MAYER • BROWN

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Quarterly Review

Trustee Quarterly Pensions Review

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A review of the DWP consultation on RPI/CPI

BACKGROUND

The Government is consulting on proposals which would clarify how occupational pension schemes will be affected by the decision last year to use the consumer prices index (CPI), instead of the retail prices index (RPI), as the measure of inflation used to determine minimum increases to deferred pensions and pensions in payment.

The change will directly affect revaluation and pension increases in a scheme whose rules provide only for whatever increases legislation requires. However, some schemes' rules expressly say that deferred pensions or pensions in payment must be increased by reference to the RPI. Exactly how the changes will affect those schemes has remained unclear and is the subject of the consultation.

The consultation closes on 2 March 2011. The Pensions Bill 2011 is to make the necessary amendments to the revaluation and indexation legislation.

SUMMARY

The consultation suggests that the Government will be giving pension schemes less flexibility to make changes than many people had expected.

FACTS

The key points in the consultation are:

- The Government does not intend to pass legislation that would directly override scheme rules which promise increases based on the RPI, so that references to the RPI are automatically replaced with references to the CPI.
- Nor does it intend to give trustees or employers any new powers to change their schemes' rules so as to replace references to the RPI with references to the CPI, at least for benefits which have already built up.
- Where a scheme's rules about increases to pensions in payment already at least match the old statutory minimum (annual increases reflecting RPI inflation capped at 5% for pensions earned between April 1997 and April 1995, and reflecting RPI inflation capped at 2.5% for pensions earned after April 2005), they will not have to pay increases based on the CPI where that would be higher. In other words, schemes in that position will not have to apply a CPI underpin.
- However, it seems that a CPI underpin will apply where scheme rules about *deferred pensions* expressly require revaluation by reference to the RPI. Schemes will have to uplift deferred pensions by the better of statutory revaluation (based on RPI inflation before 2010 and CPI inflation from then onwards) and whatever their own rules may require.
- The Government intends to amend the consultation rules, so that employers will have to consult employees before their scheme rules are changed to adopt the CPI as the measure of inflation going forwards.
- The Government does not intend to make any overriding amendments to existing annuity contracts, buy-in or buy-out policies where these refer to RPI increases.

Helen Parrott

March and April deadlines for reducing the PPF levy

A number of deadlines for PPF levies will soon be upon us. Trustees who want to minimise their levy will need to ensure that the deadlines are not missed. Employers will also have an interest here, since they pick up levy costs, directly or indirectly.

The 2011/12 levy

The 2011/12 levy is based primarily on data as at 31 March 2010. However, certain measures taken after that date may serve to reduce the levy, provided that the PPF's rules are met. The deadlines are as follows:

- Any contingent asset arrangements will need to be certified or recertified by **5 p.m. on 31 March 2011**.
- Any deficit reduction contributions will need to be paid by **31 March 2011** and certified by 5 **p.m. on 7 April 2011**.
- Any "full" block transfers will need to be made by **31 March 2011** and certified by **5 p.m. on 30 June 2011**.

Note that a contingent asset arrangement which was certified for the purpose of years will need to be **recertified** in order for it to be recognised for 2011/12.

The 2012/13 levy

The PPF have not yet reached a final decision about the basis on which the 2012/13 levy will be determined. However, the PPF have indicated that:

- "The measurement date would be aligned to the start of the levy year." In other words, the levy would be based on data as at 30 March 2012. (31 March 2012 is a Saturday!)
- However, an employer's insolvency risk would be assessed on the basis of its D&B failure scores over the year to the start of the levy year. An employer's score as at 31 March 2011 could be relevant too, if the PPF decides to bring in a system of "transitional relief".
- Deadlines for levy-reduction measures are likely to be consistent with current practice. For example, any contingent asset arrangements would need to be certified or recertified by 30 March 2012.

Taking action

We would be glad to assist clients in connection with any levy-reduction measures. However, please note that we will take action only where specifically instructed by you.

