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Quarterly Review

Trustee Quarterly Pensions Review

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ECJ ruling on sex-specific actuarial factors

The European Court of Justice (ECJ) recently ruled that the use of sex-specific factors by insurers will be prohibited from 21 December 2012. This decision does not prevent UK occupational pension schemes from using sex-specific factors. However, as there is a clear philosophy behind this decision, over time we would expect the law to move towards equality and the use of unisex factors.

UK law allows the use of sex-specific actuarial factors in a number of situations, particularly transfers, commutation and early retirement. The ECJ had previously ruled that pension schemes can use sex-specific factors where the differences reflect differences in the actuarial cost of the benefits. This recent decision does not change the UK law or reverse the ECJ's previous decisions on these points.

However, in reaching this decision the ECJ stressed the need to eliminate inequality between the sexes. We understand that unisex annuity rates are already required in a number of EU states, as well as in the US. The Equal Treatment Directive in the pensions context is to be reviewed by the European Commission by 15 February 2013 and it would seem likely that the issue of unisex rates will be addressed. In addition, the UK Government might before then decide to revisit the current law allowing pension schemes to use sex-specific factors.

Practically, the decision affects the value of annuities members can buy with their money purchase benefits from 21 December 2012 (typically, men will get a smaller pension than before and women a bigger one). Trustees and employers in the process of an enhanced transfer value exercise will need to consider whether to base the exercise on unisex factors and independent financial advisers will need to consider how to build in likely future annuity purchase rates when giving advice.

Where a scheme has bought a bulk annuity, as long as the benefits are unisex there is no need for any action, even if the price paid was based on gender.

In conclusion, no immediate action is required, but trustees may wish to consider what the impact on their scheme would be if in the future sex-specific factors are prohibited.

Helen Parrott

Court restricts trustees' ability to unscramble past decisions

A Court of Appeal ruling will make it harder for trustees to revisit their own decisions, even in cases where the decisions have had unintended consequences.

Previously trustees could overturn decisions where their use of a discretion resulted in different consequences than intended, if they had failed to take into account relevant considerations or took into account irrelevant considerations (known as the *Hastings-Bass* rule). This was a "powerful weapon" which trustees could use to unwind decisions which had unforeseen consequences. However, the Court of Appeal has recently held that the *Hastings-Bass* rule has been too widely interpreted. The Court ruled in the cases of *Pitt v Holt* and *Futter v Futter* that the position is actually as follows:

- if trustees exercise a discretion outside their powers, the decision will be void; and
- if trustees exercise a discretion within their powers, the decision is voidable (not void) if they acted in breach of their fiduciary duties. Such a breach could include failing to take into account relevant considerations or taking into account irrelevant considerations, but will not generally include circumstances where trustees acted on appropriate professional advice.

For more detail on the *Pitt v Holt* and *Futter v Futter* cases, please see our legal update which can be found at http://www.mayerbrown.com/publications/article.asp?id=10595&nid=6.

Beth Brown

Challenging decisions – when does the decision maker go too far?

In a recent case[1], the High Court has reviewed an employer's decision to change its policy on discretionary pension increases by applying a cap which it had not applied in the past. Some pensioners argued that this decision breached the employer's duty of good faith, as they had a legitimate expectation that the employer would go on awarding increases in line with the (uncapped) RPI. The court concluded that the employer had acted within its rights, and provided important guidance on employers' duties of good faith.

For a challenge to be successful, members must be able to show that the employer has made a decision which is irrational or perverse; in other words, the employer must have acted in a way in which no reasonable employer would have acted and its conduct destroys or seriously damages the relationship between the employer and members.

The court said that an employer is entitled to take its own interests into account where the scheme rules give it absolute discretion to determine pension increases and that, in those circumstances, the duty of good faith does not require an employer to arrive at a decision which was "substantively fair". Ultimately, this will severely limit the circumstances in which an employer's decision can be considered irrational or perverse and sets the bar high for successful challenges in future.

The court also looked at a construction point on whether the trustees had the power to grant pensions (without increases) for certain members. Counsel for the affected members contended that the trustees had failed, in breach of their fiduciary duty, to acquaint themselves with the scope of their powers.

The court said that the trustees had not breached their duty. The court went on to explain that it was important for trustees to familiarise themselves generally with their powers but that there was no obligation for them to know the full scope of every power given to them by the rules – the extent of their duty would depend on whether they have acted with reasonable care and skill. Therefore trustees do not need to embark on unnecessary investigations to clarify the scope of their powers where that would not serve any practical purpose.

