the Bill will introduce a regime for the authorisation and supervision of superfunds.
- **Recovery of overpaid benefits**: The Bill will confirm that The Pensions Ombudsman is a "competent court". This will ensure that trustees do not need a court order in order to enforce Ombudsman determinations as to the recovery of overpayments.

Comment: Although the announcement of a Pension Schemes Bill was unexpected, the proposed content will be familiar. The new Government has chosen to take forward various long-running initiatives. Most will attract broad support, but it remains to be seen whether they will drive a material increase in productive investment.

Government launches landmark pensions review

As expected, the Government **announced** a wide-ranging pensions review soon after taking office. Chancellor Rachel Reeves pledged a "big bang on growth to boost investment and savings".

The review will be in two phases. The first phase, to be completed "in the next few months", will focus on investment, including measures to support the Pension Schemes Bill. The second phase, to begin later in 2024, will be broader. Besides investment, the Government will consider further steps to improve member outcomes, including assessing retirement adequacy.

The Government subsequently published **terms of reference**. These state that the first phase will seek to develop policy in four areas:

- Driving scale and consolidation of DC schemes.
- Tackling inefficiency in the Local Government Pension Scheme, through consolidation and improved governance.
- "The structure of the pensions ecosystem", focussing on value (rather than cost) so as to deliver better outcomes for future pensioners.
- Encouraging further investment in UK assets to boost growth.

Comment: In the King's Speech memorandum, the Government noted that the UK had high levels of undersaving, with 40% of people not providing adequately for retirement.

As yet there is no word on whether the Government will address this via changes to the auto-enrolment regime, either using powers in the Pensions (Extension of Automatic Enrolment) Act 2023, or by ratcheting up minimum contributions, as the Department for Work and Pensions **proposed** in 2017.

Will the issue feature in the landmark review? The signs are promising. The second phase will extend to retirement adequacy, and the Government chose in its press release to quote two industry figures who called for an increase in minimum contributions.

DB Funding Code finally published

The Pensions Regulator published the new **DB Funding Code of Practice** and an associated **consultation response**.

The Code will come into force in the autumn (it must first lie before Parliament for the prescribed period of 40 days). It will apply to valuations under the new scheme funding regime – those where the effective date is on or after 22 September 2024.

As discussed in previous Pensions Planners:

- Under the new funding regime, trustees will have to determine, and in most cases agree with the employer, a long-term funding and investment strategy (**FIS**). The FIS must cover the intended endgame for the provision of benefits, and the journey towards it. The trustees must plan for the scheme to be operating on a low-dependency basis at or before the point at which it achieves "significant maturity".
- Trustees will have to produce a statement of strategy, which records the FIS and associated matters.
- TPR will adopt a twin-track approach to the assessment of valuations under the new regime: "Fast Track" in cases where specified conditions are met, and "Bespoke" in other cases. "Bespoke" valuations will typically receive greater scrutiny.

The Code sets out TPR's expectations as to compliance with the new funding regime. It also deals with matters which, under the relevant legislation, are to be determined in accordance with the applicable code. In particular the Code specifies the basis for deciding when a scheme reaches "significant maturity".

The changes incorporated into the final Code are summarised in the consultation response and an **explanatory memorandum**. Key changes include:

- Significant maturity is now deemed to be a duration of 10 years, rather than 12. There are provisions for small schemes to use a proxy.
- For open schemes, the final Code allows greater flexibility as to assumptions for new members and future accrual.
- The final Code provides greater clarity about assessing the reliability period (for employer cashflows) and covenant longevity. The Code outlines the Regulator's expectations in this regard: in most cases the reliability period will be three to six years, and covenant longevity will not exceed 10 years.
- The Code no longer includes a formulaic test for assessing the maximum risk that can be supported by the employer covenant. Instead, a principles-based approach will apply.
- The Code no longer prescribes how trustees should test the resilience of their low-dependency investment allocation. Wording has been changed to make clear that trustees do not necessarily have to align their actual investment strategy with the FIS.
- The final Code includes extra guidance as to proportionality. The lengths to which trustees are expected to go will depend on the level of risk being run, and the stage which the scheme has reached in its journey plan.