If you do wish us to assist, please contact us as soon as possible. Some of the necessary processes **may take a significant amount of time to complete**. And the PPF will almost never waive the deadlines or otherwise relax their rules.

Sally Taylor

The latest on s251 (payment of surplus to employers)

As mentioned in our November 2010 edition, the DWP had announced that s251 Pensions Act 2004 would be amended to remove the ambiguities which had been causing concern within the pensions industry and to extend the deadline for trustees to pass a resolution.

The draft amendments to s251 have now been published (in the new Pensions Bill, which is currently working its way through Parliament). The draft amendments are in line with the DWP announcement and include:

- giving trustees until **6 April 2016** to pass a s251 resolution (trustees who have already passed a s251 resolution will, it seems, be given the chance to pass a new one).
- making it clear that s251 only affects scheme rules about payment of surplus to an employer while the scheme is continuing. In other words, s251 will not affect scheme rules about payments of surplus when a scheme is winding up, and will not affect scheme rules which allow the scheme to reimburse an employer for administrative expenses. But trustees who have not done so already will need to pass a s251 resolution before **6 April 2016** if they wish to maintain current rules allowing payment of surplus when the scheme is not winding up.

For some schemes this means that no further action will be required. The implications for your scheme will depend on the particular circumstances. Please get in touch with your usual contact in the Mayer Brown pensions team if you want to discuss the appropriate next steps.

Giles Bywater

An update on Auto-enrolment

In October 2012 the first employers will be required to enrol employees automatically into a "qualifying scheme" unless the employees actively opt out. The overall legislative structure of auto-enrolment is set out in the Pensions Act 2008. The Pensions Bill 2011(introduced into Parliament on 12 January 2011) makes a number of amendments to the automatic enrolment provisions endorsing the recommendations of the Government-commissioned review (published October 2010) of the automatic enrolment requirements.

The key aspects of the Bill include:

- A jobholder will only be eligible for auto-enrolment when he/she earns in excess of £7,475 per year (aligned with the income tax personal allowance for 2011-12);
- An optional waiting period of up to three months for the auto-enrolment process. The employer must provide the jobholder with a prescribed notice; and
- A simplified test for employers to self-certify that their defined contribution schemes meets the relevant quality threshold. An employer will need to satisfy any one of three tests based on a past year's scheme data.

Given that the legislative framework is almost complete, employers should be taking steps to develop a plan to comply with automatic enrolment, if they have not already.

Sally Taylor

Welcome news from the Court in the IMG case

s91 Pensions Act doesn't stand in the way of compromises of genuine legal disputes.

In *International Management Group (UK) Limited v German*, the High Court had concluded that s91 Pensions Act 1995 prevented compromise agreements relating to good faith disputes about pension entitlements. The Court of Appeal has now overturned that decision.

The Court adopted a straightforward reading of the s91 ban on people surrendering pension entitlements or rights. It concluded that s91 didn't cover *possible* entitlements or rights in dispute. As such, s91 does not stop people compromising good faith disputes over pension rights (whether or not the settlement is approved by the Court).

This confirmation that employers (and trustees) can settle disputes with members over benefit rights, and can do so without having to seek the Court's blessing, is welcome news.

Elizabeth Brown

The Regulator publishes new guidance on monitoring employer covenant

The Regulator has softened its stance a little but trustees will have to be careful to take the guidance into account and be prepared to justify any different approach when monitoring and taking action on employer covenant.

The Regulator began consulting on this issue in June 2010. In the August edition of the Trustee Quarterly Review we reported on the draft guidance. The Regulator has now published its final guidance together with a consultation response, which addresses some of the issues raised in the consultation.

The Regulator's key message is that it places a high level of importance on the assessment of employer covenant and expects trustees to have monitoring plans in place so that they are in a strong position to anticipate future events and take timely action if the covenant weakens. Trustees should think about the practical steps that would be taken if the need for employer support crystallised. A variety of mechanisms can be used to strengthen covenant and increase scheme security (this may include, but is not limited to, the use of contingent assets).

