MAYER • BROWN

Pensions Legal Update

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Do one thing this month

The Regulator's statement on current financial pressures (see below) contains sensible suggestions on actions which trustees can take in the current financial situation. These include:

- **DB Schemes: monitor investment portfolios, looking at the overall investment approach and any exposure to toxic asset classes.**
- **Recovery plans: keep the employer covenant under review, and decide if existing plans and processes are adequate given current conditions. Trustees must consider carefully any proposal for change proposed by the employer.**
- **DC Schemes: Trustees should give careful consideration to their member communications. Trustees should also review groups of members that may be at particular risk, for example people close to retirement.**
- **Lifestyling: Trustees should remind members to keep their choices under review.**

Regulator statement on current financial pressures

Summary. The Pensions Regulator has issued a statement to pension trustees about the current financial pressures.

Facts. Key points in the statement include:

- Defined benefit (DB) schemes. The Regulator's contacts with large DB schemes indicate that most have relatively limited direct exposure to toxic assets or counterparties in difficulty. Trustees should continue to monitor investment portfolios, in relation to the overall investment approach and exposure to toxic asset classes. The general fall in asset values, the emerging pressures on company covenants and ultimately insolvency are likely to be the main issues faced.
- Scheme funding. The impact of falling asset values and weakening covenants falls within the framework of the Regulator's scheme specific funding regime guidance, which the Regulator is not planning to change. The principles found in the Regulator's code of practice on funding defined benefits will not be changed as they work across a range of economic conditions.

- Recovery plans. There is no evidence of significant numbers of employers failing to meet their commitments under recovery plans. Trustees should keep the employer covenant under review and decide if existing plans and processes are adequate given current conditions. If an employer believes that a recovery plan has a serious risk of jeopardising the company's future development or solvency, this will need to be discussed with the trustees. The trustee board should consider carefully any proposal for change taking into account among other things plans for payments to other creditors and dividends to shareholders. The Regulator must be informed of any agreed revisions to the recovery plan.
- Funding triggers. The triggers for regulatory investigation of funding arrangements (such as level of technical provisions and length of recovery plan) are expected to remain unchanged. The Regulator anticipates that recovery plans arriving in 2009 may show larger deficits and weaker covenants due to the current economic difficulties. This is likely to imply higher technical provisions and may result in longer recovery periods being proposed, because of the emerging pressures on company cash flows and affordability.

The Regulator encourages trustees to remain vigilant and keep the position of their schemes under review, and focus on making sound decisions in the long term interests of scheme members.

- Defined contribution (DC) schemes. Members of DC schemes have more responsibility for the final outcome of their pension fund. Members need to review their pension fund in light of current circumstances to see if they need to make any changes (to investments, level of contributions or retirement date).
- Trust based schemes. Trustees of DC schemes should give careful consideration to their member communications, ensuring that members have full knowledge of their options, are prompted to review their position and are directed to seek advice where appropriate. Trustees should review groups of members that may be at particular risk, for example people close to retirement. Trustees should have clear and appropriate processes for members approaching retirement, including the provision of information on options and direction to appropriate advice, which should cover the impact of timing on decisions to purchase annuities. The legal requirements on the open market option for annuities are important.
- Lifestyling. Where a scheme operates lifestyling (moving into less volatile assets as the member approaches retirement), those assets already switched will have had some protection from recent market fluctuations. Where lifestyling is ongoing, the value of assets being switched will be lower. Trustees should remind members to keep their choices under review.
- Contract based schemes. Employers may want to encourage employees to engage with their providers to address any issues arising from current economic conditions.

Comment. The Regulator encourages trustees to remain vigilant and keep the position of their schemes under review, and focus on making sound decisions in the long term interests of scheme members. In DC schemes, communications with members about their options seems particularly important.

Source: www.thepensionsregulator.gov.uk/pdf/StatementToTrusteesOct08.pdf

Transfer values guidance

Summary. The Pensions Regulator (the Regulator) has published final guidance for trustees on transfer values (the guidance).

Background. Since 1 October 2008, trustees (instead of the scheme actuary) have become solely responsible for determining the basis for calculating a defined benefit transfer value (cash equivalent).