With the Code, TPR published a **consultation response** on the twin-track approach to assessment. The response indicates that TPR will proceed very much as previously proposed. However, as regards the conditions for Fast Track:

- Significant maturity will be aligned with the Code – ie a duration of 10 years.
- A change will be made to the discount rate, in the light of market movements.
- Minor changes will be made for smaller schemes and for schemes open to accrual.

Comment: The new Code has had a long gestation: consultation began back in December 2022.

In the interim the document has evolved subtly, in part because of concerns that an over-emphasis on de-risking could have adverse implications for economic growth. Notably, TPR states in its consultation response that the Code gives flexibility for trustees to adopt scheme-specific investment strategies, and to invest in productive assets where "appropriate and supportable".

Several associated documents are still awaited: TPR's covenant guidance; guidance and a template as to statements of strategy; and the final parameters for the Fast Track approach.

Value for money: major changes proposed

The Financial Conduct Authority launched a **consultation** about a new VFM framework for contract-based workplace schemes. The FCA believes the new framework will enable industry stakeholders to assess and compare VFM on a consistent basis, with a holistic consideration of value rather than a focus on cost.

The consultation builds on the long-running VFM initiative of the FCA, the Department for Work and Pensions and The Pensions Regulator. The plan is for the framework to extend to all workplace DC schemes. Provision for trust-based schemes will be made in the Pension Schemes Bill (see above).

The framework will apply only to default arrangements. If a scheme has more than one default arrangement, the framework will apply to the largest default arrangement (based on membership) and any other default arrangement with 1,000 or more members.

There are four key elements to the framework:

- Transparency through the publication of key VFM metrics: investment performance, quality of services, and costs and charges.
- Annual assessment and reporting on an "RAG" basis, to gauge comparative performance.
- Public disclosure of the assessment.
- Actions required for underperforming arrangements.

Under contract-based schemes, responsibility for assessment and reporting will lie with independent governance committees established under the FCA's existing rules. Under trust-based schemes, responsibility will lie with trustees.

Further information about the FCA's proposals can be found in the box below.

The consultation closes on 17 October 2024. The FCA has not said when the framework might take effect.

In a **blog post**, TPR urged trustees of occupational schemes to respond to the consultation. TPR also encouraged master trusts and large single-employer schemes to adopt the new framework early on, rather than waiting until the proposed legislation is in place.

Comment: These are radical proposals. An express aim is to drive consolidation among workplace DC schemes. Those overseeing small arrangements will have two concerns. First, the sheer volume of data which will have to be collated and reviewed. Second, the need to assess VFM relative to far larger arrangements, with the possibility of enforced wind-up if a "green" rating is not achievable.

Some elements of the framework are evidently a work-in-progress. The "quality of service" metrics are a case in point. The FCA recognises that measuring service quality is "very challenging". The consultation paper states that the proposed list of metrics is not exhaustive, and that there might be better alternatives: "we are keen to receive further feedback". Some trustees and providers may be uneasy about being assessed, in part, on the basis of how many members contact the scheme, access the relevant website, or cash out pots above £30,000. The proportion of people doing those things will depend significantly on a scheme's membership demographic.

VFM metrics

Information will have to be disclosed on a standardised basis, to standardised end-dates (31 December). The information to be disclosed covers:

- Investment performance, over various different periods and for various member cohorts.
- Risk – standard deviation and maximum drawdown.
- Asset allocation, including breakdowns as between listed/unlisted and UK/non-UK assets.
- Quality of services, including processing of transactions, member satisfaction, support for retirement planning, the ease with which members can make changes, and member engagement.
- Costs and charges, over various different periods and for various member cohorts.