A few changes have been made to the detail of the guidance as a result of the consultation responses. In particular, the Regulator has concluded that employer "willingness" is not part of the objective assessment of employer covenant, on the basis that *"recent experience has shown that willingness can evaporate just when it is needed most"*.

The final guidance also emphasises that it does not intend to impose unnecessary costs on schemes; the costs of measuring and monitoring the covenant should be proportionate to the size of the scheme and the employer. It is recognised that there may be instances where carrying out a lesser degree of monitoring than that envisaged by the guidance could be appropriate. This is a matter for the trustees to decide (and their reasons should be recorded), but the Regulator has set out some considerations that might be relevant when deciding to adopt a less exhaustive approach.

The Appendices give further practical guidance to trustees on assessing the employer's financial strength. Where trustees do not have relevant expertise on the trustee board, they should consider appointing a covenant assessor, having regard to Appendix B, which recommends factors that should be taken into account when commissioning a covenant report.

The Regulator's main message in relation to employer covenant remains the same, with an emphasis on forward looking assessments and the establishment of a monitoring framework within which trustees can react to changing economic circumstances. However, there is a greater recognition in the finalised guidance that in certain instances an alternative approach could be adopted. Any departure from the guidance should be carefully considered and trustees should ensure they record their reasons for doing so in writing.

Olivia Mylles

The Regulator takes a tougher stance on inducement exercises

Following rising concern about how transfer incentive exercises have been conducted in the past, the Regulator published its final form guidance on transfer incentives on 9 December 2010. The guidance has changed very little from the draft version that was previously published for consultation purposes.

(a) **Background**

An inducement exercise involves the employer offering some or all of the scheme members an "incentive" to transfer out their benefits (i.e. something on top of their normal transfer payment – normally an enhanced transfer value, or a cash payment) or to forgo certain pension increases (typically in exchange for a larger, but non-increasing, pension).

(b) **The need for revised guidance**

Since issuing initial guidance in January 2007, the Regulator has monitored the development of, and common practices involved with, inducement exercises. The main observation was that employers were taking a "box-ticking" approach and not giving due consideration to the needs of members.

(c) **The Regulator's "principles"**

The guidance sets out the following fives principles:

- information should be clear, fair and not misleading;
- an offer should be open and transparent;
- conflicts of interest should be identified and appropriately managed or removed;
- trustees should be consulted and engaged from the start and their concerns should be addressed before the exercise progresses;
- independent financial advice should be made available to affected members.

The Regulator will investigate any behaviour that is outside the spirit of these principles.

(d) **Points to note**

The Regulator's starting point is that any incentive is probably only in the interests of a minority – it therefore advocates a tougher, more proactive, stance to protect members' benefits that it has done so previously. The key messages are that trustees will be expected to apply a high level of scrutiny in order to protect members' interests; financial advice will be key to determine whether a member will benefit from accepting any offer; and no pressure should be placed on members to decide to accept any offer.

This guidance is also intended to have wider application. The Regulator's view is that it should also apply to other situations where members are asked to make a choice – e.g. where they are invited to agree to scheme modifications or benefit forfeitures – but it is not intended to apply to proposals for closure to future accrual.

Rozet Shah

GMP equalisation – some new developments

There are two new developments relating to the equalisation of the "guaranteed minimum pensions" ("GMPs") which men and women built up in contracted-out pension schemes between 17 May 1990 (the date from which schemes are required to "equalise") and 5 April 1997 (when GMPs stopped accruing).

First, the PPF has published a document explaining how it means to address GMP equalisation when it calculates compensation for members whose schemes have fallen into the PPF. Its chosen method treats the equalised GMP as an underpin to a member's overall benefit (while recognising that the GMP may have to be paid at a different time from the member's other benefits). But it falls short of subdividing male and female pensions into separate GMP and non-GMP components and saying that both components must be provided on whichever of the male and female basis is more generous.