Facts. The Regulator has said that no new principles have emerged since publishing its earlier draft guidance. The guidance should also be considered when calculating transfer payments which are only paid at trustees' discretion and calculating defined benefits granted in exchange for a transfer-in. The key points in the guidance are:

- Calculation of the cash equivalent. The trustees (rather than the scheme actuary) are responsible for setting the relevant assumptions to calculate cash equivalents. Trustees are encouraged to discuss assumptions with the scheme actuary.

  An initial cash equivalent (ICE) must be calculated, which is then adjusted (as appropriate) to arrive at the final cash equivalent. The ICE places a value on the member's accrued benefits, together with any options and discretionary benefits included by the trustees.

  There are two methods for calculating cash equivalents: the best estimate basis and the alternative method. Trustees should aim to calculate cash equivalents on a best estimate basis, which is broadly the amount of money required to be invested in the scheme to reproduce the member's benefits. The alternative method allows trustees to provide a higher cash equivalent than that which would be calculated under the best estimate basis (for example, to accommodate a transfer inducement exercise). The guidance has more information on the two methods of calculation and what the trustees should consider when calculating cash equivalents.

- Reducing cash equivalents. Under certain circumstances, trustees are allowed to offer reduced cash equivalents (for example, to make allowance for under-funding in the scheme) provided they have obtained an insufficiency report from the scheme actuary.
- Disclosure obligations. The guidance recommends that trustees make reasonable details of the transfer value basis available to a member on request. It also recommends that trustees should tell members (when providing statements of entitlement) what options and discretionary benefits (if any) are included in the cash equivalent.
- Practicalities. Trustees should discuss with the scheme actuary and the administrators how best to ensure that cash equivalent calculations are carried out correctly.

The guidance helps trustees to understand their responsibilities in relation to transfer value matters as well as providing useful guidance for actuaries, scheme administrators and employers.

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Source: Guidance to the trustees of private sector occupational pension schemes providing defined benefits, www.thepensionsregulator.gov.uk/pdf/CETVguidanceSept08.pdf.

Conflicts of interest guidance

Summary. The Pensions Regulator (the Regulator) has published final guidance on conflicts of interest (the guidance).

Background. The Regulator issued a consultation on draft guidance on conflicts of interest in March 2008.

Facts. The guidance, which broadly mirrors the draft guidance, is designed to help trustees of occupational pension schemes to identify conflicts of interest, monitor them and manage them. It concentrates on the governance aspects of conflicts management.

The guidance, which broadly mirrors the draft guidance, is designed to help trustees of occupational pension schemes to identify conflicts of interest, monitor them and manage them.

The five key principles covered in the guidance are:

- Understanding the importance of conflicts of interest. Trustees should be aware of their duties to members and be able to exercise independent judgment.
- Identifying conflicts of interest. A conflict of interest may arise when a trustee is required to act in the best interests of members but has a separate personal interest or, for example, owes a duty of confidentiality to his employer which conflicts with his duty to act in members' best interests. Conflicts of interest (or duty) can be real conflicts or potential conflicts, and conflicts should be notified to the trustee board as soon as practicably possible. An up to date register of trustee interests/conflicts should be maintained and a specimen register is provided in the guidance.
- Evaluation, management or avoidance of conflicts. It is important for trustees to have a process for assessing how a conflict should be managed and the Regulator sets out a number of points to consider. In some cases simply disclosing the conflict may be enough but in other cases a more active form of management may be needed, such as removing the conflicted trustee from the decision making process. Trustee minutes should detail conflicts and record how they will be managed.
- Managing adviser conflicts. Trustees should ensure that advisers declare conflicts of interest and where a conflict is disclosed, trustees should evaluate and actively manage that conflict.
- Conflicts of interest policy. Trustees should have a policy setting out procedures for identifying, monitoring and managing conflicts and review that policy from time to time. A specimen conflicts policy is provided in the guidance.

The Regulator has also produced a summary guidance to accompany the main guidance. The summary conveys the key messages and sets out some questions that trustees should ask when considering the five key principles.

Comment: The guidance acknowledges that conflicts of interest is a complex area of law and that trustees should be prepared to seek legal advice (as necessary). The guidance concentrates on the governance aspects of conflicts management.

Source: The Pensions Regulator's Guidance: Conflicts of Interest, www.thepensionsregulator.gov.uk/pdf/ConflictofInterestGuidanceOct08.pdf

Effective member communications guidance

Summary. The Pensions Regulator (the Regulator) has published guidance for trustees, managers and employers on producing effective written member communications (the guidance).