Assessment

An IGC will have to assess annually whether an arrangement provides VFM, comparing it with three or more VFM arrangements offered by other providers.

- At least two of the providers must be major players in the workplace market (assets above £10bn).
- The comparators must include at least one contract-based scheme and one trust-based scheme.
- Assessment should be a four-stage process, covering value delivered by investment performance; value delivered by services; provisional overall value; and an RAG determination as follows.
  - **Green**: The arrangement provides VFM. Investment performance (allowing for risk) and service quality must not be materially worse than the comparators'. Nor should costs and charges be materially higher, assuming that performance is otherwise similar.
  - **Amber**: The arrangement provides poor value, but improvements are proposed which are expected to deliver VFM within a reasonable period.
  - **Red**: The arrangement provides poor value which cannot be addressed as just described.

Public disclosure

For each in-scope arrangement, providers will be required to publish on a website annually:

- The framework data.
- The IGC chair's annual report, which will need to cover the VFM assessment and associated information (including an explanation of action to address poor value, where applicable).

Actions for arrangements which provide poor value

If an arrangement is found to provide poor value:

- Participating employers will have to be notified, and no new employers may be admitted unless and until the arrangement achieves a green rating.
- Action will have to be taken to address the issue, either via changes to the arrangement (in the case of an amber rating) or via the transfer of members to another arrangement which offers VFM. The provider will have to submit an action plan to the FCA.

Court of Appeal rules on BBC amendment power

The Court of Appeal **dismissed** an appeal as to the scope of the BBC Pension Scheme's amendment power.

The power included a proviso, whereby amendments which affected the "interests" of active members could be made only if specified conditions were met.

The BBC argued that the interests protected were only benefits already earned, based on pensionable service and pensionable salary as at the date of the amendment.

The Court of Appeal disagreed. The proviso referred to interests, rather than rights or accrued rights. "Interests" was a deliberately simple, broad and open-textured word. One of the most valuable interests which an active member had was the ability to continue accruing benefits on the Scheme's current terms.

Upholding the High Court decision, the Court of Appeal said that interests, for the purpose of the proviso, included not just benefits earned by past service, but also:

- the link between past service benefits and final pension salary; and
- the ability to accrue benefits for future service.

As regards the salary link, the Court acknowledged a wrinkle. For certain members, the BBC had power under the Scheme's rules to determine what counted towards pensionable salary. In the 2017 *Bradbury* case, the Court of Appeal **held** that the BBC could use that power to decide what part (if any) of a pay rise would be pensionable. In this latest judgment, the Court said that, for relevant members, the interests protected by the proviso were qualified accordingly. So the salary link was subject to the BBC's power to determine, in accordance with *Bradbury*, what counted for pension purposes.

Comment: Some had hoped that the Court of Appeal might take the opportunity to reconsider established principles as to the interpretation of amendment powers. They will be disappointed. The Court endorsed the textbook approach: when interpreting pension scheme rules, the focus should be on "the words which the drafter has chosen to use". The Court would attach less weight to the factual background than it might do in other, non-pensions, contexts.

The judgment will also disappoint those who had hoped that the Court might revisit the long line of cases, starting with *Courage*, in which provisos referring to "accrued rights" or "benefits already secured" have been held to cover salary links. The Court declined to be drawn: "It is not plausible to suggest that *Bradbury* casts any doubt on *Courage* in that respect. Nor do the grounds of appeal in this case independently suggest that *Courage* and the cases which followed it were wrong."

Appeal dismissed in Virgin Media case

The Court of Appeal **dismissed** the employer's appeal in the *Virgin Media* case, as to amendments to post-April 1997 benefits under contracted-out salary related (**COSR**) schemes.

