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Trustee Quarterly Pensions Review

Summary

Welcome to our Winter 2008 trustee quarterly review. In this edition:

- Cases concerning scheme funding and Section 75;
- Government issues its response to the consultation on the Myners principles;
- PPF news on 2008/09 and 2010/11 levies;
- Progress of the Pensions Bill;
- The Pensions Regulator ("tPR") conflicts guidance;
- Changes to pension sharing calculations;
- Changes to notifiable events; and,
- tPR statement on current market turmoil.

Winter 2008

Scheme Funding and the Contribution Rule

Allied Domecq have lost their appeal for the High Court's ruling to be set aside in relation to the construction of the contribution rule in two of their defined benefit schemes.

The case, *Allied Domecq (Holdings) Ltd v Allied Domecq First Pension Trust Ltd and another*, was heard by the High Court last December. The Claimant was the principal employer under two pension schemes.

The principal employer issued proceedings as to whether under the respective schemes' governing documentation the employer contribution rates were determined by the actuary, or in some respects were determined on the advice of the actuary, without (in either case) employer consent. If this was the case, special provisions of the scheme funding regulations would have applied: regardless of what the trustees and the employer have agreed, the actuary would also have to certify that if he, the actuary, had been left to his own devices he would have set a rate which was no greater than what the trustees and the employer have agreed.

The background to the case was that, although any disagreement on contribution rates would ultimately have to be resolved by tPR, the principal employer felt that its bargaining position would be stronger if tPR was not specifically required by the relevant legislation to take into account the actuary's recommendations (even though tPR might be expected in any event to have regard to them). From the trustees' perspective if the special provisions applied, this might lead to agreement on a higher or accelerated employer contribution rate without any need for tPR involvement.

Whether the special provisions applied turned on the drafting of the particular scheme rules.

The Court agreed with the trustees' reading of the scheme provisions – that the collective employer contribution rate was determined by the actuary alone, which meant that the special provisions applied. The decision turned, in the end, on whether a semi-colon meant that the employer contribution rule fell into two distinct parts (as the trustees argued) or whether it was to be construed as a single seamless provision (as the principal employer suggested). The first part, down to the semi-colon, dealt with determination of the collective rate, whereas the words after the semi-colon dealt with the apportionment of that collective rate between participating companies. The Court concluded that the rule was in two distinct parts and, on that basis, the principal employer and the trustees had no role under the rule until the second stage of apportioning the collective rate was reached.

The principal employer appealed to the Court of Appeal on this issue.

The Court of Appeal agreed that the special provisions applied because the principal employer's influence was limited to how the deficit could be shared across participating employers and did not extend to having to agree with the period over which the deficit was to be repaired – and for the special provisions not to apply it would have been necessary for the scheme funding regulations to have applied to the rate of contributions payable by each employer specifically (rather than, as they do, the rates payable collectively).

This decision emphasises the importance of considering the specific provisions of a scheme's governing documentation in order to understand how the statutory scheme funding regime applies.

Section 75 debt: Company/Trustee dispute over its calculation

The High Court has passed judgment in the case, *Easterly Limited v Headway PLC*, concerning a disagreement over the calculation of section 75 employer debt where the scheme in question was wound-up in deficit, even though the principal employer remained solvent. Easterly Limited is the sole trustee of the Headway PLC Group Pension Fund, of which Headway PLC is the principal employer.

As the scheme's winding-up started in 2001, the section 75 debt fell to be determined on the MFR basis. This meant that even after the debt was paid, the scheme's assets would be insufficient to secure members' benefits in full. The trustee therefore proposed to effect a partial buy-out of liabilities before fixing the "applicable time" at which the section 75 debt would be calculated. By applying the scheme's assets to secure part of the scheme's benefits ahead of the "applicable time" for setting the section 75 debt, the trustee sought to ensure that when measuring the section 75 debt the liabilities so discharged ahead of the applicable time were effectively valued on a buyout basis rather than the much weaker MFR basis, thus increasing the debt to be collected from the solvent employer.

The principal employer did not agree that the trustee's proposed course of action would have the effect the trustee believed, and also challenged the propriety of the trustee's proposal.

The Court found in favour of the trustee to some extent, accepting that its proposal was not improper and that the partial buy-out was therefore in principle permitted. However, the Court expressed doubts about whether the partial buy-out route would in practice have the effect the trustee thought, broadly because the Court was not convinced that the trustee would be able (due to the specific wording of the scheme's provisions and also issues relating to contracted-out benefits) fully to discharge the scheme from liability for the benefits to be secured under the partial buy-out route. The judge therefore added a rider to the Court Order the trustee was seeking, stating that the trustee may not engage in any partial buy-out unless it is satisfied that the consequences, after deducting implementation costs, will be to provide worthwhile value for scheme members by materially increasing the employer debt.

This decision is another example of how the specific drafting of a scheme's governing provisions may affect the options open to trustees.

Government issues its response to the consultation on the Myners principles

The Government announced a "new framework" for changing how trustees use the Myners principles on best practice in investment decision-making and its views on updating those principles in Updating the Myners Principles: a response to consultation (October 2008).