Background. The Regulator wants schemes to improve the effectiveness of member communications so that members can appreciate the value of pension schemes to help them save for retirement. If members have a lack of understanding of their pension arrangements they may well make poor decisions or take no action at all. The guidance does not deal with the legal requirements for disclosure of information to members.

Facts. The key points to note in the guidance are:

- Issuing communications. Communications may need to be issued to active, deferred and pensioner members. The guidance highlights key stages when communications may need to be made, for example joining the scheme, approaching retirement, notifying scheme changes and so on.
- Effective communications. For communications to be effective they should have:
  - impact (to get the members' attention);
  - clarity (so that members are able to understand it); and
  - accuracy (so that members receive full and reliable information).
- Identifying the objectives and having a clear communications plan. The guidance suggests that everyone involved in the communications exercise should understand its objectives and should try to evaluate whether those objectives have been achieved after the event (for example by seeking feedback where appropriate). In cases where a difficult message needs to be conveyed, it may be helpful to send "test communications" to a limited cross-section of relevant members to see if the message is clear.
- Identifying the best ways to communicate. For example:
  - consider the advantages of various forms of communication (for example, poster, single page handout, newsletter, presentations) when communicating with members;
  - tailor communications to the appropriate audience (for example, consider who the communication is addressed to, the levels of financial awareness, access to technology and any disabilities of members);
  - be open and honest;
  - avoid jargon;
  - try to avoid overburdening members with too many communications in a short time; and
  - make provision for feedback to make the communication a two-way process.

The Regulator wants schemes to improve the effectiveness of member communications so that members can appreciate the value of pension schemes to help them save for retirement.

Comment. The Regulator's focus appears to be on schemes that may be in most need of support, such as smaller schemes which may have less to spend on communication experts and advice. However, all schemes can benefit from the guidance.

Source: The Pensions Regulators Guidance: "Effective Member Communications" September 2008, www.thepensionsregulator.gov.uk/guidance/dcScheme/memberComms/index

Mortality assumptions guidance

Summary. The Pensions Regulator (the Regulator) has published final guidance on trustee good practice when choosing mortality assumptions for defined benefit schemes (the guidance).

Background. The new scheme funding regime requires actuarial valuations in respect of defined benefit schemes broadly to set out the assumptions used in the valuation (known as the technical provisions). Trustees have a statutory responsibility to set the funding assumptions and one of the key assumptions is looking at how long scheme beneficiaries are expected to live (mortality assumptions).

Facts. The Regulator's new regulatory approach to monitoring mortality assumptions applies to valuations with effective dates from 22 September 2008. A scheme's mortality assumptions will not themselves be a primary "trigger" for further scrutiny by the Regulator. The Regulator will seek to investigate mortality assumptions only if one of its existing primary triggers applies, for example if the recovery plan is more than ten years.

Although the guidance outlines how trustees (and their advisers) should choose mortality assumptions for an actuarial valuation, it is also relevant to employers considering whether to agree to such assumptions.

The main points in the guidance are:

- Trustees should familiarise themselves with the main issues and obtain actuarial advice when choosing the mortality assumptions. Trustees should have a robust process for choosing those assumptions and understand why they have adopted particular mortality assumptions in relation to their scheme. They should also seek input from the scheme actuary to help their understanding.
- Trustees should choose their assumptions prudently. Broadly this means taking a margin on the cautious side of a best estimate. They should also allow for future mortality improvement rates. A prudent approach would be to use the most up-to-date evidence and currently accepted projection methodologies in setting those assumptions.
- Trustees should discuss with the scheme actuary how sensitive the technical provisions are to changes in assumption values. If the technical provisions are very sensitive to variations, a more prudent approach is likely to be required.
- Trustees should consider analysing the scheme's own mortality experience (as well as looking at more general factors) in respect of past, current and future trends, including discussing the statistical reliability of scheme specific information with the scheme actuary, when setting assumptions. In practice it may be appropriate for small schemes to rely solely on more general factors, but this should be discussed with the scheme actuary first.
- Trustees should document their reasons for the decisions made.

Comment. Although the guidance outlines how trustees (and their advisers) should choose mortality assumptions for an actuarial valuation, it is also relevant to employers considering whether to agree to such assumptions.

Source: The Regulator's Guidance on good practice when choosing assumptions for defined benefit pension schemes www.thepensionsregulator.gov.uk/pdf/MortalityAssumptions.pdf.

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