For more detail on this case, please see our legal update which can be found at http://www.mayerbrown.com/pensions/article.asp?id=10832&nid=11078.

Nina Choudhury

New annual allowance regime – some practical points for trustees

Trustees will be aware that the annual allowance for tax relief on pension savings for individuals reduced from £255,000 to £50,000 from 6 April 2011. The new limit applies to any pension input period (PIP) ending on or after 6 April 2011. There are three practical points which trustees should be aware of associated with this change:

(a) **Ill-health retirement**

The current general exemption from the annual allowance test in the year benefits are drawn has been removed. However, the annual allowance will not apply where a member is awarded an early retirement pension and the trustees have received medical advice that the member is unlikely to be able (otherwise than to an insignificant extent) to undertake gainful work (in any capacity) before reaching normal retirement age. (It will also not apply in the year in which a member dies or is diagnosed with terminal ill-health.)

Where trustees cannot obtain that medical advice, any enhancement by way of additional pensionable service would be taken into account under the annual allowance test and the member may be taxed on it. Trustees should consider asking their medical advisers to cover this point as a matter of course in future.

(b) **"Scheme pays"**

An individual will be able to require trustees to pay the annual allowance charge if the annual allowance charge exceeds £2,000 and the total benefits built up under the scheme exceed £50,000. Members cannot be charged for the administrative costs incurred.

Members who want to have the scheme pay the charge must opt to do so by 31 July in the year after the end of the tax year (except that for 2011-12 tax bills, members will be able to make such elections until 31 December

1 Prudential Staff Pensions Limited v The Prudential Assurance Company Limited & Ors

2013). If members wish to make an election in the year that they retire, they need to do so before they start taking their benefits.

The draft legislation doesn't set out any particular approach to be taken to adjusting members benefits if trustees have to pay the charge. It just says that any adjustments must be "*just and reasonable having regard to normal actuarial practice*". Trustees will need to consider, with actuarial advice, whether only the member's own pension will be adjusted and also how benefits will be adjusted. Rule amendments are not required. Although they won't be paying any tax until 2013, members will probably want to understand the approach to be taken well before then.

(c) **Pension input periods**

The rules about PIPs - the period over which a member's pension saving under a particular pension arrangement is measured for annual allowance purposes - are changing.

The Finance Bill:

- Provides for a default PIP end date (for new schemes or new members) of 5 April (so aligning it with the tax year); and
- Allows schemes (or members if a defined contribution arrangement) to nominate a different PIP end date but only for future tax years (not retrospectively).

For pension arrangements which are already in existence, if a PIP end date has already been nominated, then that will not change. If a PIP end date has not been nominated then the original default rules will still apply although a new PIP end date may be nominated for future tax years.

The original rules about PIPs, in the Finance Act 2004, provided for a default PIP end date which was the anniversary of either:

- For defined benefit arrangements, the date the member's benefits first started to accrue after 5 April 2006 (which for schemes in existence on that date effectively means 6 April 2006, with a PIP end date of 6 April 2007 and each 7 April afterwards); or
- For defined contribution arrangements, the first date contributions are made after 5 April 2006.

A different PIP end date could be nominated by the scheme (if a defined benefit arrangement) or by either the scheme or member (if a defined contribution arrangement), but only if it ended earlier in the same tax year as the PIP would have ended anyway. For a scheme with a default 6 April PIP, it therefore appeared impossible to change.

However, a PIP end date could be nominated retrospectively so that schemes could align members' PIPs with, for example, their scheme year or the tax year. Many schemes have nominated a PIP end date for all the tax years going back to 2006-7. Under the Finance Bill, schemes will lose the ability to nominate a PIP retrospectively, but HMRC has said that it is happy for retrospective nominations to be made until the Finance Bill becomes law (expected to be July 2011).

Ian Wright

A (temporary) sigh of relief on derivatives regulation

Proposed new European rules may make it harder and more expensive for pension schemes to invest in derivatives which they want to use to reduce risk – but there may be some relief.

De-risking and liability-driven investing represent the main trend in pension fund investment in recent years. In liability-driven investing, pension funds use swaps to hedge interest rate and inflation risk and increasingly longevity risk. (Swaps are derivatives arranged directly with investment banks by managers. Because of this, they are known as "over-the-counter" (OTC).)

The global financial crisis and the collapse of Lehmans highlighted problems in how the OTC market manages the risk of counterparty default – that is the other party to the swap contract not being able to keep its side of the contract. This was compounded because the market lacked transparency so regulators and the investment banks did not have enough information on the exposures of particular investment banks and the investment banks became wary of dealing with each other.