There were special statutory requirements for amendments affecting COSR benefits. The Court considered the requirements as they stood from April 1997 to April 2013. During that period, under the relevant Regulations:

- amendments could not be made to section 9(2B) rights unless the scheme actuary confirmed in writing that the scheme would continue to satisfy the statutory standard (or reference scheme test); and
- "section 9(2B) rights" were defined as rights to pensions in payment and accrued rights to pensions, so far as attributable to contracted-out employment after April 1997.

The Court of Appeal upheld a key point decided by the High Court: that actuarial confirmation was required for amendments to benefits for future service as well as past service.

The judges' reasoning was as follows:

- Terms used in the contracting-out legislation had to be interpreted in the light of the legislation's general scheme and purpose.
- Under the general scheme of the legislation, the actuary was central to the operation of the statutory standard. It would be surprising if amendments for future service could be made without the actuary's involvement.
- The test in the Regulations ("would continue to satisfy the statutory standard") appeared to be forward-looking, concerned with the value of benefits to be earned in the future.
- At first sight, the "section 9(2B) rights" definition appeared to cover past service benefits only. "Accrued rights" do not usually include future service benefits. However, when the Regulations were first made, a different definition was used, which did include future service benefits. The definition had been changed shortly before the Regulations came into force. Bearing in mind the general scheme of the legislation, the change could not have been intended to cut down the scope of the Regulations, such that they would no longer protect future service benefits.
- In view of the above, "accrued rights" must (unusually) have meant rights which had already been earned or which would be earned in future.
- Accordingly the requirement for actuarial confirmation extended to amendments for future service, as the High Court had said.

Comment: The appeal did not revisit two other conclusions of the High Court:

- That a failure to obtain actuarial confirmation, where required under the legislation, rendered the relevant amendment void.
- That the requirement for actuarial confirmation applied to all amendments to section 9(2B) rights, not just to adverse amendments.

The Court of Appeal said that the first point was subject to a possible argument that a void amendment became valid when the actuary next recertified the scheme. The point had not been formally raised at any stage of the proceedings.

The case did not consider the statutory requirements as they stood from April 2013 until April 2016 (when contracting-out was abolished). The Regulations were amended with effect from April 2013. The amended Regulations made it clear that actuarial confirmation was required for amendments to benefits for future service.

Various industry bodies are lobbying the Department for Work and Pensions for Regulations to validate historic amendments which would otherwise be void on *Virgin Media* principles.

BHS directors ordered to pay £150m for misfeasance and wrongful trading

In a series of judgments, the High Court found three former BHS directors liable in connection with the retailer's insolvency. The Court ordered the directors to pay amounts totalling £150m by way of recompense.

These were not pensions cases, but BHS's pension schemes were major creditors, and some of the directors' failings related specifically to the schemes.

In the main (530-page!) **judgment**, relating to two of the directors, the Court held that:

- The directors were liable for wrongful trading; that is, continuing to trade when they knew or should have known that there was no reasonable prospect of avoiding insolvency (section 214 of the Insolvency Act 1986).

- For wrongful trading purposes, the directors were fixed with knowledge from September 2015. By then they had had the opportunity to engage with the pension scheme trustees and The Pensions Regulator, yet no "rational plan" was in place to deal with the schemes' deficits. In the circumstances, the directors should have known that BHS would not be able to afford to pay future pension contributions, and accordingly that there was "no light at the end of the tunnel".
- The directors were also liable for trading misfeasance, in that they had breached various obligations under the Companies Act 2006. They had failed to promote the success of BHS while having due regard to the interests of creditors, as required by section 172 of the Act. And they had failed to exercise reasonable care, skill and diligence, as required by section 174. Among other things, they did not "inform themselves fully" about the pension schemes' deficits, or the funding implications of expected developments such as the dilution of the employer covenant and fresh valuations.
- The liability of the relevant directors should not be limited by reference to their insurance cover or ability to pay, because limiting liability would send the wrong message to other risk-takers.
- The directors should pay £10.4m and £8.1m respectively, in respect of wrongful trading and certain individual misfeasance.