The principles themselves are not new but they have been reduced to a smaller number of higher-level principles. The revised principles are supplemented both by best practice guidance and also by references to other materials which should provide practical help and support to trustees and their advisers in applying the principles. Trustees are not expected to implement every element of the best practice guidance, but to use it where appropriate.

The revised principles are coupled with a move towards industry overseeing and developing the principles through a new body, the Investment Governance Group ("IGG"). The IGG's purpose is "to improve the governance of investment decision-making". The IGG will be made up of experienced "figures involved in the governance of investment decision-making". tPR will chair the IGG and the Treasury and the DWP (its sponsors) will participate in the IGG on an ex-officio basis.

The Government explains that higher-level principles have been adopted to provide greater flexibility, recognising that there is no "one size fits all" approach to ensuring that standards of investment decision-making and governance continue to rise. There is recognition that smaller schemes face different issues, and the IGG has been asked to develop a tailored set of principles and guidance for smaller schemes as one of its first tasks.

The Government has accepted that a voluntary "comply or explain" approach to trustee disclosure of the trustees' compliance with the principles remains the right approach at present, and the IGG has been asked to consider "brief and practical guidance" on how trustees should approach this.

Pension Protection Fund – recertification of contingent assets

The PPF has said that it will **not** be reminding schemes this year about the need to recertify their contingent assets.

Trustees and managers of schemes who wish to rely on existing contingent assets in order to claim a reduced PPF levy for the coming levy year need to ensure that they meet the recertification deadline of 31 March 2009.

Pension Protection Fund announces 2009/10 levy situation

The Government has announced that "to avoid putting additional cost pressures on pension schemes at the current time" the General Levy and Pension Protection Fund (PPF) Administration Levy for 2009/10 will be held at the levels set for 2008/09.

This should mean the following:

- General Levy – applicable to occupational and personal pension schemes to meet the costs of tPR, the Pensions Advisory Service and the Pensions Ombudsman, will range from a flat rate of £33 for schemes with less than 12 members up to £1.00 per member with a minimum of £14,300 for schemes with 10,000 or more members.
- PPF Administration Levy – applicable to defined benefit schemes, will continue on a sliding scale ranging from a flat rate £42 for schemes with less than 12 members up to £1.29 per member with a minimum of £18,400 for schemes with more than 10,000 members.

The PPF has chosen to stick to its three year commitment on the overall level of the pension protection levy despite the recent worsening in financial conditions, which must have increased the chance of employer insolvency. The risk-based element of each scheme's levy will be calculated with reference to its shortfall against a 121% section 179 funding level – schemes which are better than 140% funded will avoid the risk-based element entirely and a taper will operate for those with funding levels in between.

The cap on the risk-based element of the levy will remain at 1% of section 179 liabilities. As proposed last year, the section 179 liabilities and shortfall, used in the scheme-based element and the under-funding risk aspect of the risk-based element respectively, are to be measured on financial conditions as at 31st March 2008. The D&B failure scores used in the insolvency risk aspect of the risk-based element are also to be measured as at 31st March 2008.

There will be limited room for schemes to effect levy reduction measures with an immediate impact in the run up to 31st March 2009. In particular, those who suffered poor D&B scores in their 2008/09 levy will be hit hard again as the 31st March 2008 scores are being used again.

Dates to note: 5pm on 31st March 2009 is the deadline for contingent asset certificates, 5pm on 7th April 2009 for actuarial certificates of deficit reduction contributions and 5pm on 30th April 2009 for block transfer certificates where the transferring scheme has become ineligible.

Schemes also need to be keenly aware that some important deadlines for the 2010/11 levy are being proposed for early next year, in particular 5pm on 31st March 2009 for submission of scheme return data (including section 179 valuations) and for providing information to D&B regarding sponsoring employers' failure scores and 5pm on 30th April 2009 for block transfer certificates in respect of partial transfers of assets and liabilities (which will be mandatory rather than optional for 2010/11).

tPR publishes finalized conflicts of interest guidance

tPR has published the final version of its guidance which is intended to help trustees of occupational pension schemes and employers identify, monitor and manage conflicts of interest.

The final guidance follows a similar form to the draft guidance issued for consultation earlier in the year. However, tPR has taken the opportunity to clarify some areas – in particular its views on the need for legal advice and the chairman's role - as well as giving more emphasis to the position of defined contribution schemes, with specific case studies being added to the guidance.

tPR sees the management of conflicts of interest as key to good scheme governance. However, the final guidance emphasises the scheme specific and fact specific nature of conflict situations and the importance of the trustees seeking and following legal advice in those situations. tPR sees the role of independent legal advice as assisting trustees to identify, and find ways to manage, conflicts and determine whether a conflict could result in a decision being invalidated.