This led to the European Commission's European Market Infrastructure Regulation (EMIR) proposal, which was originally published in September 2010.

EMIR is expected to come into force by the end of 2012 (although this may suffer slippage). It will require standardised OTC derivatives entered into between "financial counterparties" to be centrally cleared. In practice, a central counterparty would act as buyer to every seller and seller to every buyer. The problem for pension schemes is that they would be included within the definition of "financial counterparties" - alongside investment banks, hedge funds and other financial institutions. Other participants – for example, companies hedging a particular commercial risk – are "non-financial counterparties". These are end-users of derivatives.

The intention of EMIR is to reduce risks and protect end-users. Pension funds are end-users and use derivatives to reduce risk – as they are required to under the IORPS Directive and the Investment Regulations. So it might seem more logical to treat them as "non-financial counterparties".

For centrally cleared OTC derivatives, financial counterparties will need to transfer cash or bonds to the central counterparty when they enter into a swap (called "posting initial margin") and make cash payments (known as "posting collateral") on an ongoing basis, depending on price movements. Currently pension funds rarely need to post initial margin and make ongoing collateral payments in gilts or cash. Pension funds would need to source cash, which would increase costs. Bespoke swaps (including those beyond ten years) will not be centrally cleared but risk management techniques including making collateral payments will be required.

A compromise proposal on EMIR was published the EU Council of Ministers at the end of April and it is expected that the final text will be published in July. For pension funds the good news is a three-year exemption from central clearing requirements for derivatives "objectively measureable as reducing risks directly related to the financial solvency of pension schemes", pending a review. It will be important for the industry to use the review to press the case for continuing exemption – with pension funds being reclassified as non-financial institutions so that this temporary sigh of relief becomes a permanent one.

Philip Stark

Proposed abolition of DB contracting-out

As part of the simplification of the state pension system, the State Second Pension may be abolished. The Budget Report delivered on 23 March 2011 includes a proposal to abolish contracting-out for defined benefit (DB) schemes.

The Government's intention is to reform the state pension for future pensioners so that it provides a simple, contributory, flat-rate support above the level of the means-tested Guarantee Credit. It intends to do this by removing the contracted-out rebate for occupational pension schemes, thereby creating a single-tier state pension system.

This will clearly have huge implications for DB schemes (not least because National Insurance Contributions paid by members of DB schemes and their employers would increase under the proposals) and the Government has advised that it will investigate the potential impact on employees and schemes in the public and private sector. The Government has also said that it would honour contributions made under the current system.

Rozet Shah

Pensions trustee training foundation course – forthcoming dates

Becoming a trustee can be an exciting yet daunting experience, especially because the Pensions Regulator expects newly appointed trustees to get up to speed with the law relating to pensions and the regulatory framework in just 6 months!

Our foundation course aims to take trustees through the pensions landscape and the key legal principles relating to defined benefit funding and investment matters in a practical and interactive way. Forthcoming dates are:

Friday 24 June 2011

Thursday 15 September 2011

Thursday 1 December 2011

If you or any of your colleagues would like to join us at our London offices for one of these events, please do get in touch with your usual Mayer Brown contact.

Dates and deadlines for your diary

Date	Event
2011	Next pensions increase will take account of change from CPI to RPI. Trustees will need to consider how this change applies to their scheme before the increase is calculated
5pm 30 June 2011	Deadline for certification of full block transfers that have taken place up to and including 31 March 2011 if to be taken into account for PPF levy
1 October 2011	Default retirement age abolished
April 2012	Contracting-out abolished for DC schemes
October 2012	Auto enrolment into NEST or better alternative arrangement starts for large employers - 1% employer contributions required
21 December 2012	Gender based insurance premiums become unlawful for individual contracts
December 2012	TPR's target for data cleanse
January 2013	New IAS19 likely to apply affecting how employers account for pension liabilities
July 2013	New tax regime - deadline for employers to provide members with information about their pensionable pay and benefits and length of service
6 October 2013	New tax regime - deadline for schemes to provide members with information about last 3 years' pension savings
31 December 2013	First deadline for member requests for "scheme pays"
6 April 2016	Proposed revised deadline for making resolution under s251 to retain scheme rules allowing surplus payments to employer
October 2016	NEST or better alternative arrangement - 2% employer contributions required
October 2017	NEST or better alternative arrangement - 3% employer contributions required

Key:

Important dates to note

For information

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