In another judgment, the Court held that the third director was similarly liable, and should pay £21.5m in respect of wrongful trading.

A **further judgment** determined liability in respect of trading misfeasance. The Court held that two directors were jointly and severally liable for a total of £110m. (The other director had by that stage reached a settlement with BHS's liquidators.)

Comment: Cases about wrongful trading and misfeasance are rare. The *BHS* judgments will therefore be studied with interest. A discussion of the main judgment and its implications can be found **here**.

For distressed companies with underfunded DB schemes, two points are immediately apparent:

- It is vital that directors obtain information and advice about the pension deficit and funding issues. A failure to do so may constitute a breach of the directors' duties.
- If there is not already a "rational plan" to deal with the deficit, the directors should, as a priority, work with other stakeholders to put one in place.

Ombudsman makes changes to address backlog

The Pensions Ombudsman **announced** that, in response to increased caseloads and turnaround times, it will make changes to its operating model:

- Complainants will not be able to use TPO's resolution service until they have exhausted the relevant scheme's internal dispute resolution procedure. Volunteer advisers may be able to assist with IDRPs, but they will focus on "vulnerable members and cases". These changes will be implemented in the autumn.
- TPO will extend the use of short-form decisions in appropriate cases.
- TPO will explore whether some types of complaint should be dealt with by other organisations, and whether de minimis thresholds should apply.

Comment: The Ombudsman has a bulging in-tray. He received 6,900 complaints in 2023/24. Volumes have typically grown by about 12% a year. That trend is expected to continue.

There are knock-on implications for turnaround. Waiting times in 2023/24 were well beyond target, although that was partly due to a cyber incident. On average a complainant waited 12 months before their case was initially reviewed, and thereafter 15 months before it was allocated for adjudication. No surprise that "reduced waiting times" appeared as the first priority in the Ombudsman's 2024/25 **corporate plan**.

The measures now proposed involve streamlining the process for dealing with complaints, and being more selective about those taken on. Separately the Ombudsman has suggested that some schemes should be doing more to resolve complaints at the IDRP stage. He is considering publishing factsheets about common issues, in the hope that they will facilitate resolution.

Timeline

22 September 2024
New funding regime

New regime applies to valuation dates from 22 September 2024 onwards

April 2025 to September 2026
"Connect by" dates for dashboards

These are the expected connection dates specified in the DWP's staged timetable. The applicable date depends on a scheme's size and type

31 October 2026
Longstop date for dashboards

This is the mandatory deadline for connection

2024

2025

2026

2026-2028
State Pension Age

Increases to 67

6 April 2028
Increase in normal minimum pension age

NMPA increases to 57. The change affects people born after 6 April 1971

2030
Indexation

RPI to be aligned with CPIH, with no compensation for holders of index-linked gilts

2028

2030

In the spotlight

Next 3 months

Scheme funding regime

As mentioned above, we expect The Pensions Regulator to publish further documents relevant to the new funding regime, including as to:

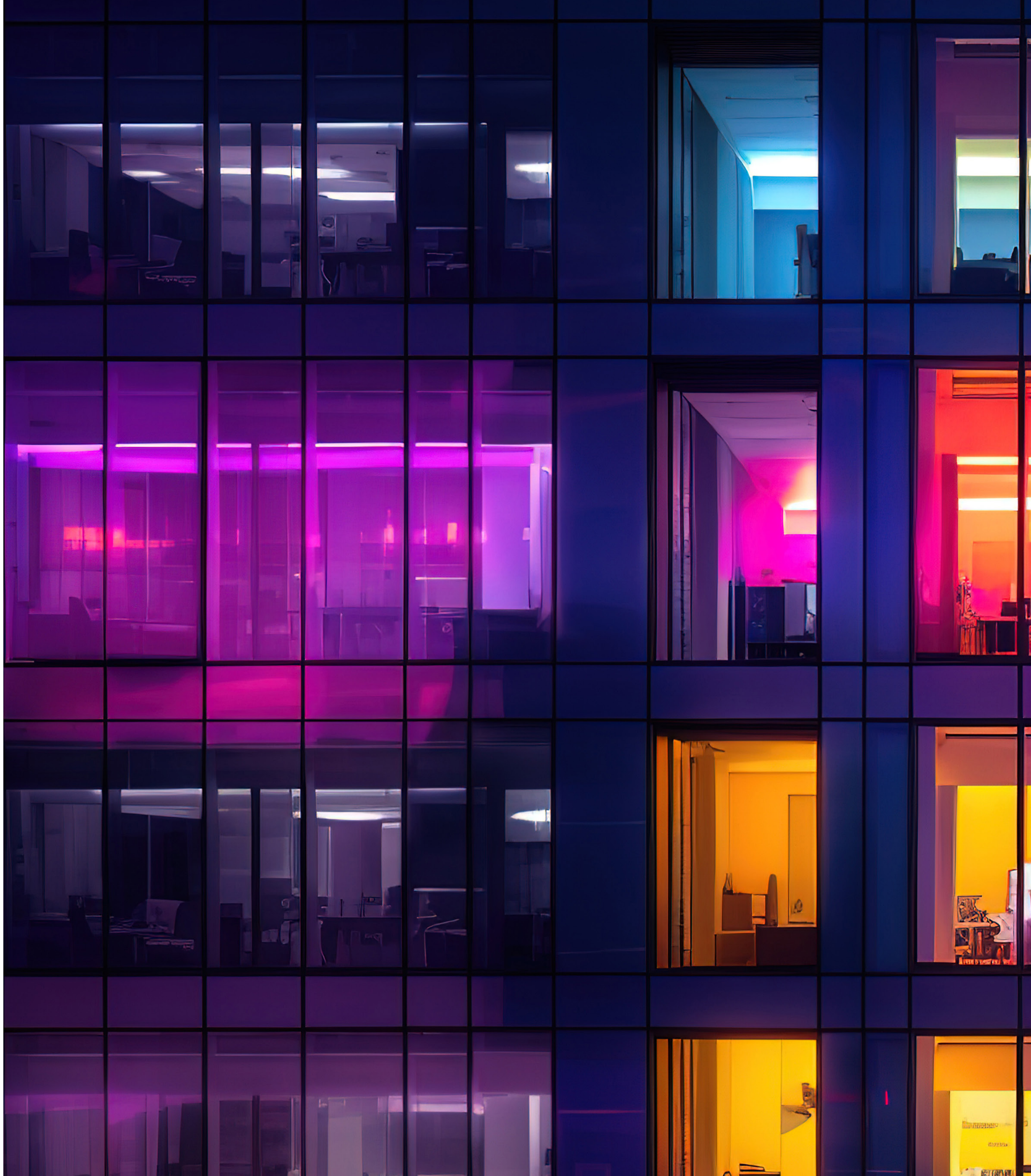
- Covenant assessment – practical guidance about the cashflow-focussed assessment which is expected under the new regime.
- Statements of strategy – as to which TPR's **original proposals** met with a fair degree of pushback

Autumn Budget

Chancellor Rachel Reeves will deliver her first Budget on 30 October. It would be surprising if the Government made radical changes to the pensions tax regime at a time when its "landscape review" is still ongoing. However, lesser changes may well be on the cards. For example, many commentators have suggested that the Government will change the inheritance tax rules around DC pots. It was reported in June 2024 that the Labour Party had decided not to reinstate the lifetime allowance, but no formal statement to that effect has been made.

Pensions review and Pension Schemes Bill

We anticipate that, before the end of 2024, the Government will report the outcome of phase one of its pensions review, with publication of the Pension Schemes Bill to follow.



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