Given the situation specific nature of conflicts, the guidance does not seek to provide answers but rather it identifies the key principles which underpin sound conflict management and governance. The guidance identifies five of these:

- Understanding the importance of conflicts of interest
- Identifying conflicts of interest
- Evaluation, management or avoidance of conflicts
- Managing adviser conflicts
- Conflicts of interest policy

The guidance says that all schemes should have formal documented procedures for identifying monitoring and managing all conflicts of interest. The guidance recommends the adoption of a formal conflicts policy and the creation of a conflicts register as an important part of this. tPR does not regard it as safe merely to rely on scheme provisions which purport to authorise trustee conflicts.

The guidance also emphasises the pivotal role of the trustee chairman in establishing and supervising robust conflict management and avoidance procedures.

Helpfully, the guidance reaffirms tPR's view that appointing senior staff of the sponsoring employer as trustees can bring additional benefits to the trustee board which cannot easily be replaced, while recognising the need to pay particular care to conflicts of interests for such individuals, and notes that similar issues arise for trade union representatives acting as trustees.

However, tPR also expresses reservations about whether confidential information conflicts can be managed either by excluding the trustee from the decision making process or by providing in the trust deed that there is no duty to share that information. In these cases, tPR recommends the individual seriously considers seeking independent legal advice.

In our view, the final version of the guidance is helpful to trustee boards seeking to address conflict issues. It recognises that conflict of interest situations are situation specific and does not seek to impose a "one size fits all" solution on schemes, while emphasising the importance of ensuring that conflicts are identified and managed.

As part of our Pension Scheme Governance Programme we will be discussing these issues with our trustee clients in order to assist them to develop or update pragmatic conflicts policies and registers.

Pensions Bill progress

The House of Lords has completed its Report Stage of the Pensions Bill.

Concerns are growing that the timing of the commencement of the proposed reduction of the cap on revaluation of deferred benefits from 5% to 2.5% will need to be put back from its January 1st proposed implementation date.

Further changes to the Bill since our Autumn quarterly review also include:

- an intended easement to the operation of the forthcoming auto-enrolment provisions for those employers that sponsor money purchase schemes. Employers will be able to self-certify that their money purchase pension scheme arrangements meet the quality standard;
- amendments requiring a review to be undertaken of the yet to be finalised Personal Accounts contribution limits and the ban on transfers into and out of the scheme;
- clarification that non executive directors are not generally to be treated as "workers" for the purposes of the automatic enrolment requirements in the Bill;
- moral hazard: The proposals are mostly in line with those set out in April. However there are two fundamental changes: the new 'material detriment' test will apply in limited circumstances, intended to focus mainly on non-insured buyout scenarios, and these limits will be built into the regime rather than just applying on a transitional basis as previously proposed. tPR is set to publish a Code of Practice to improve clarity on how it will operate its powers; and
- clarification as to the circumstances in which tPR can delegate a number of its existing powers and those to be granted under the forthcoming Act.

Pension sharing on divorce: Government sticks with cash equivalent approach

The DWP has confirmed its existing policy position on two issues concerning the valuation and treatment of pension rights on divorce:

- Schemes should continue to use the same cash equivalent methodology for valuing a member's pension rights for divorce purposes as they do when valuing pension rights if the member wishes to transfer his benefits to another scheme;

- Trustees should not be required to offer scheme membership to former spouses in respect of their pension share – trustees should remain free to choose whether or not to offer this facility.

Government proposes changes to Notifiable Events

Subsequent to a review by tPR, the Government intends to remove the following items from the notifiable events regulations:

- Trustee notification events: two or more changes in the holders of any key scheme post within the previous 12 months; and
- Employer notification events: any change in the employer's credit rating, or the employer ceasing to have a credit rating; and two or more changes in the holders of any key employer posts within the previous 12 months.

tPR also intends to update its Directions concerning notifiable events. These have been in place since 2005 and exempt trustees and employers from having to report some notifiable events if certain conditions are met. One of these concerns the funding level of the scheme where currently an exemption may be possible if the scheme is fully funded on a section 179 basis (or the old MFR basis where the scheme has yet to complete its first scheme funding valuation). The intention is to change this to the scheme funding technical provisions (or the higher of section 179 and FRS17 where the scheme has yet to complete its first scheme funding valuation).

tPR issues statement on market turmoil

tPR has issued a statement to trustees of all work-based pension schemes regarding current developments in financial markets.

The statement indicates that tPR's contact with larger UK final salary pension schemes suggests relatively limited exposure to 'toxic' assets and, while a few individual schemes have higher levels of exposure, tPR has not been informed of any significant problems and does not believe the issue to be systemic.

tPR believes that the main issues facing pension schemes are likely to be first the general fall in asset values and secondly the emerging pressures on sponsoring employer solvency. The statement suggests that trustees should keep the employer covenant under review and consider whether their approach to scheme funding is adequate. The statement also suggests that where an employer believes that an existing recovery plan is at serious risk of jeopardising the employer's future development or solvency, that will be a matter for discussion with the trustees.

This Mayer Brown publication provides information and comments on legal issues and developments of interest to our clients and friends. The following is not a comprehensive treatment of the subject matter covered and is not intended to provide legal advice. Readers shouldseek specific legal advice before taking any action with respect to the matters discussed herein.

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