The PPF is not expecting schemes to reflect its approach to GMP equalisation in their next s179 valuations, although that position will be reviewed shortly.

In addition, the Government has announced that it intends to issue, apparently "around Easter", draft legislation which may require occupational pension schemes to equalise GMPs. (The PPF has a statutory duty to equalise GMPs, but the law is not currently clear as to whether contracted-out occupational pension schemes must do so). It remains to be seen

whether the draft legislation will provide in detail for the approach schemes should follow, but if any detail is provided it now seems likely that it would adopt an underpin approach similar to the PPF's.

Joanna Myerson

A ruling expected from Europe which could affect annuity costs

On 1 March, the European Court of Justice (ECJ) is due to issue its decision in the "Test Achats" case. This test case is about whether insurance companies can charge premiums and provide benefits on a basis which assumes women generally live longer than men. It has been brought by a Belgian consumer protection group.

The preliminary stage of the ECJ process is a recommendation by a legal expert, the Advocate General (AG). In this case, the AG's recommendation to the ECJ in summary is that it should decide:

- that sex-specific differences in respect of insurance premiums and benefits should be unlawful in future, but
- that this should not be retrospective; and
- that there should be a transitional period of three years to allow the insurance industry to adjust.

This is an insurance case, not a pensions case. However, if the ECJ decision follows the main recommendations of the AG, it will directly affect any pension schemes which insure death benefits or secure benefits by buying annuities.

It may also raise concerns about whether using sex specific factors for providing lump sums out of pension or calculating transfers remains sensible. There is a specific decision which says this is acceptable, and this is reflected in UK legislation (the Equality Act 2010).

However, Trustees may want to start thinking about how they would change factors, and the administration, if the ECJ decision goes further, faster than anticipated.

Ian Wright

An update on changes to the UK pensions tax regime

In our Quarterly Review last November, we outlined the Government's proposals for the tax treatment of high earners. In broad terms, these proposals will limit individual's tax-relieved pension saving for any year to the new annual allowance of £50,000 from 6 April 2011.

In December 2010, the Government issued draft amendments in the Finance Bill 2011, which contains details of the changes to both the annual allowance and lifetime allowance. In particular:

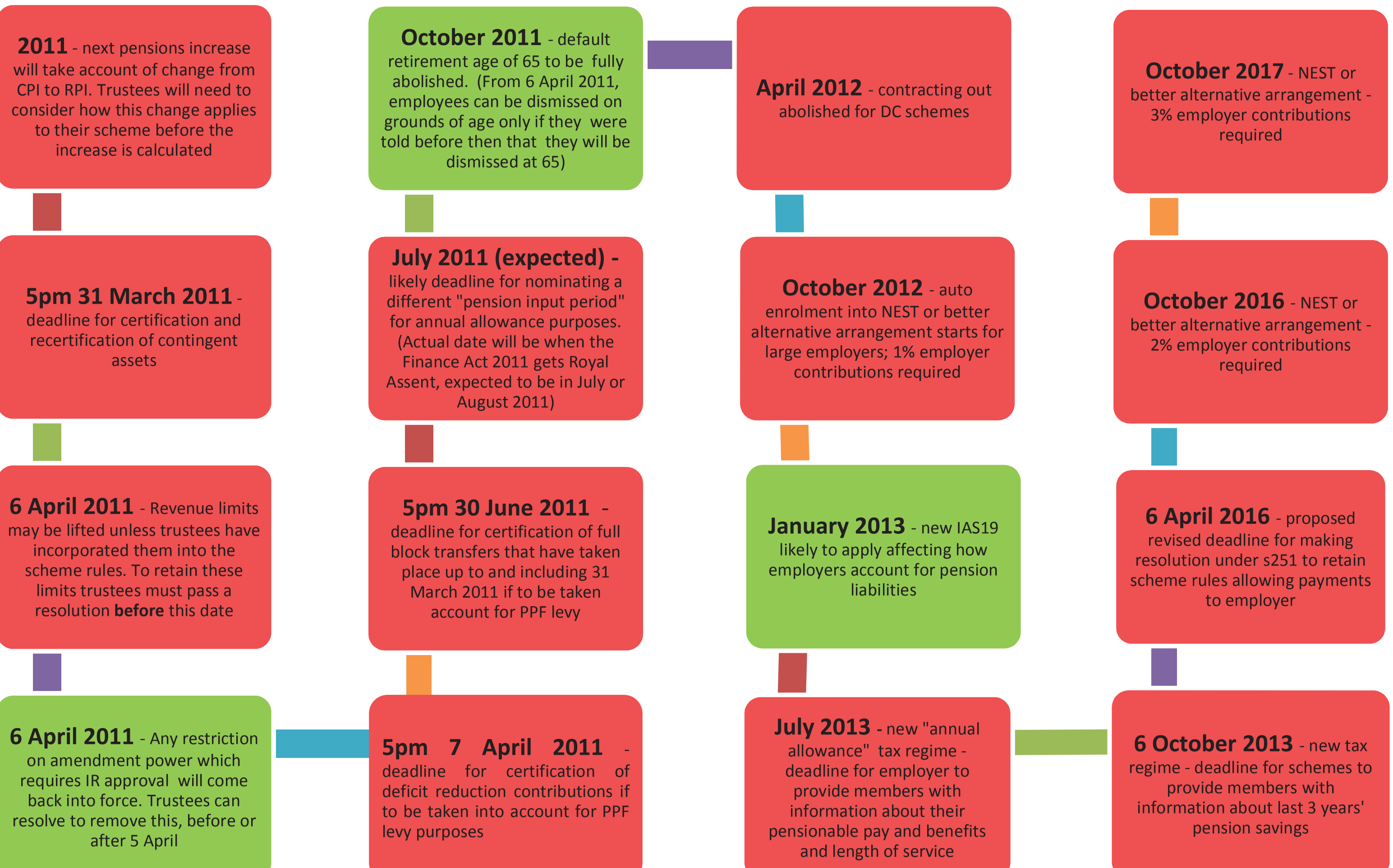
- Further details were given of what conditions need to be met in order for a member to come within the exemption from the annual allowance charge for retirement on grounds of severe ill-health. The test will be that a doctor must have confirmed that the member is suffering from ill-health which makes him or her "unlikely to be able to undertake gainful work (in any capacity) at any time in the future (otherwise than to an insignificant extent)". In practice, this is likely to mean that, in many cases where an ill-health retirement pension allows for additional years of service, that enhancement triggers an annual allowance charge.
- The Government has confirmed that the reduction in the lifetime allowance from £1.8m to £1.5m will apply from 6 April 2012.
- For these members who opted for primary protection or enhanced protection after the 2006 changes to the pensions tax regime, the protection will be based on the greater of the standard lifetime allowance and a new "underpinned" lifetime allowance of £1.8m.
- There will be a new "frozen" lifetime allowance of £1.8m for members who expect their current pension savings to grow to more than £1.5m through investment returns alone when they come into payment and who agree to cease future accrual.
- The limit for trivial commutation lump sums will be set at a monetary amount of, initially, £18,000, rather than 1% of the lifetime allowance. This means there will be no immediate changes to the limit when the lifetime allowance reduces to £1.5m.

One immediate action for pension scheme trustees is to consider whether to nominate a "pension input period" for annual allowance purposes where they have not already done so. If no pension input period has been nominated, then the pension input period will be 7 April to 6 April. Trustees can nominate a different pension input period by notifying the affected members but this must be done before 6 April 2011, when the legislation will change. If they are nominating a different pension input period, trustees will need to state that it takes effect retrospectively, from the 2006-2007 tax year.

Trustees may also find employers approaching them over the next few months with proposals for scheme amendments both to address the position of senior employees who will be affected by the reduced annual and lifetime allowances and also more generally the approach to ill-health retirement.

Beverly Cox

Some dates and deadlines for your diary



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